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Haves and have nots

Evan Lorenz writes:

"Valuation as a thinking tool has prevented participation in 98% of the best stock outcomes," says a hedge-fund manager, formerly of the value tribe, who probably did not carry Benjamin Graham's *Security Analysis* with him to the beach this summer. "Fool me once," he goes on, "shame on you. Fool me twice, shame on me. And we've certainly done that with valuation."

AppFolio, Inc. (APPF), a software-as-a-service company trading at almost 200 times earnings, is the featured subject of the essay in progress, but a stock-market overview comes first. In preview, we're thunderstruck by the market, bearish on APPF.

The total market cap of U.S. stocks, as measured by the Wilshire 5000, stands at $36.8 trillion, or 190% of GDP, surpassing the post-1970 high of 167% of GDP set at the dot-com peak of March 2000. So far in 2020, the S&P 500 is up 9.2%, the weight of 494 underperforming issues notwithstanding. Bianco Research calculates that just six stocks—Facebook, Inc., Apple, Inc., Amazon.com, Inc., Netflix, Inc., Microsoft Corp. and Alphabet, Inc.—contributed more than 100% of the year-to-date gain.

Signs of froth abound, from heavy levels of retail participation to the boom in special-purpose acquisition companies led by, among others, former Republican House Speaker Paul Ryan and Billy Beane of *Moneyball* fame. On July 30, Apple announced a four-for-one stock split. Less than two weeks later, Tesla, Inc. did Apple one better with plans for a five-for-one split. Since their respective communiques, the duo have added $833 billion to their combined quoted value, a figure far greater than Berkshire Hathaway, Inc.'s $521.7 billion market cap.

"Why do I like when stocks split?" David Portnoy, founder of Barstool Sports and another non-subscriber to the canon of value investing, tweeted on Aug. 25. "Because you get double the stocks. Two stocks are better than one especially when they always go up." Let us say that the point survives the exaggeration. On Tuesday, Apple's market cap topped the combined market cap of the Russell 2000.

Value is a mindset as much as it is a statistical test of price in relation to earnings or book value. Risk aversion is one characteristic of the value adherent, humility before the future another. The value tribe doesn't shun growth, but rather it refuses to pay fancy prices for projected growth.

The ultralow cost of capital and the world-beating success of the likes of Apple and Amazon have turned the tables on Graham's disciples. Seeking a margin of safety in low valuation, the prudent people have instead wound up performing the investment equivalent of the David Blaine stunt of entombing oneself in a plastic box underneath a three-ton water-filled tank for seven days, except, for the value proponents, it's been years.

In a new unpublished paper, Rob Arnott, founder and chairman of Research Affiliates, along with his colleague Vitali Kalesnik and Campbell R. Harvey of Duke University and Juhani Linnainmaa of Dartmouth College, examine the record of growth versus value over time. They find that, measured on a price-to-book basis, value has lagged behind growth by the immense margin of 55% over the 13½ years ended mid-2020, the longest span of underperformance since at least 1963. And, as Arnott adds, "the valuation spread between growth and value is wider than it was at the peak of the tech bubble."

Given the importance of intangible assets in corporate success today, and the vogue in "asset-light" business models and the fetish for top-line growth, some such disparity seems warranted. But the authors determine that, measured on other valuation metrics, like price-to-sales and price-to-earnings, cheaper stocks still have fallen behind the most expensive ones.

Indeed, if anything, the spread has lately gapped wider. According to a new Bank of America report, the past three months have produced the biggest outperformance of growth for any like period except in the singular years of 1932, when Herbert Hoover lost the presidential election to Franklin D. Roosevelt, and 2000, when the Nasdaq briefly ascended to heaven.

Which is not to say that value stocks are cheap in absolute terms, either. Just about any way you slice it, the market is expensive. At 20.4 times, according to Bianco Research, the forward multiple on S&P 500 Value issues noses out the 20.2-times record set in 2000. Look past the impact of Covid-19 to two- and three-year forward estimates, Bianco continues, and the valuation result remains the same. As there are ever fewer basis points in "high yield," so there are fewer and fewer bargains in "value."

It would be hard to escape from the highly valued Big Tech names even if you wanted to. S&P Global, Inc. last

AppFolio, Inc. at a glance
all figures in $ millions except per share data

	TTM*	2019	2018	2017	2016
revenues	$288.8	$256.0	$190.1	$143.8	$105.6
operating income	13.4	6.5	19.7	9.3	-8.4
profit before taxes	11.7	4.8	20.4	9.8	-8.2
taxes	-18.9	-31.5	0.4	0.1	0.1
net income	30.6	36.3	20.0	9.7	-8.3
earnings per share	0.86	1.02	0.56	0.28	-0.25
cash	80.2	50.8	102.0	68.3	52.9
debt	97.0	48.6	49.8	0.0	0.0
total assets	320.4	260.1	175.7	110.2	92.6
cash flow from operations	54.5	38.9	36.3	29.4	11.5
capital expenditures	20.0	8.1	2.1	2.2	4.2
capitalized software	24.3	21.0	12.3	10.5	11.2
free cash flow	10.2	9.8	21.9	16.7	-3.9

* For the 12 months ended June 30, 2020.

source: company reports

week booted Exxon Mobil Corp. from the Dow Jones Industrial Average to make room for Salesforce.com, Inc., the cloud-computing phenomenon with a $256 billion market cap and slightly more than $2 billion of non-tax-derived GAAP earnings—that is, earnings collected over 18½ years. Dig into the Russell 1000 Value Index and you find growth stalwarts Alphabet, Inc., Twitter, Inc., Uber Technologies, Inc. and Lyft, Inc. among the constituents.

Even the Financial Select Sector SPDR Fund (XLF on the NYSE Arca) owns the FANGs. Owing to Berkshire Hathaway's $134.7 billion stake in Apple, the financial-only XLF, which counts the insurance giant Berkshire as a constituent, has a 3% exposure, Alexander Altmann, head of U.S. equity-trading strategy at Citigroup, Inc., discovers.

Growth seems almost to buy itself, so dazzling is the price action. "[T]he hedge fund long portfolio tilt away from value ranks as the most extreme in our 18-year data history," notes the Aug. 20 edition of Goldman Sachs's Hedge Fund Trend Monitor report. As far as that goes, the word "hedge" has almost become a misnomer: "At the start of August, the median S&P 500 stock had outstanding short interest equating to just 1.8% of market cap, the lowest level in our 16-year data history." By Goldman's reckoning, only energy stocks have short interest above their long-term average.

But not even growth is a strong candidate to grow to the sky. "The tech bubble in the 1990s was really almost two bubbles back-to-back," Arnott tells me. "You had the biotech bubble in the early 1990s and then the tech bubble in the late 1990s with an intervening peak that lasted only one month in large-cap stocks. You had what worked out to a 14-year dry spell for value from 1986 to 2000. Value had underperformed by 4,000 basis points, and of course simple arithmetic tells you that if you are down by 4,000 basis points, then you need 6,700 basis points to get back to where you started. That 6,700-basis-point snapback took 13 months.

"I look at today's markets as a remarkable time to ramp up value exposure to more or less as high a level as an investor can tolerate for a year of disappointment," Arnott continues. "I normally say only as far as you can bear two years of back-to-back disappointment. Today I set that aside because it seems like such an extraordinary bubble."

Tech management teams may not disagree. Insiders in the constituent companies of the Nasdaq 100 sold $10.4 billion's worth of stock in the second quarter, a 171% year-over-year increase. By contrast, they bought $35 million's worth of shares, a 67% year-over-year plunge, reports Vincent Deluard, director of global macro strategy at StoneX Group, Inc.

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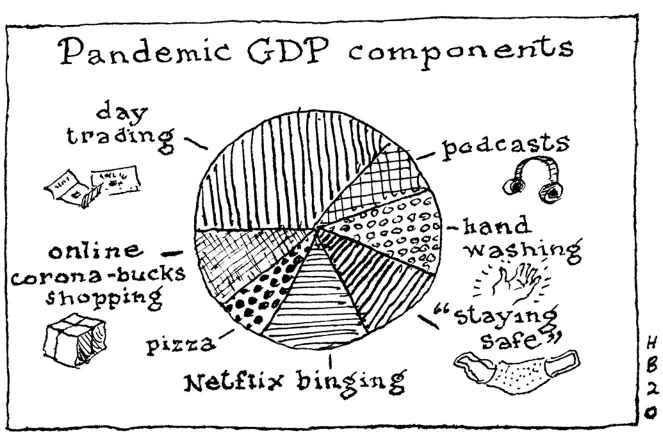
AppFolio was founded in 2006 with the goal of delivering niche software solutions to small and medium businesses within, as the expression goes, "specific industry verticals." In 2008 came the first product, AppFolio Property Manager (APM), a cloud-based accounting system for owners and managers of apartment buildings. In 2012, AppFolio acquired MyCase, Inc., an online legal-practice management-software provider.

In addition to these core accounting and case-management offerings, AppFolio markets what it calls "value+" services, e.g., creating customers' websites, screening tenants and handling electronic payments. As of June 30, AppFolio customers consisted of 15,011 property managers overseeing 4.9 million apartments and 11,305 law firms. For the APM product, AppFolio charges clients based on the number of apartments they oversee. In the second quarter, value+ solutions accounted for 64% of sales followed by core solutions (APM and MyCase, 32% of sales) and other (4%).

AppFolio sells mainly to the property segment, although the front office keeps those details to itself. (The 10-K report does not disclose the proportion of sales to legal customers, only noting that they account for less than 10% of total revenue.) Management, which takes no questions on its quarterly conference calls, avoids investor



conferences and keeps financial disclosure to a minimum, declined my invitation to come to the phone.

Rapid growth is the centerpiece of the bull argument. Between 2015, the year APPF completed its initial public offering, and the 12 months ended June 30, revenues compounded at the annual rate of 35%. The top line climbed by 27.4% in the second quarter, the pandemic notwithstanding. At $16.8 million on the June 30 balance-sheet date, net debt is negligible.

In a May 27 note, William Blair analysts Stephen Sheldon and Josh Lamers attempted to estimate the size of the market for property-management software sales. The pair identified 21 million multifamily units and 24 million single-family houses up for rent, though owners of just a handful of units are unlikely to use advanced software like AppFolio's APM. Cutting the universe to owners with enough scale to consider buying software reduces the addressable market to 17.1 million multifamily units and 2.5 million single-family homes, for a total of 19.6 million units. With AppFolio's customers managing 4.9 million units, that would still seem to leave quite a bit of room for growth.

The unnamed hedge-fund manager we quoted above counts APPF as a long position in his fund. The company will continue to compound its share price by increasing sales, he told me. "And, if they don't, gosh, I know five companies that covet the asset that would buy it in a heartbeat. So, it's kind of: You win because they compound, or they get bailed out if they don't. And that's a nice feeling."

However, good news is more than discounted into APPF's share price. The stock is valued at 199 times trailing earnings and 20.4 times enterprise value to trailing sales. While the Street likes the AppFolio story—with two holds and one sell recommendation—analysts want it at a cheaper multiple.

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The contrary case starts with the competition: The property market is more crowded than the bulls believe. RealPage, Inc. (RP on the Nasdaq), according to William Blair, sells software solutions to 19 million rental units, including 14–15 million multifamily, 2–3 million single-family and 2 million home-owner association units. Yardi Systems, Inc., a privately held company, has around 10 million units in its customer base. Add to that the 4.9 million units in AppFolio's portfolio and other private competitors such as Entrata, Inc., and the rental market looks almost saturated. (There is some double counting as RealPage's solutions are open-architecture and a customer using Yardi or AppFolio can also purchase products from RealPage.)

Nor is the competition standing still. RealPage and Yardi have historically focused on large property managers, a market segment for which AppFolio doesn't vie. On Dec. 18, 2019, RealPage acquired Buildium, LLC, a provider of cloud-based property-management solutions targeted to small and medium businesses, i.e., AppFolio's core demographic. At the time of the acquisition, Buildium's customers managed 2 million apartments. On RealPage's July 30 earnings call, CEO Steve Winn told analysts that RealPage is in the process of integrating its wider product suite into Buildium's platform and has hired additional sales people to boost growth. On Feb. 20, 2018, Yardi unveiled Breeze, a property-management solution for smaller clients.

AppFolio drives revenue growth both by adding clients and lifting average revenue per client. Despite a one-time boost in sales per client last quarter, each driver is slowing. Apartments managed by AppFolio's software increased by 16.8% year-over-year in the second quarter, a deceleration from the 19.2% and 21.2% registered in the second quarters of 2019 and 2018. Growth in average revenue per unit had been flagging—to 11.3% in first-quarter 2020, from 14% and 15.5% in the March quarters of 2019 and 2018—but picked up to 13.1% in the second quarter this year. In the 10-Q report, AppFolio highlighted the rise in rents paid electronically—the company charges tenants a fee for the convenience—as landlords and tenants socially distanced during the pandemic. "It is unclear whether the trend will continue over the long term," the AppFolio filing conceded.

The rising cost of customer acquisition adds to inferential suspicions that competition is hotter than the bulls acknowledge. Between the second quarters of 2018 and 2020, the sales and marketing outlay per new property customer rose to $46,950 from $25,774. "Their incremental cost of acquisition has materially increased in the last two years," an investor who is short APPF and asks to go unnamed tells me. "What does that say about the market opportunity left?"

Between the second quarters of 2018 and 2020, adjusted margins of earnings before interest, taxes, depreciation and amortization declined to 19.4% from 25.9%, in keeping with steeper costs for customer acquisition and R&D. Historically, according to Peter Heckmann, who rates APPF a sell for D.A. Davidson & Co., investors expected highly valued software companies to deliver both revenue growth and margin expansion. "What's fascinated me is this change in thought process in the software-as-a-service space," says Heckman, "where investors are primarily focused on top-line growth and not too concerned about

Sure about growth?

source: The Bloomberg

the bottom line or margins or when they might get to those margins. In the case of RealPage, they've played by the traditional rules, delivering both revenue growth and margin expansion, whereas AppFolio hasn't. What's interesting is if you look at the chart, AppFolio's stock started working really well when they made that decision to invest in growth."

After AppFolio's rapid share-price ascent, the company commands a market cap of $5.9 billion, almost matching RealPage's $6.5 billion. However, RealPage's second-quarter revenue and operating income footed to $285.6 million and $25.9 million, respectively, versus AppFolio's $81 million and $6.3 million. If AppFolio traded at the same multiple of revenue as RealPage, the stock would be 67% lower. This nosebleed valuation means it would be difficult for RealPage or Costar Technologies, Inc., the two likeliest buyers, to acquire AppFolio and make the deal accretive.

One of the oddities of this recession is that income has risen despite large job losses. Between July 2019 and July 2020, disposable personal income increased by 9.5% while the unemployment rate leapt to 10.2% from 3.7%. However, the $600 weekly unemployment benefit from the Cares Act expired on July 31. While President Trump has authorized an additional $400 per week from the Federal Emergency Management Agency, the money doesn't come for free. To lay hands on it, a state must reconfigure its unemployment systems and chip in $100 per week. So far only three states have signed up. As most state unemployment-benefit programs last for 26 weeks, many out-of-work consumers will see a further step down in income by mid-September.

It would be strange if this loss of income support did not lead to more skipped rental payments and vacancies with resulting pressure on the property managers' bottom lines. While the clientele is unlikely to rip out AppFolio's software, it may not buy more. "What you might see is a slowdown," says Sheldon. "If the property owners and managers are challenged themselves, it is probably tougher to get them to focus on buying new solutions. It might be a headwind on the sales side."

Or in the wise words of Cory Wong, a longtime Bernstein technology analyst who's departing the sell side for Big Tech, "the multiple matters just as much as the growth."

Elaborating, Wong recalls how "Microsoft effectively quintupled its EPS from $0.71 in 1999 to $2.59 in 2013. Yet the stock was down 30% over this 14-year period, as it ultimately de-rated from 70-plus times earnings (or 20x sales, for those more familiar with that parlance) to a trough of just 9x earnings in 2013."

"What's the takeaway for investors here?" he goes on. "Your entry and exit multiples matter. When you have a high entry multiple, there is just more random stuff that can go wrong. Misses are scrutinized more than beats. Macro rotations get weighted more than micro fluctuations. The narrative becomes more important than the actual numbers."

To judge by its actions, the AppFolio C-suite sees the matter Wong's way. Year-to-date, insiders have sold 284,554 shares worth $40.8 million—and purchased not even one.

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