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THE BIG SECRET ON WALL STREET

The Disruptors

- Daring “Regulatory Entrepreneurs” Who Rewrite the Rules
- Capital Efficient... and Taking Market Share

FROM THE DESK OF PORTER STANSBERRY

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The Disruptors

Daring "Regulatory Entrepreneurs" Who Rewrite the Rules

Capital Efficient...and Taking Market Share

"Gene" clearly was not short for "genius."

Gene (short for Evgeny) Freidman apparently thought he could outwit the New York Police Department – and beat a $200,000 failure-to-pay child-support rap – by climbing to the roof of a three-story apartment building and hiding in a tiny elevator shed.

It didn't work.

New York's finest dragged Freidman off the roof, and four days later he found himself sitting in a Manhattan courtroom across from his stony-faced ex-wife Sandra, offering a lame defense: "I don't have any money."

The rooftop hideout was a dramatic comedown for the former "Taxi King" of New York City, who just four years earlier, in 2014, owned 900 of NYC's 13,500 taxi medallions, and had manipulated medallion prices up to as much as $1.3 million apiece.

If you've been to New York – or one of many other cities with a medallion system – you've likely seen metal emblems that look like an oversized police badge bolted onto the hoods of city taxis. The medallion is the city's official license to operate a taxicab – and the supply of medallions is capped to ensure that cabs stay in demand (a system that started in the 1930s to cut down on Depression-era taxi turf wars).

The Big Secret

With millions of property listings and even more active renters, this company dominates the home-sharing industry. And as it expands its listings, it draws in even more renters, and as it draws in more renters, it increases its new property listings. This network effect, in turn, powers its remarkably capital efficient business.

Medallions, like all artificial constraints on the free market, fail in the long term. And in the meantime, "geniuses" like Gene Freidman often find ways to exploit the system.

Starting around 2006, Freidman – the son of a cab driver – decided to buy as many medallions as he could, and bid them up (to what he described as "crazy prices") at auction. That way, his own medallions would be worth more on paper… and he could lease them out to cab drivers at ever more-exorbitant rent.

The plan worked out great for Freidman… for a few years.

It didn't work out so well for cab drivers – often immigrants, like Freidman's own father, struggling to make ends meet in the Big Apple.

Drivers who lease a medallion start every workday underwater: they must make enough money to pay back the daily lease, before they can start earning money for their shift. In New York in 2015, drivers had to make $100 a day just to break even.

The medallion owner, of course, makes out like a bandit. That's why, in addition to operating the largest taxi fleet in New York, the "Taxi King" amassed a net worth of $525 million, bought swathes of pricy NYC real estate, and paraded around a series of model girlfriends… while starving cabbies fought over the diminishing supply of medallions, and took out hefty loans to buy or even lease one of the tiny metal badges.

Then… Uber came to town. And the taxi medallion bubble imploded.

Loopholes and A**holes

Uber Technologies Inc. (UBER) – the $134 billion market cap rideshare giant launched in 2009 by Garrett Camp and Travis Kalanick, after they had trouble getting a car to take them home from a party – is so big these days that it's a standalone verb. "I'll Uber."

But when Camp and Kalanick first debuted their app in New York City in 2011, Uber was a fledgling startup… small enough to squeeze through a loophole in the city's taxicab regulations.

Uber aimed to operate an unauthorized taxi service in the city – and thereby sidestep the medallion price wars and the bureaucratic licensing restrictions (including the entire 61-page **rule book** for official taxi drivers).

"We're in a political campaign, and the candidate is Uber and the opponent is an a**hole named Taxi," Kalanick told Vox Media in 2014. "Nobody likes him, he's not a nice character, but he's so woven into the political machinery and fabric that a lot of people owe him favors."

Camp and Kalanick would need to wage their war on Big Taxi without going to jail or getting fined. So they pulled out one of the oldest tools in the "get s*** done" toolbox: **regulatory arbitrage**.

Regulatory arbitrage, put simply, is the art of finding gaps in the law that you can exploit to your benefit. It's what businesses do when they store their money in tax-free havens like the Cayman Islands… or get incorporated in the lower-tax-rate state of Delaware.

New York taxi law stringently regulated the behavior of cars and drivers. How to get around that? Build a rideshare service that had nothing to do with cars or drivers.

How's that, you ask? Well, according to founder Kalanick, Uber is a "technology" company, not a car company. All the app does is connect people who are looking for a service. That includes both the passengers *and* the drivers – who aren't Uber employees, by the way.

"Drivers do not provide services to Uber," a lawyer for Uber claimed earlier this year. "It's actually the other way around. Uber provides services to its customers on both sides of its platform." She contended that Uber and rival rideshare company Lyft were more akin to "travel agents" than to taxi services.

Oh, and while we're on the subject… in the early days of the app, Uber riders didn't even "pay" for services. They just tapped a little button on the app to make "donations." That couldn't be *more* un-taxi-like, now could it?

The Next Taxi King

Weasel words aside, Uber moved in on New York in a big way in 2011 – and taxi drivers, fed up with crushing medallion leases, abandoned their yellow cabs and downloaded the new app. Taxi riders, tired of trying to flag down cabbies who already had a fare, did the same.

The impact on NYC's taxi industry was dramatic. Between 2011 and 2019, NYC yellow cab revenue plunged 30%. During the same time period, the amount of rideshare vehicles in the city roughly tripled, to 120,000. And the price of the once-coveted taxi medallion plummeted, from $1.3 million to $80,000.

Somewhere in there, Gene Freidman fell behind on his taxes… his Mercedes payments… and his child support. He climbed a roof. He landed in jail. The city repossessed his medallions. And a couple of years later, in 2021, he died of a heart attack at age 50.

The Taxi King is dead… long live the Taxi King.

In 2024, Uber is the undisputed monarch of transportation in New York City, and most other big cities, too. Regulatory arbitrage paid off for the scrappy "tech" company: by the time big-city bureaucrats had even begun to wrap their heads around the rideshare firm's unorthodox business model, Uber had eaten the cab industry like Pac-Man. Today, Uber (trading at all-time highs) has absorbed yellow-cab industries in New York City, San Francisco, Chicago, Boston, and other major American cities – listing the cabs on its app and offering to refer riders to them. By 2025, Uber has said it hopes to add every taxi in the world to its app – and the cab companies are, mostly, OK with living in the Uberverse.

In many ways, Uber's strategy moved beyond regulatory arbitrage into the neighborhood of "regulatory entrepreneurship." That is, the Uber developers didn't *just* slip through legal loopholes – they actively sought to create a product that would change an unfavorable legal landscape. And they succeeded. Uber has so fundamentally altered the taxi industry that it's difficult to imagine a night out on the town without it.

We're not recommending Uber shares in this issue… but rather, a company that's similarly used creative "regulatory entrepreneurship" to upend an existing industry – and which, like Uber, is a household name.

The Email That Launched a Travel Revolution

The company we're recommending in this issue is **Airbnb (Nasdaq: ABNB)**, the world's largest peer-to-peer home-sharing platform. Airbnb operates an online marketplace that enables property owners to rent out their homes to guests for short- and long-term stays. In exchange, Airbnb takes a percentage of every rental transaction made on its platform.

As of the end of 2023, Airbnb had 150 million active users in 220 countries and over 5 million owners renting out 7.7 million properties. Last year the business generated $9.9 billion in revenue and $4.8 billion in net income, and it has a market valuation of $93 billion.

The Airbnb story begins with two cash-strapped 20-somethings hoping to “make a few bucks” to cover their rent bill.

In September 2007, recent college graduates Brian Chesky and Joe Gebbia – who both studied industrial design at the Rhode Island School of Design – quit their jobs to launch a company. They had no real idea or formal business plan, just hopes and dreams… and very little cash. To save money, they shared an apartment in San Francisco, but even then rent was more than either could afford.

In a scramble to come up with some rent money, inspiration struck Gebbia. He knew that one of the design industry’s largest conferences was coming to town, and that most of the nearby hotel rooms were sold out. He sent an email to Chesky explaining how they could capitalize on the situation:

From: joe
Date: September 22, 2007
To: Brian
Subject: subletter

brian
i thought of a way to make a few bucks - turning our place into "designers bed and breakfast" - offering young designers who come into town a place to crash during the 4 day event, complete with wireless internet, a small desk space, sleeping mat, and breakfast each morning. Ha!

joe

They put together a web ad offering air mattresses in their apartment as a place to sleep, and Pop-Tarts for breakfast, calling the service “Air Bed and Breakfast.” To drum up interest from conference attendees, they asked design-industry bloggers to share the quirky concept with their subscribers. The grassroots marketing campaign secured three bookings, and just enough cash to keep paying their rent.

And with that, the budding entrepreneurs had found an idea to run with, in 2008 founding Airbnb, the world’s first home-sharing platform.

Airbnb’s business model is straightforward. The company provides an online marketplace that connects hosts with guests who book short- or long-term rentals in the host's property. In exchange for providing this marketplace, Airbnb collects a 3% fee from the host, plus another fee of up to 14% from the guest (the majority of the guest fee pays hotel taxes, a topic we revisit below).

At the time of its founding, the concept of a home-sharing network wasn't new. Similar websites like Vrbo (Vacation Rental by Owner) existed, but they mostly catered to the small niche of renting out entire vacation homes in beach and mountain towns. Airbnb was the first platform built specifically for renting out – initially – spare rooms in shared living spaces. And the founding vision was to expand the marketplace to cities across the U.S., and, eventually, the world. This ultimately unleashed a travel revolution that would (and still does) take a big bite out of the $2 trillion global market of hotel and lodging accommodations.

As with many tech-startup success stories, like Uber, Airbnb's founders disrupted the status quo by exploiting gaps in both the competitive and regulatory landscape.

Moving Fast and Breaking Laws

As late as 2013, the hotel industry was blissfully ignorant of the threat posed by Airbnb. By then the platform had reached 300,000 property listings and was adding hundreds of thousands of new users each month. While performing the research for his definitive book on Airbnb's early history, *The Airbnb Story*, in 2013 author Leigh Gallagher contacted executives of major hotel chains to get their thoughts on the disruptive new market entrant. The top response he received was "What's Airbnb?" followed by, "We're not paying much attention to it."

There was an equal level of complacency among industry regulators.

Before the emergence of Airbnb, lawmakers didn't envision a world where virtually anyone with a spare bedroom could become an overnight landlord. Thus, in many jurisdictions, no formal framework existed to regulate the home-sharing industry. In others, short-term property rentals of 30 days or less were technically illegal, but the laws were seldom, if ever, enforced. And for the most part, the legal onus to follow these laws fell on the property owner, not on Airbnb. Thus, Airbnb's founders didn't bother engaging with regulators. They simply opened up their platform to any hosts willing to take the gamble.

In effect, Airbnb enabled millions of individuals to become unregulated mini-hotel operators. Unburdened by having to obtain business licenses or follow local zoning regulations, Airbnb's platform enjoyed a significant advantage over its regulated peers in the hotel industry.

By far, the biggest loophole Airbnb exploited early on was not having to pay hotel taxes. Virtually every city and state in America charges hotel operators a tax on each daily room rental. These taxes make up a major operating cost for the hotel industry, which can range anywhere from 5% to 20% of a daily room rate.

In the early days of the company, Airbnb did not collect or pay hotel taxes from the properties it listed on its platform. As with Uber, the Airbnb founders used a simple rationale to implement their own version of regulatory arbitrage: since Airbnb wasn't a hotel operator, it wasn't obligated to pay hotel taxes. And it got away with this tax dodge for the first six years of the company's existence.

By avoiding forking over (or increasing its rates by) as much as 20% of each rental bill to the tax man, Airbnb unlocked a significant pricing advantage over its hotel rivals. This allowed Airbnb hosts to keep more money in their pocket, while guests enjoyed significantly cheaper rates than with hotel stays. This cost advantage fueled the platform's rapid early growth and market-share gains.

It wasn't until 2014, six years after the company's founding, that a handful of cities such as San Francisco began pushing for hotel-tax collections on home-sharing rentals. However, lawmakers moved slowly, and both Airbnb and the hosts on its platform took advantage of their lethargy. In a 2014 NPR interview, Airbnb host Emily Benkert, who managed 50 properties in San Francisco, noted:

> *"I personally have decided to wait until the city was actually enforcing it [hotel taxes], and Airbnb was collecting it."*

Airbnb gradually began implementing guest fees as a way to collect hotel taxes in the few jurisdictions that mandated it. But by waiting on the slow-moving legal system to enact formal regulations, Airbnb continued undercutting its hotel rivals and gaining massive market share for short-term stays in a growing number of cities.

Business was doubling each year, and by 2016 Airbnb was booking 125 million reservations annually, worth $14 billion in gross revenue (that is, total income from rentals and not just the company's share). That same year, Airbnb made headlines when its valuation reached $30 billion in the private market – or 50% more than industry leader Marriott International's market cap at the time.

The hotel industry could longer ignore this disruptive threat, and decided to take action to fight it.

Hotels Wake Up to Airbnb

In April 2017, The New York Times reported that the American Hotel and Lodging Association (which includes Marriott International, Hilton Worldwide, and Hyatt Hotels as members) launched a full-scale political assault on Airbnb and other home-sharing networks. During the association's board meetings in 2016, the members detailed a "multipronged, national campaign approach at the local, state, and federal level" aimed at the short-term rental industry. The goal: convince political leaders to begin imposing regulations and taxes that would make doing business more expensive, if not impossible, for short-term rental operators.

The New York Times

Inside the Hotel Industry's Plan to Combat Airbnb

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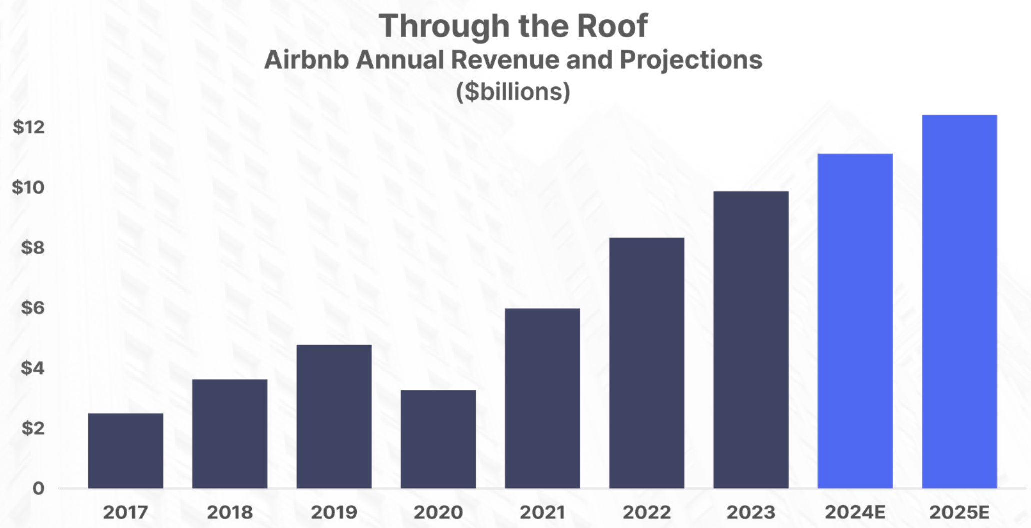
In the past, hotel executives played down Airbnb's impact on their industry, but documents reveal a "multipronged, national campaign" to rein it in. Minh Uong/The New York Times

The hotel lobby achieved two specific actions from these lobbying efforts. First, a group of U.S. senators successfully pushed the Federal Trade Commission to launch an investigation into whether home-sharing companies took housing supply off the market and contributed to rising rents and home prices. Second, New York Gov. Andrew Cuomo signed a bill to impose hefty fines on rental properties that violated local housing rules.

This sparked a series of follow-on actions by state and local regulators in New York and elsewhere to impose regulations and hotel taxes on the short-term rental industry. And while some of these measures were implemented, the bottom line was that the hotel industry, with the help of their powerful political allies, tried to kill Airbnb – and failed.

The regulatory crackdown pushed Airbnb to change its strategy from plausible deniability to active engagement. It began working with lawmakers to enact sensible regulations for the short-term rental industry. At the same time, Airbnb began proactively collecting and paying taxes on behalf of their hosts, through new platform fees.

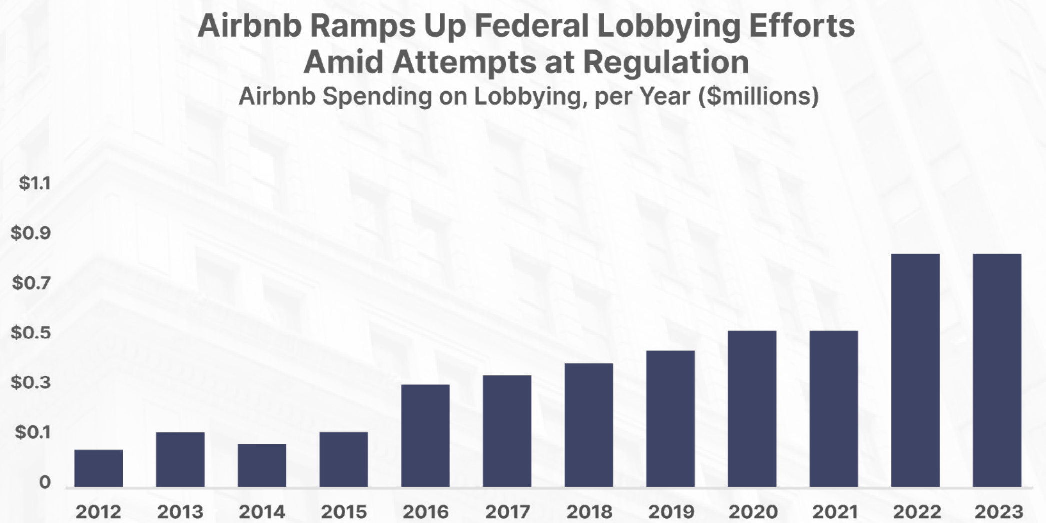
Fast forward to today, and Airbnb has paid over $6 billion in hotel taxes. And 80% of their top 200 markets are now regulated. While this pushed up Airbnb's rental rates through new guest fees of up to 20% on its listings, it's done nothing to stymie the company's growth. Revenue has increased 400% since 2017, from $2.5 billion to $10 billion last year:



Source: Bloomberg

Airbnb's $10 billion in annual revenue last year puts it on par with some of the world's largest international hotel chains, like Hyatt Hotels (H), with $6.7 billion in revenue; Hilton Worldwide (HLT) with $10.2 billion; and Marriott International (MAR) with $24 billion.

This growing revenue stream has enabled Airbnb to become a powerful political force in helping shape regulations in the home-sharing market. It now spends over $1 million each year lobbying government officials – more than Marriott, which brings in more than twice as much revenue.



Source: OpenSecrets

Note: 2023 spending reflects only first nine months

After failing to squash Airbnb, the hotel industry did the next best thing – it tried to join them, by entering the home-sharing market themselves. But by giving Airbnb a decade-long headstart, the big hotel brands were unable to catch up. Consider the case of Marriott, which entered the home-sharing market with its Homes & Villas by Marriott in May 2019. Like Airbnb, this service allows guests to book rental stays in third-party residential properties. But as of year end 2023, Marriott offered a total of 13,948 residential rental units across its entire business – a negligible fraction of the 7.7 million properties available on Airbnb.

Therein lies the key competitive advantage Airbnb has over Marriott and every other home-sharing marketplace: its unmatched selection of available rental properties. This gives Airbnb a dominant network effect – when the value of a network increases as it grows in size.

Beating the Competition Through Sheer Size

Examples of network effects can be found in the world's largest social media networks, like Facebook. The value of Facebook's platform rests in the billions of users who provide content and engagement. As more people join and become users, the more valuable the network becomes for existing users. And the more users there are, the more valuable the platform becomes for advertisers (more users means more eyeballs to see ads).

The same dynamic applies to home-sharing networks, where the greatest value belongs to the platform with the largest selection of rental properties. The biggest selection of rental properties provides the most powerful draw for attracting guests looking to book their next rental. More guests makes the platform more valuable for hosts, by providing the greatest number of potential renters of their properties. The compounding power of this growing network effect creates a reinforcing cycle: more properties draw in more guests, and more guests draw in more property listings, and so on.

Early on, Airbnb's biggest advantage came from regulatory arbitrage – undercutting the rates of its hotel competitors by avoiding hotel taxes. But as Airbnb built up a dominant network effect, the sheer size of its platform became a far more powerful advantage than cheap room rentals. That's how Airbnb continued to thrive, even when its rental prices increased as it began charging fees to pay hotel taxes.

What began as a simple room-sharing platform has now evolved into the world's most impressive array of lodging accommodations. These include venues that hotel rivals cannot offer, like mansions, castles, mountain homes, treehouses, and even farms.

To get a sense of the properties Airbnb lists on its platform, consider the Barbie Dream House, as part of Airbnb's Icons collection of theme homes. Located in Malibu, California, the decadent mansion is modeled to resemble the house in the

2023 blockbuster Barbie movie. Features include an outdoor dance floor, lush-green landscaping, and an infinity pool with panoramic oceanfront views, replete with Barbie-style branding throughout.

These one-of-a-kind properties do more than drive revenue for Airbnb. They also create a halo effect around the brand that can generate a huge source of free publicity and marketing.

The Barbie Dreamhouse listing generated 13,000 press mentions and more than 250 million social media impressions. For perspective, this one house got more than twice as much media coverage as Airbnb's announcement of its initial public offering ("IPO") in December 2020.

This style of advertising is known as "earned media" – where the press (and social media users) write about a business purely because of organic interest and not because they are paid to do so. Airbnb is the master of earned media in the travel industry, with 90% of its website traffic coming direct from users – meaning it doesn't come through a paid advertisement. CEO Brian Chesky explained Airbnb's powerful earned media on its Q3 2023 earnings call:

> *"We have some 500,000 to 600,000 press articles a year. I mean the share of voice of Airbnb compared to most travel companies is overwhelming. We have a greater share of voice than almost all the other major travel brands combined."*

For much of Airbnb's history, it failed to fully capitalize on the power of this organic marketing machine. Up until 2020, Airbnb spent heavily on paid media advertising to promote its business, laying out nearly $1 billion in 2019. This expense played a big role in the company's consistent operating losses for most of its history… until a crisis pushed the business to become a lean cash generating machine.

COVID-19 Forces Airbnb to Get Efficient

When the COVID-19 outbreak brought global travel to a halt in April 2020, Airbnb revenues plunged by over 70%. This forced the company into a crisis-mode of cost cutting, starting with its advertising budget.

A famous marketing maxim contends, "Half of the money spent on advertising is wasted. The trouble is you don't know which half." In Airbnb's case, it turned out that number was well above half. The COVID-19 pandemic provided the company a rare opportunity to see what happened when it shut down its entire marketing program. CEO Chesky explains:

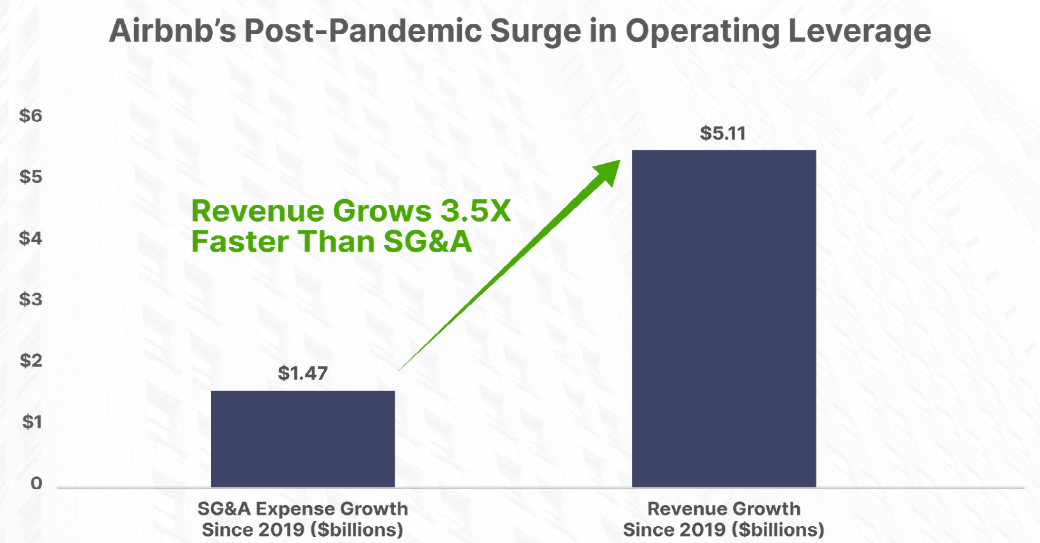
> *"I got to do the one experiment every CMO [chief marketing officer] wanted to do. What happens if you shut off all your marketing? And the answer was hardly anything. That was really interesting. And that's when I realized performance marketing [paid advertising] is the drug. And you've got to be careful about that drug, and you've got to get that needle out of your company."*

Instead of paying for advertisements, the company leaned heavily into organic marketing to promote the business through earned media. This allowed Airbnb to slash its advertising budget from $713 million in 2019 to $176 million in 2020. Despite a 75% drop in ad spending, Airbnb's business recovered in the second half of 2020 to just 20% below pre-pandemic levels, as travel restrictions slowly began lifting.

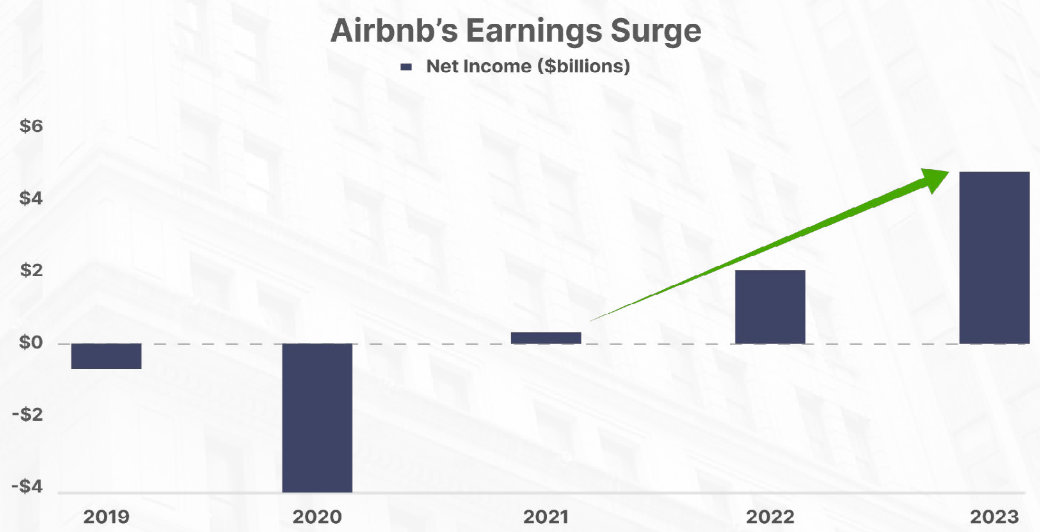
As global travel continued recovering in 2021, Airbnb increased its advertising spending to $542 million, still 25% below 2019 levels. Even though paid advertising fell 25%, Airbnb generated 25% more revenue in 2021 versus 2019. While the post-pandemic environment played a role in driving demand for home-sharing rentals, the company also learned how to do more business with less paid advertising.

The company also cut costs by dramatically simplifying its operating structure during the pandemic and reducing headcount by 25%, from 7,500 employees to 5,600. As growth recovered after the pandemic, Airbnb remained disciplined with its hiring. The total number of employees at year end 2023 was 6,900 – still 8% below 2019 levels. Meanwhile, revenue has more than doubled from $4.8 billion in 2019 to $9.9 billion last year. Thus, Airbnb now generates 125% more revenue per employee than it did pre-pandemic.

The end result of these cost savings is a tremendous reduction in Airbnb's largest segment of operating expenses: sales, general, and administrative (SG&A). This has unleashed tremendous operating leverage in the business, where revenue growth has significantly outpaced SG&A expense. From 2019 through 2023, Airbnb's revenue grew by $5.11 billion while SG&A only increased $1.47 billion:



These efficiency gains have transformed Airbnb's financials from years of red ink into billions of dollars of annual earnings power:



Source: Bloomberg

Next, we'll show how Airbnb has become one of the most profitable and capital efficient businesses in the world.

A Franchise Model for the Travel Industry

The key feature of Airbnb's business is that it doesn't invest in or manage physical real estate. Instead, it acts like a franchisor of rental properties. Airbnb relies on its hosts (franchisees) to acquire, operate, and maintain all of the rental properties on its platform. And Airbnb takes a cut of every dollar its franchisees generate (royalties) from rentals on its platform.

As long-time readers know, we like franchising for its capital efficiency. As an example, let's compare the economics of Airbnb to one of the world's largest and most profitable hotel chains, Marriott International.

As of year end 2023, Marriott operated 589,078 hotel rooms compared with the 7.7 million rental properties on Airbnb's platform. Since Marriott collects all of the revenue generated from its fully owned properties, it generates 140% more revenue from these rentals than Airbnb does. However, full ownership of these properties also comes with the full burden of operating and maintenance costs. Since Airbnb doesn't incur these expenses, it generates substantially more net income than Marriott does.

In the table below, we compare the current analyst projections for 2024 revenue and net income of Airbnb versus Marriott (note: we use 2024 estimates because Airbnb enjoyed a one-time tax benefit that temporarily boosted its profitability in 2023). Marriott is expected to generate $25.4 billion in revenue this year, or 126% more than Airbnb's $11.2 billion. However, Airbnb is expected to earn $3.2 billion in net income, 20% more than Marriott's $2.7 billion.

This disparity is due to Airbnb's 29% profit margins, which are nearly 3x Marriott's 11% margins:

Royalty vs Owner-Operator Economics, Estimated for 2024

	Revenue ($billions)	Net Income ($billions)	Profit Margin
Airbnb	$11.2	$3.2	29%
Marriott International	$25.4	$2.7	11%

The far bigger distinction lies in how much capital is required in the two businesses. Airbnb operates much more like a software company than a real estate business. Since Airbnb has already made the upfront investment to build its digital platform, it can generate more sales by simply adding new users, which come at a very low incremental cost. By comparison, hotel operators must invest into building new physical properties to drive growth in rental income.

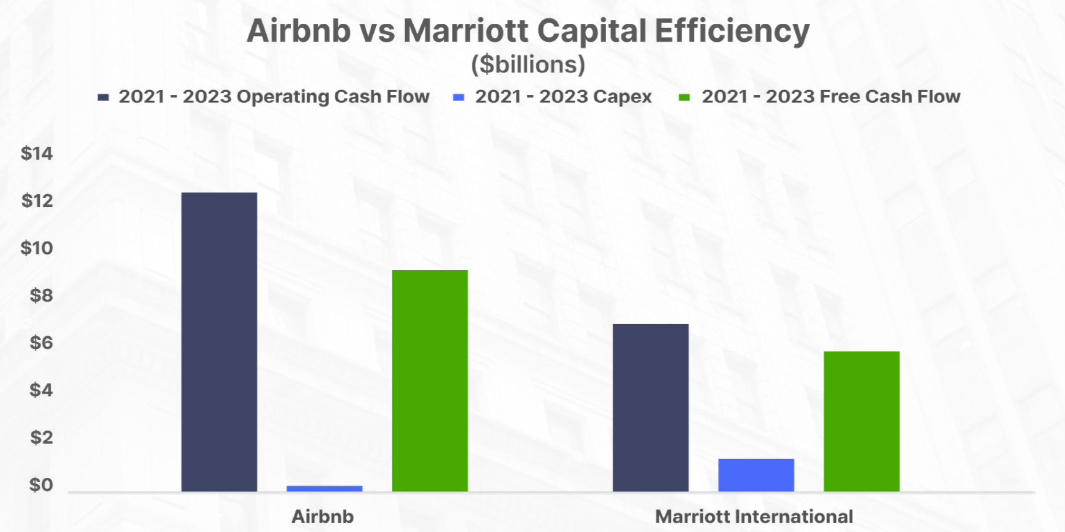
We can measure this difference in capital intensity by analyzing the following cash flow metrics:

1. Operating cash flow, defined as how much cash the business generates from normal operations, and

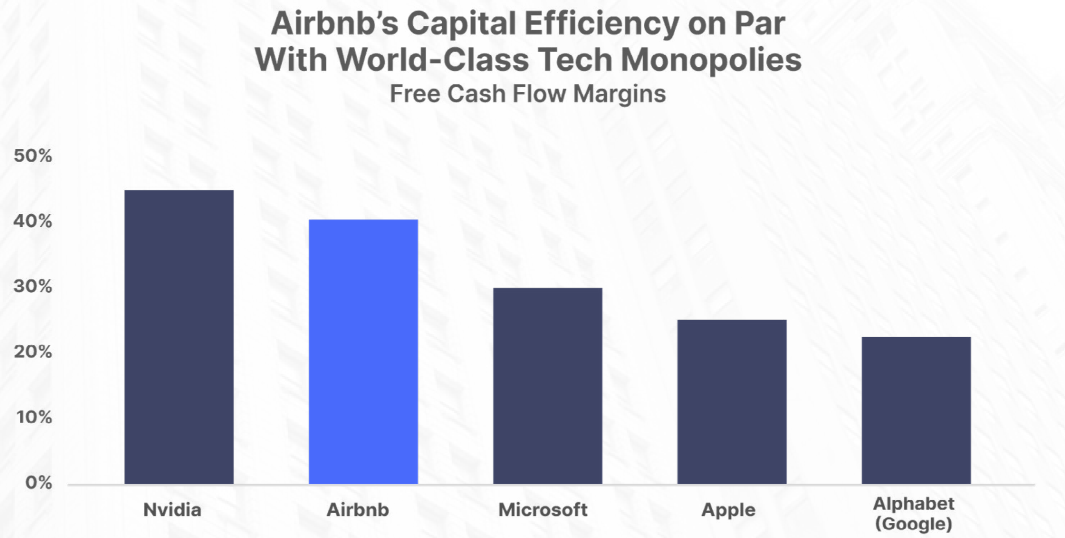
2. Free cash flow, defined as operating cash flows minus capital expenditures (i.e. the amount of capital that gets invested back into the business for maintaining existing operations and for future growth)

Over the last three years, Airbnb generated $11.5 billion in operating cash flow. In order to generate that cash flow, the company spent just $80 million in capital expenditures. Over the same period, Marriott generated $6.7 billion in operating cash flow, while spending $967 million in capital expenditures. Thus, Airbnb generated 70% more in operating cash flow than Marriott, while shelling out 90% less in capital expenditures.

That's how Airbnb generated $9.6 billion in free cash flow in the last three years, or 67% more than Marriott's $5.7 billion. Airbnb generated all of this extra cash despite bringing in roughly half as much revenue.



The incredible capital efficiency of Airbnb's business model allows it to generate 39% free cash flow margins, compared with Marriott's 11%. This puts Airbnb on par with today's world-class technology giants like Nvidia (NVDA), Microsoft (MSFT), Apple (AAPL), and Alphabet (GOOGL):



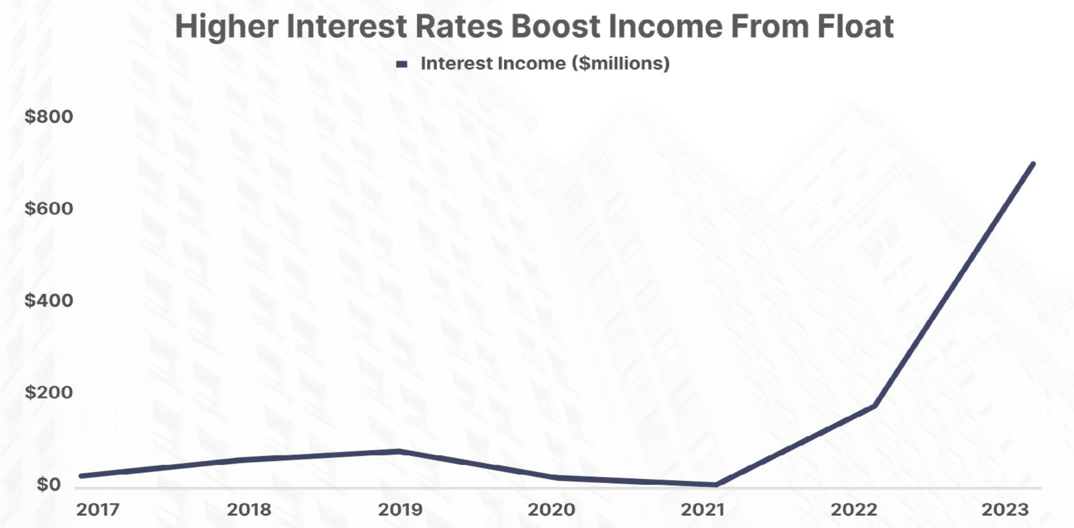
There's one additional feature of Airbnb's business model that makes it remarkably capital efficient – the lag time between when a guest pays Airbnb for a reservation versus when the company pays its hosts.

A Hidden Source of Float

Many of Airbnb's guests book their rental reservations 60 to 90 days ahead of their stay. These guests are required to pay upfront as soon as they book the reservation. However, Airbnb doesn't transfer these funds to the host until 24 hours after the guest checks into the rental property. In the meantime, Airbnb can invest these funds and earn income.

This provides Airbnb with its own "float," the term insurance companies use for the money held between collecting premiums and paying out claims.

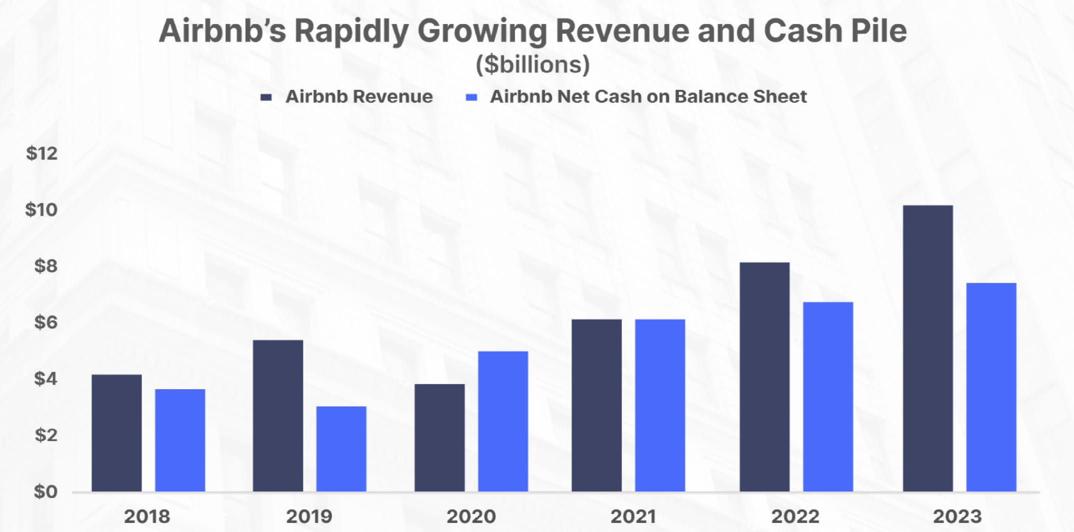
As revenue grows, so does the float. Airbnb's float reached a record high of $9.1 billion in Q2 2023, and currently sits at $8.7 billion as of its last financial report for Q1 2024. With short-term interest rates holding steady above 5%, Airbnb's growing float makes it one of the biggest beneficiaries of today's "higher for longer" interest rate environment. The company generated $720 million in interest income alone last year (15% of total earnings), up from virtually zero in 2021 (due to 0% short-term interest rates):



Source: Bloomberg

All of these factors make Airbnb one of the most capital efficient businesses in the world, with 47% returns on invested capital and 70% returns on equity. That's how Airbnb can generate significant earnings and cash flow, even as it achieves rapid growth, including 25% annual revenue increases since 2016.

Few companies in the world can grow at these rates while accumulating cash instead of consuming it:



Compare this with the traditional hotel industry, which must build new properties to generate growth. Airbnb's hotel peers rely on debt to finance their growth, resulting in balance sheets with relatively high leverage ratios (net debt to operating income). Airbnb's clean balance sheet with $8.8 billion in net cash ($11.1 billion in cash minus $2.3 billion in debt) stands in stark contrast with the balance sheets of its hotel peers, like Marriott (3.2 net leverage ratio), Hyatt (3.8 net leverage ratio), and Hilton (4.0x net leverage ratio).

So far, we have focused on comparing Airbnb's business against the hotel industry that it's disrupting. However, the company does have two key competitors with similar business models. Next, we'll see how Airbnb stacks up against these rivals.

Assessing the Competition, Part I: Vrbo

Airbnb's first key competitor is Vrbo, one of the first online marketplaces for home rentals. The website was launched in 1995, and focused entirely on the vacation rental market (the Vrbo acronym stands for Vacation Rental by Owner).

A similar vacation rental company, HomeAway, acquired Vrbo in 2006. In 2016, HomeAway was acquired by the online travel agency Expedia (EXPE), which is now Vrbo's parent company.

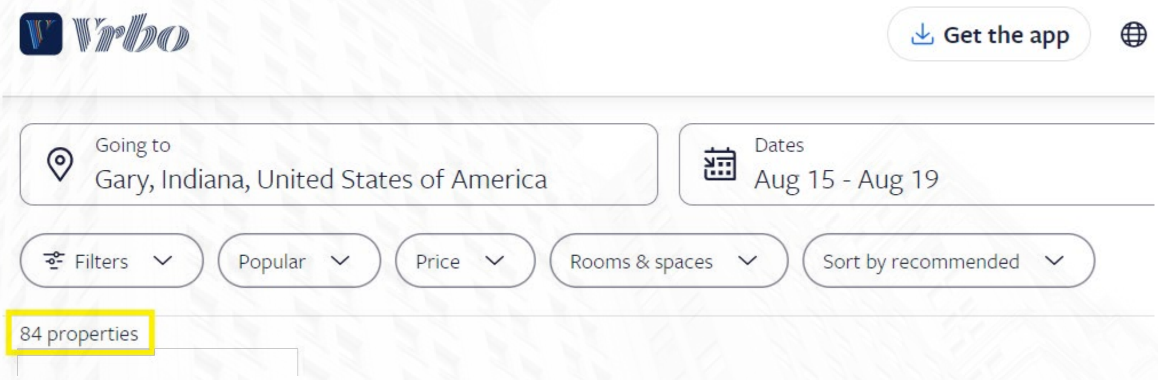
One key difference between Airbnb and Vrbo lies in the scale of their property listings. Despite Vrbo's 13-year head start, Airbnb has amassed a much larger selection of property listings.

As of the end of 2023, Vrbo had 2 million property listings compared with 7.7 million for Airbnb.

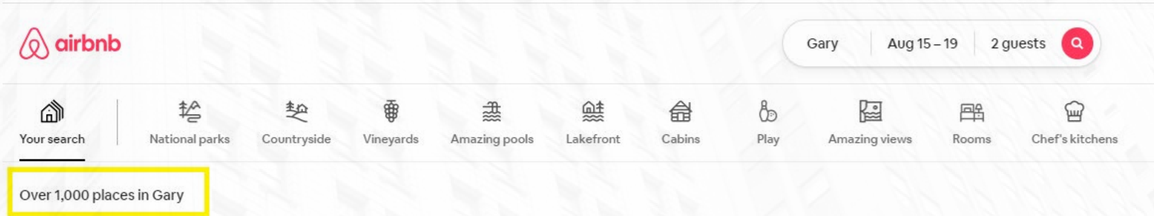
Vrbo's narrow focus on vacation homes capped its growth for the first two decades of its existence. It later followed Airbnb's lead by expanding its selection to include home and apartment rentals in cities beyond vacation destinations. But even to this day, Vrbo doesn't offer the option of renting spare rooms in shared living spaces. This is a critical differentiator that provides a powerful draw for Airbnb's guests looking for a cheap hotel alternative.

Thus Airbnb and Vrbo both have plenty of listings available in many of the top vacation destinations. However, the disparity between these platforms shows up in the available properties outside the key vacation cities. Consider the case of Gary, Indiana – a sleepy midwestern U.S. town with a population of about 70,000.

A Vrbo search in Gary for a two-person rental shows 84 available properties to choose from:



That same search on Airbnb produces more than 1,000 available listings:



Despite Vrbo's attempts to compete with Airbnb in second- and third-tier cities, it hasn't been able to overcome the powerful network effects of Airbnb's more robust platform. Airbnb's greater selection of properties draws more guests to its platform, with over 150 million active users at year end 2023 – more than triple the 48 million active users on Vrbo.

And for hosts, this greater number of guests available to book reservations makes Airbnb a preferable platform to list a property. And Airbnb's advantage in this regard has widened significantly in recent years.

In 2019, Expedia reported 2.1 million property listings on Vrbo. Four years later in 2023, that number had changed to "over 2 million." It appears that Vrbo has not grown the number of listings on its platform at all in the last four years. Meanwhile, over that same time period, Airbnb increased the number of property listings from 5.6 million to 7.7 million.

The other key metric for comparison is the total number of bookings (guest reservations made) on the two platforms. Expedia stopped reporting Vrbo's gross bookings value in 2019, so we can't get a perfect apples-to-apples comparison. However, given that the number of property listings on Vrbo hasn't grown since then, we can reasonably assume that Vrbo's bookings haven't grown much since 2019 either. It's worth noting that the total bookings across Expedia's entire business (including other travel reservations made in non-Vrbo segments) fell 4% from 2019 through 2023. Over that same period, Airbnb's bookings increased 93%.

There's one final data point to consider. Even when Vrbo was in growth mode before 2019, when Expedia still reported the platform's bookings, Airbnb consistently outpaced Vrbo in bookings growth:

Across all metrics, it's clear that Airbnb's dominant network effect allows it to continue attracting more property listings, more users, and more bookings versus its competitor Vrbo. And given the compounding effects of Airbnb's ever-expanding network versus Vrbo's stagnant growth, Airbnb should further extend its leadership over its rival going forward.

Whereas Vrbo represents Airbnb's second biggest competitive threat, its number-one rival is online travel agency Booking.com.

Assessing the Competition, Part 2: Booking.com

Founded in the Netherlands in 1996, Booking.com began as a website that allowed travelers to make hotel reservations over the internet. In 2005, Booking.com was acquired by online travel agency Priceline, the parent company that later changed its name to Booking Holdings (BKNG). Over time, Booking.com expanded into offering additional travel accommodations, like reserving flights and cruises, plus the same type of third-party home and apartment rentals that Airbnb offers.

Booking.com's home-sharing business has grown large enough to easily make it Airbnb's top competitor. As of year end 2023, the website offered 2.9 million home-sharing properties available in over 220 countries – plus another 475,000 hotel and motel properties.

While Booking.com is a formidable competitor, the superiority of Airbnb's network shows up in its growing lead in the number of property listings. Over the last four years, Airbnb has increased the number of active listings by 2.1 million, from 5.6 million in 2019 to 7.7 million in 2023. Over that same period, Booking.com has only grown its number of home-sharing options by 1.0 million, from 2.4 million to 3.4 million. As a result, though both had similar growth rates of around 40%, Airbnb's increase from a larger base further expanded its property lead relative to Booking.com – having 4.3 million more listings in 2023 compared with 3.2 million more in 2019.

There's one major advantage Airbnb provides its hosts that makes it a preferable platform over Booking.com. Airbnb does a better job solving one of the biggest concerns among hosts: protection against property damage.

The home-sharing industry is replete with **horror stories** of guests destroying properties. As just one example, in 2015 Canadian couple Star and Mark King rented their Calgary home to guests who used the property for what local police described as a "drug-induced orgy." The renters left the property trashed to the point where the Kings "wished the house had burned down." Estimated damages ranged between $50,000 and $75,000. In a statement following the incident, Airbnb noted it had banned the guests from its platform, and was working quickly to reimburse the property owner for their damages.

Airbnb provides its hosts with several key tools for avoiding (or at least minimizing the impact) of these nightmarish outcomes that Booking.com doesn't offer.

The first is a crowd-sourced system of checks-and-balances. Airbnb allows hosts to review each guest who stays at their properties. And when a user requests a reservation on Airbnb, hosts have up to 24 hours to approve or deny the request. This provides hosts with plenty of time to review the renter's prior reviews provided by other hosts. If the host doesn't like what they see, they have the right to refuse the reservation.

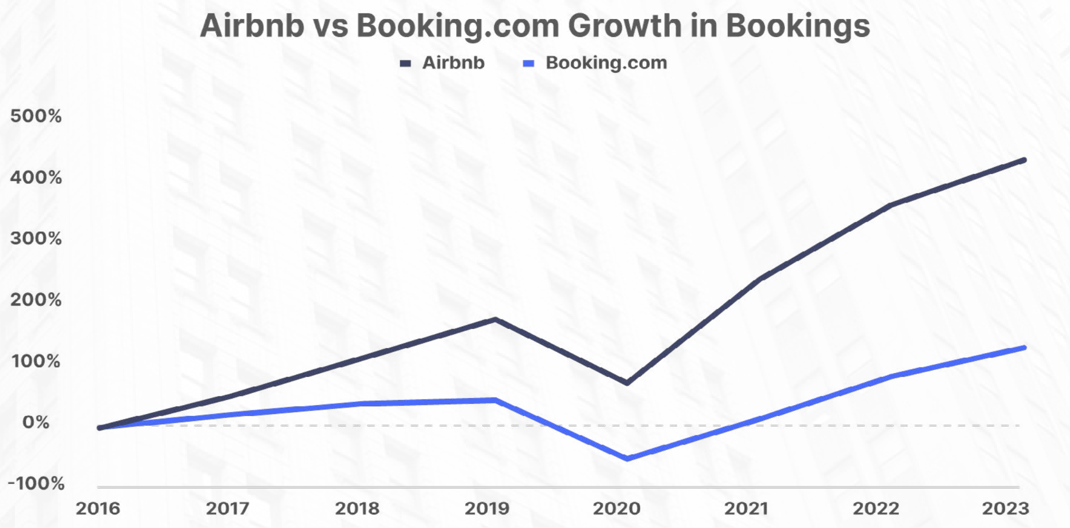
Booking.com, on the other hand, provides no way for hosts to leave feedback on guests. The company also has no system for allowing hosts to block reservation requests. Once a host lists their property on Booking.com, guests are free to book instant reservations at will. This leaves hosts on Booking.com flying blind to the types of guests that rent their properties.

Finally, Airbnb offers more when it comes to protecting guests against property damage, with $3 million of insurance coverage. This is the largest insurance protection of any home-sharing network, and three times more than the $1 million policies offered on Booking.com.

These superior protections Airbnb provides for hosts is a major factor in building trust with property owners to put listings on the platform. It's particularly valuable for the high-end homes that distinguish Airbnb listings from those of its peers. And this helps drive more guests to Airbnb, which in turn, provides a greater draw for hosts, and so on.

Booking.com only reports financial trends for its entire rental segment, which includes both home sharing and the reservations it books for hotels and motels. This prevents a direct comparison between the home-sharing segment of Booking.com versus Airbnb. However, the general direction of total booking trends between the two companies provides a useful look at their relative growth trends.

Since 2016 (the first year of publicly available data), Airbnb has grown its gross bookings volume from $14 billion to $73 billion, an increase of 426%. This is 3.5 times the growth rate at Booking.com, which increased its bookings from $68 billion to $151 billion, an increase of 121% over the same period:



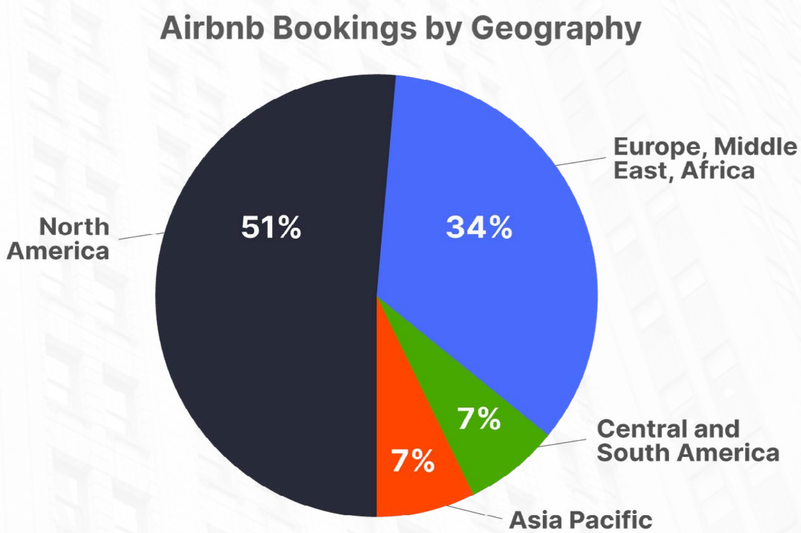
Despite Airbnb's faster growth rate and larger inventory of home rentals, Booking.com still presents a source of significant competition. However, as with the hotel industry, this isn't a winner-take-all market. Both companies have managed to grow and thrive together since Airbnb's inception in 2008. And they both dwarf their next closest competitor, Vrbo.

Thus, we see a future where both Airbnb and Booking.com can continue thriving together as the top two dominant players in the home-sharing market (with Vrbo a distant third). This would be similar to the market-share dynamic seen in many duopolistic industries, which often results in above-average profit margins and returns on capital for both players. Notable examples in other industries include soft drinks (Coke versus Pepsi), home improvement (Lowe's versus Home Depot) and credit-rating agencies (Moody's versus S&P Global).

Future Growth Opportunities

As strong as the company is now, Airbnb still has ample opportunity for further expansion. Currently, only about one in 10 U.S. travelers uses home-sharing networks versus hotels and motels. Given the value proposition and ever-expanding selection of properties available to rent, there's reason to believe this number could easily double or triple.

The even greater opportunity for Airbnb will come from international expansion. North America made up 51% of bookings last year. The company's next largest region is Europe, the Middle East, and Africa, making up 34% of bookings. Central and South America and Asia make up the remaining 14%, split equally with 7% of bookings in each region:



The company's long-term goal is to achieve U.S. levels of penetration in its European, Latin American, and Asian markets.

Europe remains the lowest hanging fruit, where Airbnb already has U.S. levels of market penetration in the UK and France. It's now pursuing aggressive growth in Germany, Italy, and Spain.

The company has also generated robust growth in South American markets including Brazil, Chile, Peru, and Ecuador – all regions where bookings have doubled since 2019.

In Asia, South Korea is the biggest near-term opportunity, where bookings are up 50% since 2019. Future growth opportunities will come from further expansion into Japan and China, and from a number of southeast Asian countries.

On Airbnb's Q3 2024 earnings call, CEO Chesky laid out the roadmap for aggressively expanding into each of these markets that have generated robust growth in recent years:

> *"So I think in the next 24 months, we're going to see a major acceleration in our penetration in a lot of these markets. There's about a dozen markets around the world that, as you know, have large tourism opportunities and we're really focused on that. And that's going to be one of our biggest near-term expansion opportunities."*

The key metric to monitor will be the number of new properties Airbnb can attract onto its platform. Management considers this the most important indicator of growth, as the platform first needs more properties before it can generate more bookings.

As of Q1 2024, this key metric remains on track to support future growth. Airbnb reported that active listings increased 15% on a year-over-year basis. That's well above its average annual growth rate of 11% per year over the last three years.

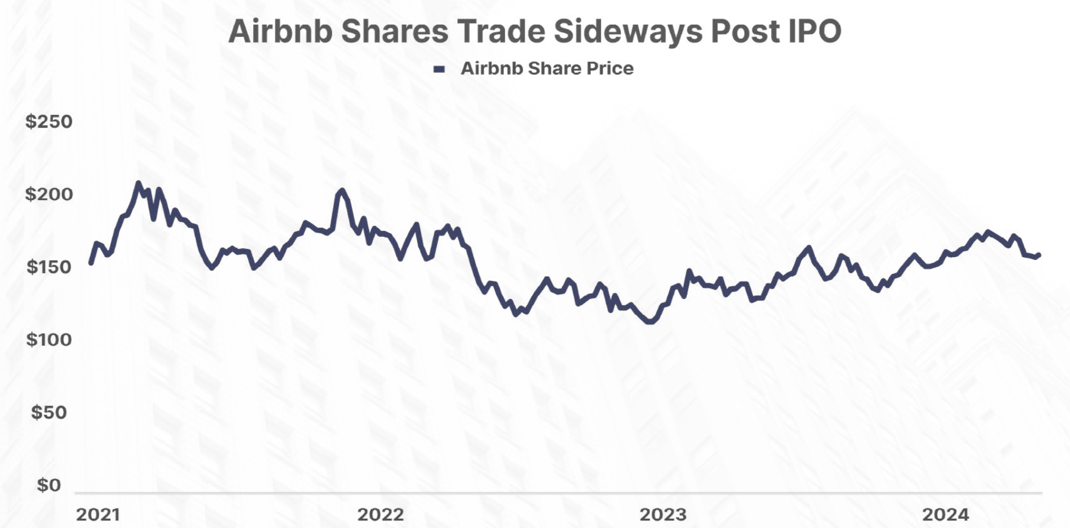
This tells us that Airbnb's long-term competitive moat – its dominant network effect – remains as strong as ever. And thanks to the efficiency gains realized during the pandemic, Airbnb is also one of the most capital efficient companies in the world, with free cash flow margins approaching 40%.

With a dominant market position solidified by an enduring competitive advantage, incredible economics, and ample opportunity for long-term growth, Airbnb is a stock to buy. The only thing left to do is determine the right price.

Finding an Entry Point

Airbnb went public in December 2020, issuing shares at $68. The timing was right near the peak of the COVID-era bubble in fast-growing tech stocks, and Airbnb shares got swept up in the speculative fervor. On the first day of trading, shares rose to $146 on their first trade in the open market, or 115% above the IPO price.

At this price, Airbnb was valued at nearly $100 billion. Back then, the company was still in the middle of unlocking efficiencies and transforming its business, and had not yet reached positive earnings or cash flow. Relative to its 2020 revenue of $3.4 billion, shares traded at nearly 30x sales. Investors had priced the business well beyond any semblance of fair value, causing the shares to trade sideways ever since then:



Source: Bloomberg

During this period, the business has significantly improved, allowing the fundamentals to catch up with its high valuation. Revenue has nearly tripled since 2020, and the financial statements have transformed from showing consistent losses to recording billions in earnings and free cash flow. This year, estimates compiled by *Bloomberg* project Airbnb will generate $3.2 billion in net income and $4.2 billion in free cash flow.

That puts its current valuation at a roughly 30x price-to-earnings multiple, and 22x price-to-free cash flow. Meanwhile, the price-to-sales ratio has now dropped to 8.4x, down from over 30x at the time of its IPO (an 8.4x price-to-sales ratio is well above the median S&P 500 company at around 2x, but high-margin, capital efficient businesses often command price-to-sales ratios of 10 or above).

If we expected Airbnb to continue growing revenue at its historical rate of 25% per year, this would present a compelling opportunity. However, Airbnb's growth rate is expected to decelerate meaningfully to just 10% this year. We don't believe this is due to any loss in Airbnb's competitive position. Instead, we suspect the company faces the same macro-driven weakness **we've previously written about**: a broad-based slowdown in consumer spending that's hit many consumer brands, ranging from Starbucks (SBUX) to McDonald's (MCD).

The cumulative effect of inflation outpacing income growth is hitting lower-income consumers more so than others. And the travel sector is not immune. Recent data from CoStar, a leading provider of data analytics on the commercial-property industry, showed that low-budget hotel chains experienced a 6% drop in rental revenue in Q1. And even though higher-end hotel chains have remained more resilient, the total U.S. revenue from all hotel chains grew by just 0.2% in Q1. With inflation running at 2% to 3%, that means the hotel industry is shrinking in inflation-adjusted revenue:

Where Inflation Hits the Hardest

Hotel Segment	Year-Over-Year Growth in Q1
Total U.S.	0.2%
Luxury	-0.3%
Upper Upscale	3.0%
Upscale	0.4%
Upper Middle	-2.0%
Midscale	-5.5%
Economy	-6.5%

Source: CoStar

We expect the emerging pressure on low-income consumers to eventually spread throughout the rest of the economy. Airbnb will not be immune.

Given this outlook, we believe a conservative valuation at which to purchase shares in Airbnb is somewhere between a 20x earnings multiple and a 15x free cash flow multiple. Splitting the difference between the two gives us a price target of approximately $100 per share.

With shares now at $146, we're putting Airbnb on the Watchlist. We'll continue to monitor the company's earnings reports and the overall trends in the travel industry, and will alert you if we see any reason to change our entry price target.

Action to Take: Buy **Airbnb (Nasdaq: ABNB)** up to $100 per share

New to the *Big Secret* Portfolio? Start With Our Top 3 "Best Buys" Today

Our goal at Porter & Co. is to bring you world-class investment research, focused on "inevitable" businesses that you can buy and hold forever. This is the surest and safest path to building permanent wealth.

While we don't believe in timing the market, we do keep a constant eye out for bargains. In each edition of *The Big Secret*, we highlight three current portfolio picks that are at an attractive buy point. We suggest you focus on these:

1. **Burford Capital (NYSE: BUR)** is the leading global provider of litigation finance, managing a $7.1 billion portfolio of assets. Burford funds lawsuits and when it wins, it takes a cut of the payout. These cases can turn small investments into supersized paydays. With the courts fully reopened in 2023 after the COVID-19 shutdowns, many of Burford's backlog of cases went to trial and reached final judgments in its favor, with net income surging 55% to $610 million in 2023. Plus, there's additional upside from a multibillion-dollar ruling in Burford's favor that's not priced into shares today. See our recent **Portfolio Update**.

2. **Franco-Nevada (NYSE: FNV)** – the **"Gold Digger" That Gets Paid to Do Nothing** – is the leading gold royalty company. Franco-Nevada provides financing for mining companies to do the capital-intensive work of pulling rocks out of the ground, in exchange for a percentage of the mine's output. As a result, Franco-Nevada is highly capital efficient, generating 57% free cash flow ("FCF") margins. Its world-class management team has established one of the best track records in the industry. FNV shares sold off in October, when the Panamanian government shut down a large copper mine that is one of the company's largest royalty assets. The Cobre Panama mine contributed 20% of Franco-Nevada's revenue and 16% of net asset value in 2023. FNV shares regained some of what they lost in October, but they remain 18% lower than when we recommended them on May 11, 2023, effectively pricing in a total loss of the mine. Meanwhile, with the price of gold near its all-time high, the rest of Franco-Nevada's portfolio is performing well. Still, the shares trade near their lowest valuation on record. (We provided more details of the latest developments in a recent **Portfolio Update**.)

3. **Philip Morris (NYSE: PM)** owns the international rights to Marlboro, the world's leading traditional tobacco brand. Over the last decade, the company has invested heavily in less-harmful alternatives to traditional tobacco products. These investments have made Philip Morris the global leader in less-harmful nicotine consumption, including its hit IQOS and ZYN brands. Unlike most traditional tobacco companies suffering from declining sales, Philip Morris' smoke-free business is delivering double-digit revenue and earnings growth. The company is highly capital efficient, with 40% operating margins and a 27%

average return on capital. It's also a recession-proof business, and trades at an attractive valuation of just 16x earnings, with a 5.2% dividend yield.

Portfolio Update

The Big Secret on Wall Street PORTFOLIO

Ticker / Latest Update Link	Description	Entry Date	Cost Basis	Latest Close	Yield	Income Received	Total Return	Status / Risk Rating
ENERGY & COMMODITIES								
EQT EQT	U.S. Gas-Focused E&P	06/02/2022	$48.87	$41.20	1.53%	$1.22	-13.19%	Buy Under $50 / 4
BWXT BWX Technologies	Nuclear Power Equipment	12/22/2022	$58.05	$89.26	1.08%	$1.40	56.18%	Buy Under $110 / 3
BTC/USD Bitcoin	Cryptocurrency	05/11/2023	$27,011.85	$68,372.49	N/A	$0.00	153.12%	Buy Under $50,000 / 4
BTU Peabody Energy	Coal Mining	06/22/2023	$21.29	$23.72	1.26%	$0.30	12.82%	Buy Under $25 / 4
CNX CNX Resources	U.S. Gas-Focused E&P	09/28/2023	$22.82	$25.85	N/A	$0.00	13.28%	Buy Under $30 / 3
BATTLESHIP STOCKS								
CACC Credit Acceptanc	Consumer Finance	07/28/2022	$560.28	$487.39	N/A	$0.00	-13.01%	Buy Under $600 / 3
WINA Winmark	Specialty Apparel Stores	09/15/2022	$217.60	$342.99	1.05%	$17.90	65.85%	Hold / 1
NVO Nordisk Sp ADR-B	Pharmaceuticals	10/27/2022	$53.31	$132.80	1.40%	$2.55	153.91%	Hold / 2
FNV Franco-Nevada	Precious Metals Streamer	05/11/2023	$154.77	$124.26	1.16%	$1.74	-18.59%	Buy Under $125 / 2
PYPL PayPal Holdings	Payment Processor	07/20/2023	$73.02	$62.51	N/A	$0.00	-14.39%	Hold / Stop Loss at $50 / 3
FOREVER STOCKS								
DPZ Domino's Pizza	Restaurants	02/27/2023	$300.00	$509.10	1.19%	$6.35	71.82%	Hold / 3
DE Deere & Co	Agricultural Machinery	08/31/2023	$410.94	$368.35	1.60%	$4.29	-9.32%	Buy Under $450 / 3
DEO Diageo Sp ADR	Alcoholic Beverages	12/14/2023	$145.72	$132.33	2.45%	$1.62	-8.08%	Buy Under $160 / 3
DHR Danaher	Medical Technology	03/21/2024	$254.11	$252.74	0.43%	$0.27	-0.43%	Buy Under $270 / 3
NKE NIKE -B-	Athletic Footwear & Apparel	04/18/2024	$95.74	$93.45	1.58%	$0.00	-2.39%	Buy Under $100 / 2
HSY Hershey	Consumer Luxury Staples	04/18/2024	$184.86	$193.13	2.84%	$1.37	5.21%	Buy Under $200 / 2
ULTA Ulta Beauty	Specialty Retail	05/30/2024	$385.58	$385.58	N/A	$0.00	0.00%	Buy Under $425 / 3
HIGH YIELD								
PM Philip Mrrs Int	Tobacco Maker	07/14/2022	$89.62	$99.41	5.23%	$8.98	20.94%	Buy Under $105 / 1
VNOM VIPER ENERGY-A	Oil and Gas Royalty	09/01/2022	$29.68	$38.20	N/A	$3.30	39.82%	Buy Under $34 / 3*
BSM BLACK STONE MIN	Oil and Gas Royalty	02/16/2023	$15.90	$15.85	9.46%	$2.28	13.99%	Buy Under $18 / 2
BRW SABA CAP INM & OPP	High Yield Bond Fund	03/16/2023	$8.01	$7.28	14.01%	$1.31	7.24%	Buy Under $9 / 3
OCSL OKTR SPCLY LNDG	Specialty Investments	03/30/2023	$18.57	$19.49	11.29%	$2.27	17.18%	Buy Under $22 / 2
PROPERTY & CASUALTY INSURANCE								
WRB W.R.Berkley	P&C Insurance	05/25/2023	$56.10	$79.50	0.55%	$1.44	44.28%	Buy Under $62 / 2
PGR Progressive (Ohi	P&C Insurance	06/08/2023	$131.08	$206.93	0.19%	$1.15	58.74%	Buy Under $160 / 2
CB Chubb N	P&C Insurance	06/08/2023	$191.60	$265.15	N/A	$3.44	40.18%	Buy Under $220 / 2
SKWD SKYWARD SPEC	Specialty E&S Insurance	06/16/2023	$24.66	$37.23	N/A	$0.00	50.97%	Buy Under $35 / 2
KNSL Kinsale Capital	Specialty E&S Insurance	05/16/2024	$383.87	$385.81	0.16%	$0.15	0.54%	Buy Under $425 / 3

EXPONENTIAL GROWTH								
TELL TELLURIAN	U.S. LNG Exporter	06/16/2022	$3.82	$0.49	N/A	$0.00	-87.16%	Buy Under $5 / 5
EVVTY Evolution UnSp ADR	Casinos & Gaming	11/30/2023	$103.87	$104.87	2.72%	$2.85	3.70%	Buy Under $145 / 4
INMD INMODE	Medical Devices	01/11/2024	$21.19	$18.87	N/A	$0.00	-10.95%	Buy under $25 / 5
BUR BURFORD CAP NPV	Litigation Finance	02/08/2024	$14.36	$14.17	0.88%	$0.06	-0.89%	Buy Under $20 / 4
CELH Celsius Holdings	Energy Drinks	03/07/2024	$89.56	$78.70	N/A	$0.00	-12.13%	Buy Under $100 / 5
CPNG Coupang Inc	E-commerce	04/04/2024	$18.32	$23.23	N/A	$0.00	26.80%	Buy Under $25 / 4
ATKR Atkore	Electrical Infrastructure	04/18/2024	$171.18	$151.26	0.85%	$0.32	-11.45%	Buy under $200 / 4
BETTER THAN THE MARKET								
SYLD CAMBRIA SHHLDR YLD	Yield Focused ETF	01/05/2023	$59.67	$69.79	2.95%	$1.82	20.00%	Buy Under $65 / 2

**Viper Energy (VNOM) pays out a $0.45 quarterly dividend for a 4.5% annual yield at $40 per share.*

The Big Secret on Wall Street WATCHLIST

Ticker	Description	Latest Close	Initial Analysis	Yield	Status
PAYC Paycom Software	Buy Under $150	$158.95	01/26/2024	0.94%	Application Software
HD Home Depot	Buy Under $240	$329.18	11/10/2023	2.73%	Home Products Stores
ABNB AIRBNB-A	Buy Under $100	$145.52	05/31/2024	N/A	Home Sharing Marketplace
SHW Sherwin-Williams	Buy Under $150	$302.05	04/14/2023	0.95%	Specialty Chemicals

CLOSED POSITIONS	Ticker	Description	Purchase Date	Cost Basis	Sell Price	Yield	Income Received	Total Return	Status
HOVNANIAN ENTERPRISES	HOV	Homebuilder	06-30-2022	$42.79	$36.50	0.00%	$0.00	-14.70%	Sold Sept. 29, 2022
ACTIVISION BLIZZARD	ATVI	Video Games	03-02-2023	$77.71	$90.99	0.00%	$0.00	17.09%	Sold July 11, 2023
AMERIGO RESOURCES	ARREF	Base Metals	03-30-2023	$1.21	$0.91	8.84%	$0.04	-21.90%	Sold Oct. 12, 2023
DREAM FINDERS HOMES, INC.	DFH	Homebuilder	04-27-2023	$14.89	$20.69	0.00%	$0.00	38.95%	Sold Oct. 12, 2023
QURATE RETAIL, INC.	QRTEP	8% Cumulative Preferred Stock	01-19-2023	$40.64	$29.28	27.32%	$6.00	-13.19%	Sold Oct. 12, 2023
ANNALY CAPITAL MANAGEMENT	NLY	Real Estate Investment Trust	02-02-2023	$24.12	$17.78	19.80%	$1.30	-20.90%	Sold Oct. 12, 2023
MICROSTRATEGY INC.	CUSIP: 594972AC5	2025 Convertible Bond	10-13-2022	$758.00	$1,371.14	0.55%	$7.50	81.88%	Sold Nov. 9, 2023
ALTRIA	MO	Tobacco Maker	07-14-2022	$41.63	$42.03	9.33%	$4.74	12.35%	Sold Nov. 30, 2023
HALL OF SHAME									
ICAHN ENTERPRISES	IEP	Specialty Investments	12-08-2022	$50.65	$20.63	38.78%	$4.00	-51.37%	Sold May 25, 2023
ALTISOURCE ASSET MANAGEMENT	AAMC	Asset Management	07-06-2023	$58.00	$10.02	0.00%	$0.00	-82.72%	Sold Aug. 17, 2023

Off the Watchlist: Buy Ulta Beauty

Shares of **Ulta Beauty (Nasdaq: ULTA)**, the leading U.S. retailer of beauty products, have become too cheap to ignore. Despite a disappointing Q1 earnings report released May 31, where the company lowered its 2024 guidance for revenue and earnings, shares rallied 7%. One of the classic bullish "tells" on Wall Street is when a beaten-down stock begins rallying despite bad news. And with Ulta shares trading near an all-time low valuation, we believe it's time to bring Ulta off the watchlist and into the portfolio.

We originally wrote about Ulta in September, when shares traded at around $415. At the time, we decided to put the company on the watchlist to buy at $350. This was based on our view that the consumer would come under significant pressure in 2024:

> *"The U.S. consumer faces extreme near-term headwinds, as inflation remains sticky and higher interest rates start to bite... While Ulta's business will likely*

> *prove more resilient than most, the company's share price will likely suffer from short-term volatility in this environment – just as it did in 2008. Given this outlook, we're placing Ulta on the watchlist today. We believe patient investors will be able to buy shares at pre-COVID levels of around $350."*

While the share price has been volatile since then, the trends in Ulta's business – along with other key consumer bellwethers – have confirmed this trend of growing consumer weakness. In Ulta's case, we can see this through the key retail metric of same-store sales ("SSS"), the change in sales among a retailer's existing store base that excludes new store openings. Ulta's SSS growth has dropped in each of the last five quarters, from 15.6% in Q4 2022 to 1.6% in its latest Q1 results. This has driven a sharp decline in the company's year-on-year revenue growth from 18.2% to 3.5% over the same period.

Despite this slowdown, Ulta's business has remained more resilient than other consumer stalwarts, like Starbucks (SBUX) – which suffered a 4% drop in SSS and a 2% decline in revenue in its latest quarterly report. Meanwhile, even though Ulta's management lowered 2024 guidance, the company remains on track to continue growing at modest rates through this weak macro environment.

In its Q1 report, management lowered its 2024 expectations for SSS down from a previous forecast of 4.5% to 2.5%, at the midpoint of its guidance range. Meanwhile, expected revenue for 2024 was revised down from $11.75 billion to $11.55 billion, which still reflects growth of 3% over last year.

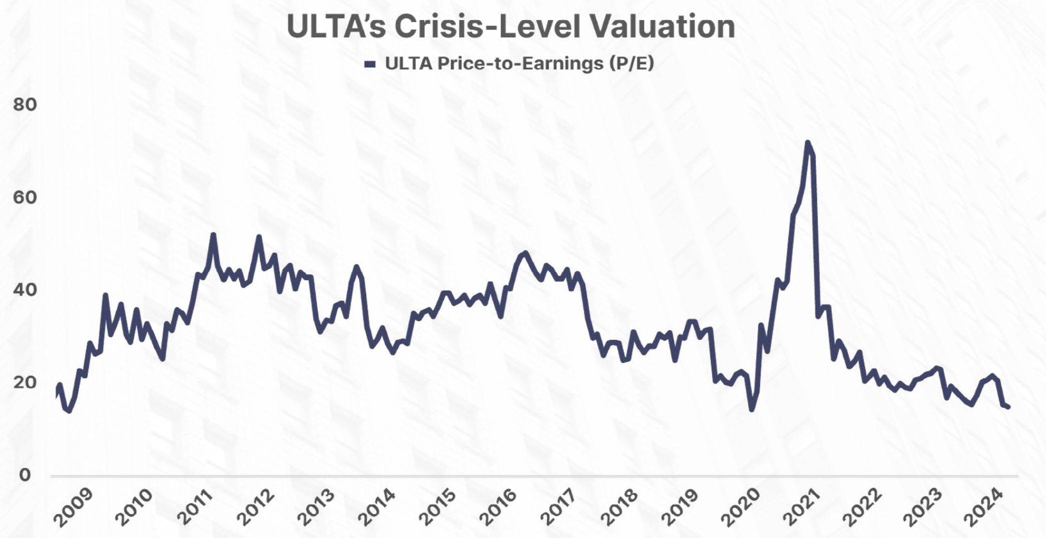
So even though business is clearly slowing from its previous double-digit growth rate, Ulta's business remains resilient in the face of the challenging consumer environment. The company is well positioned to weather further weakness, with a clean balance sheet containing $1.9 billion in debt and $760 million in cash, or $1.1 billion in net debt. Relative to its EBITDA of $2.3 billion (earnings before interest, tax, depreciation, and amortization), Ulta has a very conservative net leverage ratio of less than 0.5x.

This healthy balance sheet, amplified by Ulta's robust free cash flow of $1 billion per year, provides the opportunity to capitalize on the company's depressed share price through an aggressive buyback program. In the first quarter, Ulta returned $285 million to shareholders through buybacks. The company has another $1.8 billion in its current repurchase authorization, and it intends to repurchase a total of $1 billion in stock this year. That represents over 5% of its total share count at today's $19 billion valuation.

And therein lies the final reason why we're willing to pull the trigger on Ulta. When we first wrote about Ulta, the share price was $415, reflecting a 17x earnings multiple. At the time, we expected consumer weakness would keep revenue and earnings roughly flat this year. However, even with a tough macro backdrop, Ulta revenue and earnings continue growing. As a result, Ulta shares are now cheaper today, even with the share price trading modestly higher, at $420.

Based on Ulta's management guidance for $25.5 in earnings per share this year, the company now trades at just over 16x earnings. The stock has rarely traded cheaper outside of two notable exceptions. The first was during the Great Financial Crisis, when it reached a low of 14.1x earnings in February 2009. The second was during the initial COVID-19 outbreak in March 2020, when it fell to 14.4x earnings.

In other words, Ulta already trades like the economy is suffering from a full blown crisis:



Source: Bloomberg

That's why we believe the worst-case fears have already been priced into shares of Ulta today.

Zooming out, our long-term thesis on Ulta is simple. This is one of the rare retail companies that's managed to escape the race to the bottom in profit margins, caused by the rise of e-commerce giants like Amazon (AMZN). The beauty category has remained Amazon-proof, driven by the desire for consumers to physically try and test products in store before purchasing. And Ulta has emerged as the largest, most successful beauty retailer in America over the last several decades.

In our original write up, we explained the two key features of Ulta's long-term competitive advantage, which remain fully intact today.

First, Ulta offers an unmatched product selection of brands ranging from budget-friendly to high-end luxury. This made Ulta a one-stop shopping destination for its customers, and helped the company consistently bring in more business than its competitors.

Second, Ulta kept those shoppers coming back for repeat purchases by building one of the most successful customer-loyalty programs of all time. Ulta was one of the first retailers to capitalize on the power of loyalty programs to create sticky customer relationships, first introducing its program in the 1990s. Since then, the company has brought 42 million customers into its loyalty program. For perspective, the vaunted Starbucks rewards program has just 34 million members. Ulta's membership numbers are even more impressive when factoring in Starbucks' global footprint that generates over three times as much revenue as Ulta's purely domestic business.

By encouraging repeat business, Ulta has continuously found ways to unlock more sales and profits out of its existing stores. This is how the company generates some of the best economics in the retail industry, with double-digit profit margins and 62% returns on equity. And even with the recent 30% drop in its share price, the business has generated world-class shareholder returns of 20% annualized since going public in 2007.

With a rock bottom valuation of 16x earnings, we believe now is the time to own this stock for the long-term, even as we remain cautious about further macro weakness in the months ahead.

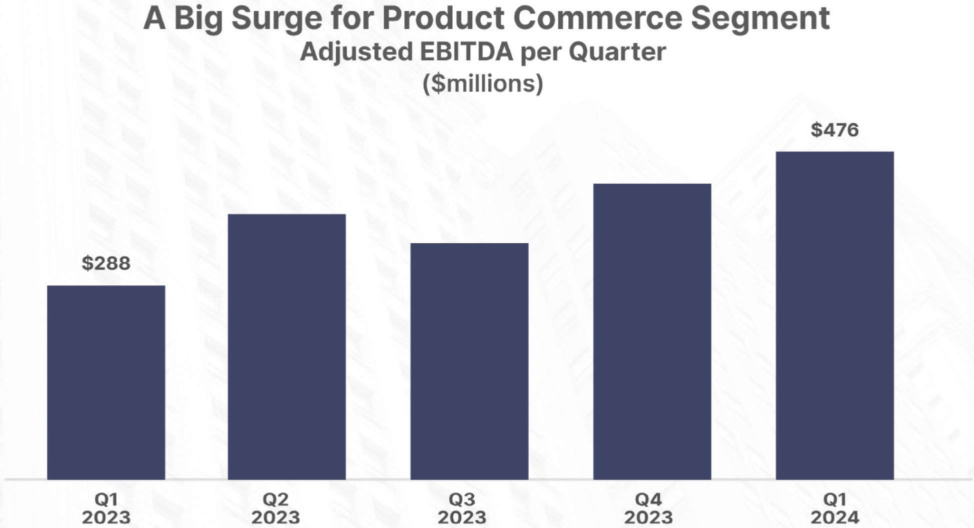
As a result, we're moving the company off the watchlist and into the portfolio with a buy recommendation today.

Action to Take: Buy **Ulta Beauty (Nasdaq: ULTA)** up to $450 per share

Coupang's Core Business Shines

Shares of **Coupang (NYSE: CPNG)** have gained 25% since our recommendation on April 5. Coupang has only a single-digit market share of the retail category in South Korea, but Coupang's size and larger infrastructure compared to its peers will help it gobble up the $500 billion retail opportunity that exists in the country.

In the first quarter, revenue for Coupang's Product Commerce segment grew 20% to $6.5 billion, while EBITDA (earnings before interest, taxes, depreciation, and amortization) expanded a remarkable 62% to $467 million for the quarter. This core segment includes merchandise e-commerce, its Fresh grocery-delivery service, and Fulfillment & Logistics by Coupang ("FLC"), which is Coupang's delivery service for third-party suppliers.



Active customers in the segment grew 16% over the last year, to 21.5 million. Fresh deliveries increased 70% while FLC recorded a 130% increase in units sold.

Since Coupang has the infrastructure to orchestrate low-cost deliveries to a large customer base, it can offer more options, further solidifying itself as a core part of South Korea's retail market. By purchasing more inventory from farmers, fisheries, and merchants in general, Coupang is making it easier and more cost effective for distributors to sell through its network. The result is that consumers can find more products on Coupang, whether from a small- to mid-sized merchant or from a local farmer. By increasing selection, Coupang is spurring greater demand.

Coupang's WOW – its version of Amazon Prime – offers a range of benefits for subscribers, like unlimited next-day deliveries, free deliveries for Coupang Eats (restaurant delivery), and exclusive discounts. In 2023, the number of WOW subscriptions grew faster (27%) than active customers (16%), and we expect the growth of WOW subscriptions to outpace active customers. On its first-quarter earnings call, Coupang reported that the majority of WOW subscribers are not ordering food through Coupang Eats – creating the opportunity to encourage more WOW subscribers to spend more through Coupang.

The Product Commerce segment is on track to deliver over $2 billion in EBITDA for 2024, or 33% year-over-year growth. However, the Developing Offers segment, which includes new business lines like Coupang Eats and its Taiwan division, are not yet profitable. This segment also includes Farfetch – an e-commerce platform that connects buyers and sellers of luxury goods – that Coupang acquired in February. But Developing Offer's net revenue jumped 337% to $620 million. While the segment will lose about $750 million in 2024, substantial profits could materialize down the road.

Since Coupang's 2021 IPO, the share price is down 35%, but the company is now generating more than $1 billion in free cash flow per year, growing its cash position to $5.2 billion. It continues to invest heavily in growth – international expansion in Taiwan and catering to the entire retail market of South Korea. At 23 times enterprise value to 2024 EBITDA, Coupang is still trading at a low valuation for a business still in its early innings of growth and already profitable.

Action to Take: Buy **Coupang (NYSE: CPNG)** up to $25 per share

Philip Morris: Despite Supply Constraint, ZYN Sales Soar

The world's largest nicotine company, **Philip Morris International (NYSE: PM)**, continues to perform strongly since we first recommended the stock in July 2022. While the price of PM shares is up a modest 11%, the company has been successfully transitioning away from traditional tobacco and into smoke-free products as a way to take market share, increase profits, and outperform other Big Tobacco companies.

Philip Morris' ZYN nicotine pouches and IQOS nicotine sticks that "heat not burn" tobacco are becoming the two most popular smoke-free nicotine brands globally.

ZYN nicotine pouches are taking the U.S. by storm and Philip Morris is struggling to keep up with demand. In 2018, ZYN sold 10 million nicotine pouches, and now, six years later, the company is on track to sell 50 times that number.

In the first quarter, ZYN shipment volumes were up more than 80% over the last year while ZYN's market share reached a record high of 79.3%, versus 75.6% in Q1 2023. ZYN's impressive growth is straining the company's supply chain, but it is confident it will have the capacity to deliver 560 million ZYNs in 2024 – a supply-limited 45% increase over 2023.

As a result of this demand overload, there is a ZYN shortage across the U.S. with smoke shops and gas stations in New York, New Jersey, Florida, and Texas (including the following empty ZYN gas-station shelf), finding them hard to get.

Empty ZYN shelf in Texas

Meanwhile, the number of IQOS users has risen from 19 million to 28.6 million. The huge demand for these two products is a testament to the success of Philip Morris's smoke-free segment, which is fueling both revenue and earnings growth for the company. When we recommended PM shares two years ago, smoke-free revenue made up 30% of the company's total. Currently it makes up 40% of total sales, while traditional tobacco products make up 60%. Philip Morris expects this ratio to flip-flop: by 2030, the smoke-free segment will make up more than two-thirds of sales.

This growth surge in ZYN indicates that the smoke-free segment could deliver another blowout quarter for Philip Morris. This recent performance also indicates the company can raise prices for these nicotine pouches, given that the most recent cost increase, in March, hasn't stopped consumers from stripping shelves bare of the product.

Since adding Philip Morris to The Big Secret portfolio on July 15, 2022, revenue has grown 13.2% – to $35.9 billion. Philip Morris shares have returned 21.4% ($8.98 in total dividends and a $10 gain in share price).

Philip Morris is proving that it can reinvent itself with smoke-free products. Philip Morris reported 25% growth in its smoke-free segment in the first quarter of 2024 driven by the strong growth of ZYN and IQOS (which we analyzed in our **May PM update**). Plus, Philip Morris is incredibly capital efficient, with a 27% return on capital and a 33% operating margin while it pays out a well-covered 5.2% dividend.

At around $100 per share, PM is one of the "3 Best Buys" in *The Big Secret* portfolio. If you don't yet have a position, we recommend buying shares today.

Tellurian Sells Production Assets to Keep Driftwood Alive

On May 29, **Tellurian (NYSE: TELL)** announced the sale of its oil-and-gas producing assets to private investment firm Aethon Energy for $260 million, providing a much-needed cash infusion for the company.

Tellurian has secured regulatory approval and has begun construction on Project Driftwood – the company's make-or-break liquid natural-gas ("LNG") export facility in Louisiana – but it lacks the necessary financing to complete it. The company has been losing $30 million per quarter, and as of Q1, it had just $50 million in cash remaining.

Tellurian has roughly $480 million in debt coming due May 1, 2025. So even with the cash infusion from this sale of its 31,000 acres of production assets across the Haynesville/Bossier shale basin in Texas and Louisiana, the company only has four to five quarters left before it runs out of money, unless it can raise additional funds or refinance its debt.

America's LNG export industry is one of the country's greatest assets. It will create billions of dollars in wealth and secure U.S. energy independence for decades to come. It's also a geostrategic asset that's helping Europe wean itself off Russian gas. Tellurian's Project Driftwood is one of the few LNG export projects approved by U.S. regulators and, if fully completed, would be one of the largest LNG export facilities in the world. At capacity, it would generate $1.7 billion of cash flow per year for Tellurian – creating huge upside for the stock.

For this reason, we continue recommending that investors hold shares of **Tellurian (NYSE: TELL)**. Owning TELL shares remains highly speculative – with our highest-risk rating of 5. Investors should keep the size of this position limited to what they can afford to lose.

Mailbag

In *The Big Secret on Wall Street* mailbag, Porter answers letters from readers. He cannot offer individual investment advice, but can respond to general questions.

Please email us at **mailbag@porterandcompanyresearch.com** to have your questions answered. We'd love to hear from you!

Today's letter is from J.P., who writes:

> *"I have a question about the September 29, 2023, Big Secret issue, "Shale Boom 2.0," about the benefits of natural gas. I have a few questions:.*
>
> ***1.*** *I was very interested in the portfolio recommendations. Obviously in CNX, but also the "3 Best Buys": CACC, VNOM, PYPL, as well as EQT and BWXT These recommendations are over seven months old. Are they still valid as purchases now? I did note that Porter wrote something like, pick good stocks and you need not worry about when to sell.*
>
> ***2.*** *EQT was spoken of positively and is in the same business as CNX. EQT pays a slightly higher dividend. Is it considered equivalent to CNX? Previously, a Marcellus Shale gas recovery stock was mentioned favorably but not identified except that three brothers owned the natural-gas company. Is that stock EQT?*
>
> ***3.*** *The Risk Rating in the table goes from 1 to 5. Is a rating of 1 or 5 the more risky?"*
>
> ***Porter's comment: Hi J.P., thanks for writing in.***
>
> ***1. Our goal at Porter & Co. is to bring you world-class investment research, focused on "inevitable" businesses that you can buy and hold forever We even have a category in the portfolio dedicated to what we call Forever Stocks. Forever Stocks are the businesses that transcend time and contain***

*some of my favorite companies, like **The Hershey Company (NYSE: HSY)**, **Domino's Pizza (NYSE: DPZ)**, and **Nike (NYSE: NKE)**. These in particular are the types of businesses we want to own forever and need not worry about when to sell.*

Every other week, we release the new "3 Best Buys" in The Big Secret on Wall Street. The "3 Best Buys" section highlights three portfolio recommendations that are at attractive buy points and that we like the most.

*Take **Franco-Nevada (NYSE: FNV)** for example. The company experienced a major setback when its largest mine was shut down by the Panamanian government in October. We believe the market overreacted – shares declined roughly 25% but the mine only contributed 18% of the company's revenue. Today, Franco-Nevada is still trading at a discount relative to its peers, but it's on track to recover production lost from the closed mine this year from new mines coming online. Plus, with the price of gold near an all time high, the rest of Franco-Nevada's portfolio is producing strong revenue numbers while trading near its lowest valuation on record.*

*For each position in The Big Secret portfolio, the "Status" on the **portfolio page** includes the current buy-up-to price and the latest "Action to Take" for each position. If the recommendation is no longer below its buy-up to price, its status is a hold – meaning if you own it, don't sell, but if you don't own it, don't buy it. To access the analysis behind the latest "Action to Take," click the link under the "Latest Update Link" header of **The Big Secret portfolio**.*

*So, **Credit Acceptance (Nasdaq: CACC)** is a buy up to $600… **Viper Energy (Nasdaq: VNOM)** is currently a hold (it's a buy up to $34)… **EQT (NYSE: EQT)** up to $50… **BWXT Technologies (NYSE: BWXT)** up to $110… and **PayPal (Nasdaq: PYPL)** is a hold with a stop loss set at $50 per share.*

2. *Yes, EQT is the natural-gas company operated by the three brothers – Toby, Daniel, and Derek Rice.*

__CNX Resources (NYSE: CNX)__ and EQT are both low-cost natural gas producers. However, CNX is more focused on returning profits to shareholders via buybacks ($1.35 billion in buybacks over the last 12 months) whereas EQT is focused on investing free cash flow back into the business to drive greater profits to eventually return to shareholders. EQT is investing aggressively to become the first fully vertically integrated U.S gas producer. This means controlling every stage of the gas value chain, from production to transportation, which will lower EQT's break-even price to less than $2 per million British thermal units (MMBtu). This will position EQT – the largest U.S. natural-gas producer – to drive significantly more

> ***profits when gas prices are higher while removing the need to hedge the majority of its production when prices fall.***
>
> ***In the long run, America's shale gas and liquified natural-gas export industries are two of the country's greatest assets. Together, they will create billions of dollars in wealth and secure U.S. energy independence for decades to come. Both CNX and EQT are well positioned to thrive as U.S. natural gas becomes more critical for the country's energy independence.***
>
> ***3. Risk Ratings**, as we explain on our website, are meant to help members appropriately allocate funds to our recommendations based on risk. Recommendations ranked closer to 1 are considered the "low risk, high allocation" stocks, whereas positions rated closer to a 5 are higher risk.*

Porter Stansberry

Porter & Co.
Stevenson, MD

P.S. If you'd like to learn more about the Porter & Co. team, you can get acquainted with us **here**. You can follow me (Porter) on **X** here: **@porterstansb**