# HUNT VALLEY WEALTH

## PORTFOLIO ACTIVITY – Q2 2022

*By Louis Foxwell, CFA and Matt Holman, CFA, Senior Equity Research Analysts*



## New Positions

We initiated a new position in **PayPal, Inc. (PYPL)** in the second quarter. PayPal is a financial technology provider with a market-leading two-sided network, which provides a compelling value proposition for each party.

*For consumers*, PayPal is best known for its industry-leading digital wallet, peer-to-peer money transfer platforms (like Venmo), eCommerce checkout button, and consumer credit options. PayPal adds value to the digital experience by consolidating digital payment options, offering wide-reaching acceptability, and enhancing security for online transactions.

*For merchants*, PayPal helps businesses of all sizes accept digital payments online and in-store. The company also helps merchants send business payments/disbursements, among other value-added services. Most merchant customers benefit from larger cart sizes, higher conversion rates at checkout, increased purchase frequency, and thus greater overall sales.

PayPal generates most of its revenue from fees on the transactions it facilitates through its checkout and processing solutions. Consumers can choose to fund their transactions with a myriad of sources such as credit/debit cards or linked bank accounts.

What do we like about the business? The digital payment industry has strong secular tailwinds and a long runway. Trends like the migration from cash to digital, growth of eCommerce, and increased access to banking and the internet are channeling payment volumes into a demand funnel that organically flows to companies like PayPal without them needing to invest heavily to capture it.

We tend to prefer businesses with optionality, i.e., multiple potential paths to grow and generate future cash flow. PayPal offers this opportunity with the further development of its digital wallet and super app. By giving consumers more ways to use the platform, management believes it can improve user engagement. This could result in higher balances, stickier customer relationships, and a more profitable funding mix for PayPal.

PayPal also has some untapped drivers to help sustain its growth trajectory. Venmo is one of the most popular P2P platforms, and management has just begun monetizing it. PayPal also recently separated from its former parent company eBay, which frees the company to work with other marketplaces. Finally, PayPal is expanding into the physical retail space with connected checkout solutions utilizing QR codes and other technologies. We believe the opportunity from these ventures presents an attractive growth runway.

We have admired PayPal's business for years, but the valuation never looked attractive enough for us. Then, PayPal's shares were among the hardest hit when the market turned last fall, with shares now trading below their pre-pandemic prices. This prompted us to ask the question: "Is this business fundamentally stronger today than it was 2-3 years ago, before the pandemic?"

We believe it is, which implies a potential value dislocation based on today's prices. This dislocation comes from the market especially punishing two types of companies lately:

1. *Pandemic beneficiary companies* – These companies “over-earned” during the pandemic when growth and demand cycles were pulled forward.
2. *High-growth companies* – Many of these businesses benefited from an extended period of cheap and easy capital funding their growth. Many generate little to no cash profits today and some have a poor outlook for future profitability.

PayPal is being grouped into both categories, and its shares have been punished accordingly. We believe this categorization is unjust and ignores two key points. First, PayPal's business and the digital payment industry are more mature than the more nascent growth companies with which it is being grouped. The migration to digital commerce trend was well underway before the pandemic. It would have persisted on a similar, albeit slightly slower trajectory, without the demand boost that stay-at-home mandates provided. Second, PayPal is highly profitable and has been generating cash flow since well before the pandemic. It maintains a stellar balance sheet and does not need access to easy capital to grow like many of the startups trying to disrupt the space.

Now that access to capital is tightening, the environment for smaller upstart competitors has become much tougher. Growth is more expensive with rising interest rates unless a business can finance growth with internally generated cash flows. Thus, this economic environment actually creates a competitive advantage for established industry leaders like PayPal – a thesis that seemingly runs contrary to the narrative we often read in the more short-term focused financial media. Many of these competitors will need to shift from hyper-growth to survival mode. Generally, when this shift happens, these smaller peers not only curb their growth trajectory and cede market share, but also make for attractive acquisition targets for the stronger incumbents in the industry.

Therefore, we were happy to initiate a starter position in the company at these prices and will look to build the position opportunistically going forward. *(Matt Holman, CFA)*

TRANSDIGM GROUP INC.

We also initiated a new position in **TransDigm Group, Inc. (TDG).** TransDigm designs, manufacturers, and sells proprietary aircraft parts. Nearly every commercial and military aircraft in service today utilizes its products. Its business model is straightforward – it sells the aircraft components (seatbelts, pumps, motors, cockpit displays, parachutes, actuators and controls, etc.) to airframers (e.g., Boeing) for a low margin and then takes a significant portion of the economics in the lucrative aftermarket.

A single aircraft can have as many as six million parts, and the regulatory hurdles and costs to qualify each of these parts are high. Once a part is qualified on a new aircraft by the FAA and the original equipment manufacturers, that part is usually the only one of its kind for the life of that aircraft. This makes TransDigm a sole-source supplier, giving it tremendous pricing power when a replacement part is needed. Most aircraft models are in production for 20-30 years, and the life of an aircraft is usually 25-30 years; therefore, TransDigm generates decades of aftermarket revenue which is recurring and high margin. Best of all, there are very few competing products outside of third-party PMA replacement parts. Since TransDigm sells small components and subsystems, it generally flies under the radar of its customers (i.e., it can raise prices without pushback). Its products cost very little relative to the aircraft but are vital to their various systems.

In addition to the attractive economic characteristics of the business, we like TransDigm's operating strategy and structure. It has a decentralized structure which creates an ownership mentality across the entire chain of command. It also regularly acquires other suppliers that sell proprietary sole-source parts with significant aftermarket content, creating a consistent and attractive destination for capital deployment. Management's compensation is highly aligned with the interests of shareholders, leading us to believe that they will continue to make intelligent capital allocation decisions.

TransDigm's performance is largely linked to revenue passenger miles, hours flown, the installed base of aircraft, aircraft out of warranty, and the age of fleets. The pandemic created major headwinds that negatively affected these KPIs and the company's revenue generation, especially in the higher-margin aftermarket business. However, we are seeing a reversal of these trends as consumers travel more and aircraft need more servicing. We ultimately view TransDigm as one of the more attractive beneficiaries of the travel recovery, and we have initiated a position in the stock as a result. *(Louis Foxwell, CFA)*

## Buys

AUTODESK

**Autodesk (ADSK)** Autodesk sells mission-critical software for design, animation, manufacturing, architecture, engineering, and construction. Its products include AutoCAD, Fusion 360, Revit, Inventor, and Maya.

We view Autodesk as a uniquely high-quality software business, yet we observe that it trades similarly to other software companies, regardless of end market, margin profile, revenue quality, financial standing, or product switching costs. We believe passive fund flows are largely responsible, creating indiscriminate selling in the stock. Unlike many of its software counterparts, Autodesk has a four-decade history of strategically expanding into numerous niche applications through accretive acquisitions and R&D. As we discussed in our *Q1 2022 Portfolio Activity*, its products are table stakes for industry employment, making revenues sticky. They also cost relatively little compared to the total expense of the projects they are used for, forming an excellent customer value proposition. We think the company will have customer acquisition advantages in the future due to its distribution scale and the network effects inherent in the professional adoption of its products. We also believe that there is still a long runway for growth despite it being a relatively mature software business.

Supply chain disruptions and tight labor markets have impacted Autodesk's end markets, but we believe these are short-term issues. Autodesk is currently changing its billing model from multi-year collections to annual collections, which has created additional concerns for investors around short-term cash flow. However, we think this transition will improve the customer value proposition in the long term. We seldom find fast-growing software companies that meet our stringent business quality standards, but Autodesk fits the bill. Therefore, we are more than pleased when we can purchase shares below our estimate of intrinsic value, as we did during the second quarter. *(Louis Foxwell, CFA)*

**CoStar (CSGP)** provides information services to the commercial real estate (CRE) industry. Throughout its history, it has expanded its reach across the CRE value chain, offering listing services and marketplaces in addition to its legacy data and analytics products. The company is now deeply embedded in industry workflows and decision-making processes, and most transactions in the U.S. CRE market involve a CoStar customer.

CoStar recently entered a new growth phase with an aggressive push into the residential real estate market. The company aims to create an agent-friendly platform that will enable collaboration with home buyers and give agents more control of their listings. For a more thorough explanation of CoStar's strategy and investments in the residential platform, we recommend reviewing our *Q1 2022 Portfolio Activity*. As we discussed in that piece, the venture has remarkable potential, but the prospective investments required to reach that potential will lower near-term profitability. For many investors, this is enough of a deterrence to stay on the sidelines – especially in the face of rising rates.

In our whitepaper, *How Interest Rates Impact Stocks*, we explained that higher-duration growth stocks are more sensitive to interest rate changes. As a refresher, duration can be conceptualized as the time it takes to receive cash flows as an investor. As a company reinvests cash into growth ventures, distributions to shareholders are deferred to a later date. When interest rates rise, the opportunity cost of deferring rises as well. Therefore, the required rate of return on the internal reinvestments increases, and the price that investors are willing to pay *in the short-term* decreases.

CoStar was already reinvesting a sizeable portion of its cash flow in its CRE business to generate growth, but this business was maturing, and some investors speculated that dividends and share repurchases were on the horizon. With the announcement that residential investments are just ramping up, that distribution of capital to shareholders will likely not happen for many years. In other words, CoStar is *increasing the duration of its cash flows* at a time when the market is punishing high-duration assets.

We can look at recent share turnover of CSGP and surmise that its shareholders have an average holding period of less than one year. If so many investors in the stock think in terms of *months*, then there will naturally be widespread trepidation when management announces a venture which will require *years* of shareholder patience. We think this has placed immense pressure on the share price as the appetite for immediate income has increased.

A cornerstone of our investment philosophy is to think like long-term owners of the business. As owners, we should focus less on short-term issues like what others will pay for the stock and more on long-term value drivers like the return on capital the residential investments will generate. We should analyze factors like management's track record, the potential economics of the residential platform, and how the new business will interact with the legacy CRE assets. This was precisely our approach, and our analysis led us to the conclusion that shares were attractively priced during the quarter for long-term owners of the stock. *(Louis Foxwell, CFA)*

We continued building our position in **Etsy (ETSY)** this quarter as its share price came down further below our fair value estimate. As we mentioned with PayPal, the market does not have an appetite for growth stocks right now and is punishing pandemic beneficiary stocks. Etsy reaped the benefits of stay-at-home mandates and demand being pulled forward, but was the subsequent selloff over the last few quarters warranted? It is important to focus on the underlying business here, not share price movements. Again, the key question is whether the business is fundamentally stronger today than 2-3 years ago, before COVID.

The pandemic materially aided customer acquisition at a low cost, where many people were newly introduced to Etsy's marketplace. The userbase saw tremendous growth, which led to greater seller volume and higher fee revenue. Currently, shares are pricing in the expectation that the company will give back much of this pulled-forward growth. In reality, the company has sustained nearly all its growth thus far. We believe the company's reach, consumer mindshare, and value proposition are much more powerful today than pre-COVID.

We should also touch on some negative attention Etsy has drawn in the past few months after raising its listing fee rate in April. We believe the situation is misunderstood, and the media and share price reactions have been misguided.

Etsy's value proposition to its sellers is offering a streamlined, comprehensive commerce solution for small business owners; and, to its buyers, the aggregation of unique and customized items in a single, consolidated marketplace. This two-sided marketplace model has inherent flywheel effects, whereby more sellers attract more buyers and vice versa. This aggregated buyer demand (or traffic) is not free and is implicit in Etsy's listing fees. Thus, arguments against Etsy earning a higher take rate should be judged against the economics of a seller running their business independently.

Is Etsy worth the fees it charges? The traffic Etsy generates for its sellers is unmatched in its niche. Further, few sellers have the aptitude and experience to take on their own advertising, payment processing, and distribution, especially without the benefit of Etsy's scale. These sellers can set up an independent shop and perhaps achieve higher margins, but that would be a big undertaking for most. This is where Etsy adds value by enabling anyone to monetize their creativity, regardless of their business aptitude, at whatever scale they choose. So yes, we believe Etsy's take rate is more than fair. In fact, Etsy's share of the sale is arguably still too low when you consider how much value they add, and the higher take rates garnered by alternative platforms like eBay and Amazon.

We should also note that those lobbying for a lower take rate represent a small minority of sellers (less than 1%). Most recognize Etsy's value and laud them for it. These anecdotal cases even acknowledge that they struggle to replicate what Etsy offers when they leave the platform – ultimately leading to them returning. We believe this is a testament to Etsy's value proposition and the durability of its economic moat.

Etsy also differs from other high-growth companies being sold heavily in the market in that it generates significant cash flow, which it reinvests internally. Specifically, management said they intend to reinvest these incremental fees to improve the customer experience and generate more buyer traffic (demand), which will trickle down to benefit the sellers. We see this as a prudent capital allocation decision. It should leverage the advantageous position the pandemic provided for further growth and extend its runway to generate future cash flow.

In summary, we believe the company is fundamentally stronger today than before the pandemic. This is a prime example of the value dislocation we often discuss when the market becomes too shortsighted. As such, we believe this is where much of the opportunity in the market currently lies. *(Matt Holman, CFA)*

**Take-Two Interactive Software (TTWO)** creates and publishes interactive entertainment through Rockstar Games, 2K, Zynga, and Private Division. It has a broad portfolio of owned IP that includes *Grand Theft Auto (GTA)*, *NBA 2K*, *Red Dead*, *Civilization*, *BioShock, Words with Friends, Empires & Puzzles, and CSR Racing.*

The company completed its acquisition of Zynga during the quarter. We think Zynga is a highly strategic asset that will enable Take-Two to scale its IP, technology, and premium development resources across every distribution channel. The balance sheet remains strong post-acquisition, leaving room for opportunistic bolt-ons and share repurchases as it scales.

As we have discussed in the past, we believe the economics of the interactive entertainment business will continue to improve as microtransactions, virtual currency, and novel monetization methods like subscriptions make up a larger portion of revenue. We also believe the economics will accrue to a few large players, including Take-Two, due to the social network characteristics of online multiplayer games. Take-Two's unmatched open-world development capabilities, in our view, provide additional optionality on untapped monetization opportunities within highly engaging virtual environments.

We believe the market is taking a wait-and-see approach with Take-Two, as the company has spent the last few years monetizing legacy titles and pouring a tremendous amount of capital into talent accumulation, technological development, and content creation. With Zynga under its umbrella, it can begin reaping the benefits of these large investments at scale, which we project will be accompanied by substantial operating leverage.

Industry-wide customer engagement has pulled back from pandemic highs (albeit at a higher level than pre-pandemic engagement). We think this has caused a general re-rating of industry valuations, along with investors waiting for the dust to settle from industry-wide consolidation. In our view, Take-Two should not be analyzed or valued based solely on industry trends – it is an idiosyncratic business when it comes to development cycles, developer incentives, quality of intellectual property, and untapped operating leverage. We view the current period as an inflection point for the company as it enters its next growth phase, and we will continue to purchase shares when we believe the market is undervaluing them. *(Louis Foxwell, CFA)*

## Sells

The positions below were reduced or eliminated in most accounts. In some cases, positions were kept in selected client accounts for tax purposes.

This quarter, we exited **Visa (V)** positions in non-taxable client portfolios. Visa is a long-standing core holding in many client portfolios and thus has significant capital gains that we must consider. Therefore, to remain mindful of capital gains taxes, we chose to only exit positions in non-taxable accounts. We should reiterate that our thesis on the business has not changed. We remain confident in the long-term investment case and would consider repurchasing in non-taxable portfolios if the valuation warrants it.

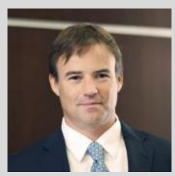
That said, our strategy for selling Visa was three-fold:

1. We believe Visa's shares are likely fairly valued here on an absolute basis.
2. Our research leads us to believe that other companies in our core equity model could be undervalued after sharp selloffs, making Visa appear overvalued on a relative basis.
3. To fund our new purchase in **PayPal (PYPL)**.

To expand on the third point, we like the economics and competitive dynamics of the payment industry and would be happy owning Visa, Mastercard, and PayPal.

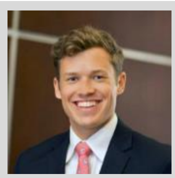
Selling Visa to fund a PayPal purchase allows us to do two things. First, it diversifies the portfolio's exposure within the payment industry. Visa and Mastercard are very similar networks and tend to trade in tandem on exogenous drivers and events. We prefer Mastercard to Visa long-term due to its greater exposure to international markets and investments in more nascent payment systems and technologies – thus, a longer growth runway, in our opinion. PayPal allows us to tap into a different part of the value chain while still participating in the secular growth trends the industry enjoys. Second, it frees up capital to reallocate to ideas we think may have more upside potential here, including PayPal. *(Matt Holman, CFA)*

### Investment Team



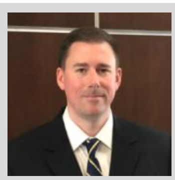
**John Heinlein**

*Senior Portfolio Manager and Managing Director*



**Louis Foxwell, CFA**

*Senior Research Analyst and Assistant Portfolio Manager*



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