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Sell a great stock

Evan Lorenz writes:

Two Fridays ago, the National Association of Realtors agreed to abandon the conventions that make America the most expensive country in which to buy or sell a house. Following the news, shares of Zillow Group, Inc. fell by 13% while those of CoStar Group, Inc. (CSGP on the Nasdaq) rallied by 8.3%. On CoStar, the market's pet and one of the great growth stories of recent years, *Grant's* is bearish. Widows, orphans and short sellers, beware, however: In part, this is a valuation story.

By long custom, Americans pay 5% and up of a home's price in agent's commissions. Ostensibly, the seller bears the cost, though the seller's agent, also by custom, remits half of the commission to the buyer's agent. From another vantage point, one could say that the buyer's mortgage finances it all.

Anyway, it's no secret that 5%-plus is double the typical rate charged elsewhere in the world. Consumers complain, not least the Wall Street sales people whose commission schedules have been on a 50-year slide to the vanishing point. That such a chunky fee structure has survived digital price discovery is another marvel, and it's one that speaks to the political power of the National Association of Realtors.

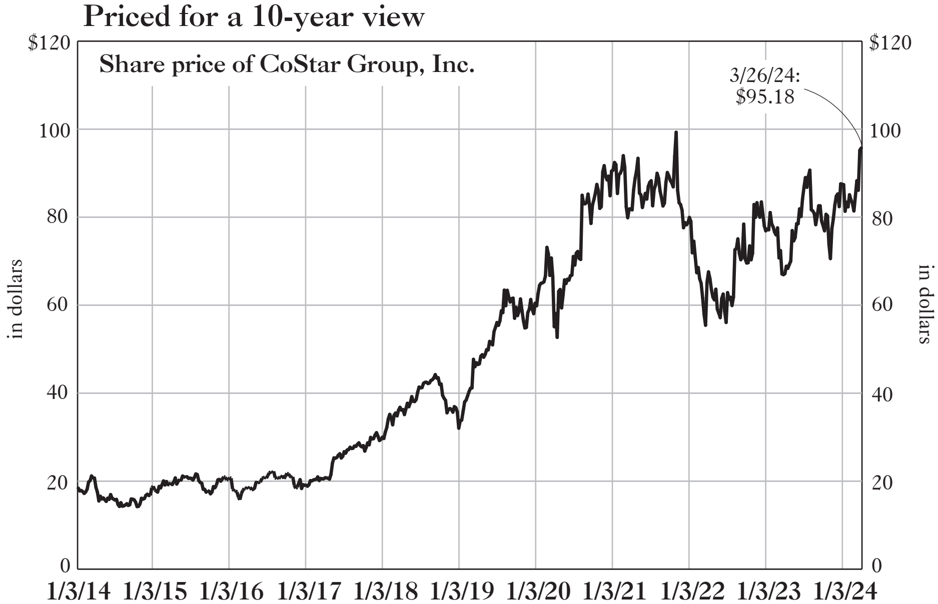
Last October, a jury found the NAR and a pair of residential-brokerage firms guilty of conspiring to inflate commission rates. The court socked the defendants with a $1.8 billion fine, and copycat plaintiffs piled on. To settle, the Realtors proposed a set of reforms, which, if approved by the Department of Justice, would take effect in mid-July. For instance: The house buyer must agree to the agent's stipulated brokerage fee before touring a house with the agent. For the consenting buyer, that could mean an invoice for $9,600 (that is, 2.5% of the national median home price of $384,500), an unwelcome, perhaps unmanageable, cash demand at the very time when a family is earmarking every spare dime for a down payment, closing costs and moving expenses. Among the looming unknowns: Might this new demand for cash knock down house prices? Might it thin the NAR's ranks?

"We've estimated," Ryan Tomasello, who rates CoStar a buy for Keefe, Bruyette & Woods, Inc., tells me, "that the $100 billion in commission dollars that buyers and sellers pay on an annual basis—that's in a normalized market, it's lower than that currently—could come down by upwards of 30%." More than 1.5 million realtors are part of the NAR; based on the size of the U.S. housing market, "we should only have around 500,000 full-time productive agents," he adds.

Naturally, the business model of monetizing leads for buyer's agents—meat and potatoes for the likes of Zillow—is on the chopping block. How much will the pool of marketing dollars shrink? What will become of the agents? Nine out of 10 American buyers retain an agent, but two-thirds of non-American buyers do without.

"I think a winner in this are the homebuilders," Rick Palacios, Jr., director of

Priced for a 10-year view



source: The Bloomberg

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research at John Burns Research & Consulting, tells me. Toll Brothers, Inc., for example, said on its Dec. 6, 2023 earnings call that two-thirds of its sales involve a third-party realtor to whom the company pays a fee equal to 2.25% of the delivered price of the home. Any cut in fees, which amounts to 1.5% of Toll Brothers' revenue, would flow directly to the homebuilder's bottom line.

Another possible winner is CoStar, which entered the residential-listing business through its 2021 acquisition of Homes.com. CoStar is approaching the market via the seller's agent: For an annual subscription, Homes.com will give premium billing to a realtor's listings in its search results and pass along contact information for potential buyers. "Your listing, your lead," the company promises.

To capitalize on the disruption surrounding the antitrust case, CoStar is teeing up a $1 billion advertising campaign. It's planning commercials for the Super Bowl, the Emmy Awards, the Oscars, etc. and just about every television network in America.

Early returns are hopeful: "The Homes.com Residential Network reached more than 149 million unique visitors in February, cementing Homes.com's position as the second-most trafficked homebuying portal," CoStar crowed in a March 14 press release.

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Founded by CEO Andrew Florance in 1987, long before the heyday of the internet, CoStar was a pioneer in digitizing and aggregating commercial real estate property data. Today it gathers proprietary information on buildings with a team of 1,600 researchers, 400 in-market canvassers, 70 analysts and economists, a fleet of 1,000-plus drones (the inanimate kind) and a Cessna to capture "aerial insights."

CoStar is the Bloomberg of the nonresidential sector. On Reddit's forum on commercial real estate last month, a newly minted CRE broker asked, "Do I need it?" To which another user replied: "It's table stakes. If you don't have it, I am not going to take you seriously. First thing I do is look people up to see what deals they have, what listing they have, who they have worked with."

In addition to showing deals and listings, the CRE platform provides property, leasing, sales, market analysis, tenant information, etc. on a subscription basis. Thanks to years of successful diversification, the legacy CoStar business accounted for just 38% of last year's $2.46 billion in revenues. Operations also include Apartments.com and other multifamily services (37% of sales); Loopnet, a listing service for commercial properties (11%); information services, which provides lease and debt analysis platforms for banks and property owners (7%); residential, the house-listing platform (2%); and other marketplaces (5%).

The bull case for CoStar is that management can repeat its multifamily success in the residential-listings market. The acquisition of Apartments.com in 2014 for $585 million was followed by subsequent purchases of such portals as ApartmentFinder.com, ForRent.com and WestsideRentals.com. Between 2015 and 2023, apartment revenues surged to $914.2 million from $160.6 million, and CoStar today is the largest apartment-listing service in the country.

Revenue growth in the core CoStar business unit, which registered at 9% in the fourth quarter, is projected to slow to 7% or 8% in 2024 (excluding a one-time reclassification of certain revenues that will tend to understate the coming deceleration). Presented with such facts, the bulls just shrug. They contend that the company still has years of high growth ahead of it. For instance, because non-U.S.-sourced revenue contributes only 3.6% of the whole, they point to opportunities for expansion abroad. And, they note, the non-broker community, i.e., property owners, lenders and tenants, presents a rich source of possible new subscription revenue.

At year end, the CoStar balance sheet showed $990.5 million in debt against $5.2 billion in cash. Fundraising in 2020 and 2022 ($1 billion in debt issuance, $2.4 billion in equity issuance), rather than retained earnings, explains the bulging corporate bank account.

But there's no gainsaying CoStar's long-term growth. Organic expansion and acquisitions have produced no fewer than 51 consecutive quarters of double-digit revenue growth, though the price tag for this glittering record is just as high as you might imagine it to be. The stock trades at 100.5 times trailing earnings and 159.7 times the 2024 estimate, valuations admittedly puffed up by the aforementioned billion-dollar ad budget. The guesstimate for the 2026 price-earnings multiple is 45 times. As mentioned at the start, such fancy figures may contribute to a bearish narrative, but they rarely, in themselves, clinch the short seller's case.

The Street is bullish on the stock (of the 16 analysts on the case, just one says sell), and the bears give CoStar a wide berth, the well-advertised troubles in commercial real estate notwithstanding; short interest amounts to just 1.4% of the float. Insiders regularly sell, dumping 567,824 shares over the past 12 months for proceeds of $45.7 million.

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On the strength of sterling past performance, CoStar tends to enjoy the benefit of the doubt when bad news strikes. For instance, after the close of trading on Feb. 20, management reported a

CoStar Group, Inc. at a glance
all figures in $ mns except per share data

	2023	2022	2021	2020	2019
sales	$2,455.0	$2,182.4	$1,944.1	$1,659.0	$1,399.7
operating profit	282.3	451.0	432.3	289.2	363.5
net interest income	213.6	32.1	-31.6	-17.4	16.7
pretax income	501.3	486.5	404.0	271.0	390.9
net income	374.7	369.5	292.6	227.1	315.0
earnings per share	0.92	0.93	0.74	0.59	0.86
shares outstanding	406.9	397.8	394.2	383.3	366.3
cash	5,215.9	4,968.0	3,827.1	3,755.9	1,070.7
debt	990.5	989.2	987.9	986.7	0
total assets	8,919.7	8,402.5	7,256.9	6,915.4	3,854.0

source: company reports

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slight beat on fourth-quarter numbers but issued disappointing guidance: 2024 revenue growth of 12%–13% versus expectations of 14%; adjusted Ebitda margins of 6%–7% versus a prior consensus guess of 20%. To top it off, CFO Scott Wheeler, age 60, was resigning. But it was the planned investment in Homes.com that explained the negative guidance on profit margins, and the share price zoomed higher by 3.4% the next day.

No doubt, Homes.com is growing, but CoStar's reporting exaggerates its success. Thus, while the Homes.com residential network is the "second-most trafficked homebuying portal," footnotes to the press release acknowledge that the traffic encompasses apartment hunters, too. Taken alone, excluding Apartments.com, Homes.com garnered 27.4 million unique visitors in February, making it the fourth most-visited single-family residential site. Redfin.com placed third, with 32 million, according to data-aggregation company SimilarWeb Ltd.

For another thing, consumers, so far, are only kicking Homes.com's tires. Visitors frequented the site just 1.6 times on average last month versus 3.0 times for Redfin and 3.4 for Zillow. As for the number of visitors in February, Zillow tallied no fewer than 88.8 million.

Downloads tell a similar story. In the lifestyle section of Apple, Inc.'s App Store, Homes.com ranks No. 110 while Redfin is No. 25 and Zillow, No. 4. It's good to be the entrenched market leader, as CoStar discovered in a past tussle with Zillow. In 2020, CoStar bought Homesnap, Inc. for $250 million, a deal that included the New York City–focused Citysnap. CoStar had big plans to dethrone Zillow's StreetEasy, the dominant rental- and residential-listing portal in the five boroughs, but four years later StreetEasy continues to dominate the Big Apple. Further to the point, according to Google, the single word "Zillow" is searched more frequently in the United States than the generic phrase "real estate."

It remains to be seen just how much the anti-trust kerfuffle will change house-buying habits. "Think about the complexity of the disclosures and everything that's involved in buying a home," Surinder Thind, who rates CoStar a hold for Jefferies Financial Group, Inc., reminds me. "Think about the number of signatures that you need to actually close. That is significantly higher than what you find in other countries."

It would be well for the bulls if house hunters persisted in seeking professional sales help. The analytical consensus on CoStar projects that residential listings will propel company-wide revenue growth from 12.7% in 2024 to 17.7% in 2025 and 19.3% in 2026. With such expectations, a CoStar holder with a two- or three-year investment horizon positively requires Homes.com to succeed.

The immensity of the new advertising campaign itself presents a set of risks. "Historically, when you spend money, you get some data out of it and then you calibrate that spend," Giridhar Reddy, co-CIO of Quantum Capital Management, LLC, which is long CoStar, acknowledges. "Now they are spending all this money without any real feedback loop."

Quantum, however, which builds its portfolio on assumptions and projections cast over a 10-year investment horizon, contends that the near-term success of Homes.com makes no real difference to CoStar's long-term growth story. "When you look at things over a 10-year period," says John Hughes, founder and president, "it really smooths out. It makes expensive stocks not that expensive. And it makes cheap stocks not that cheap."

Yes, Hughes allows, the stock market is "probably 20% to 25% overpriced relative to what the averages have been over the past 24, 25 years, the way we look at it." Which implies, he continues, a reduction in expected return for the overall Quantum equity portfolio to, say, 8%, down from about 10%. (Over the past 20 years, Reddy and he have compounded at a rate of 11.1%, net of fees.) As for CoStar in particular, taking that decade-long view, "instead of 7%–8% to 14%, we're seeing 6% to 11%–12%."

And if a miss on Homes.com knocks down the share price to the "$50–$60 range [from $95.18 on Tuesday]," says Reddy, "as it can, possibly, we will be loading up there. And our total return is probably not going to be that much different."

No matter how homes are bought and sold in the future, the pool of broker commissions is likely to drain. Compression in the ad pool for Zillow and peers would follow, leading to more competition for CoStar's apartment-rental business, its second largest by revenue. "We now set our eyes on, 'Let's grow multifamily properties,'" Zillow CFO Jeremy Hofmann declared at a March 6 Morgan Stanley conference.

In the fourth quarter, measured year over year, Zillow expanded its rental-related income by 37% compared with 23.1% for CoStar. This year, as noted, CoStar is guiding for its multifamily growth to decelerate to 17%–18%, and management is redirecting its focus to smaller landlords, perhaps indicating that the market for larger properties, CoStar's familiar hunting ground, is saturated.

Banks are also on the CoStar growth agenda, but here, too, there's competition to reckon with, notably Moody's Corp., which has begun an initiative in commercial real estate lending.

A decade and a half ago, Bloomberg made a big push to sell its eponymous terminal to law firms, but it has shared its success with competitors Westlaw, LexisNexis and Law360, among others.

To be sure, CoStar has the cash to survive a disappointing bet on Homes.com, though management's very success in CRE services works against an acquisition strategy. The Federal Trade Commission may or may not approve a potential purchase.

Of course, CoStar can still buy businesses outside the United States, but international operations produced negative $13.2 million in Ebitda last year on sales of $89.3 million. The question then becomes, Will investors, taking a two- or three-year view, be willing to wait through additional years of margin dilution until CoStar's international initiative gains scale?

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