

CoStar Group (CSGP)

Dominant Services with a World of White Space

CoStar Group is a leading provider of commercial real estate information services. With an army of researchers, a massive proprietary database, and a track record of consistent investment, its services have become essential tools for real estate professionals. The group has built a wide moat that we believe is unlikely to be crossed by any competitor. CoStar Group scores high in our quality assessment and has a clean balance sheet. We have been able to buy the company at what we believe is a significant discount to intrinsic value, making it a prime example of our Quality-at-a-Discount (QuaD) investing approach.

Founded in 1987, the group has grown into the largest provider of data, analytics, and online marketplaces to the commercial real estate industries in the United States and the United Kingdom. CoStar Group currently has three businesses that attract our interest. They are:

- **CoStar Suite:** The group's original real estate data service.
- **LoopNet:** A listing venue for for-sale and for-lease commercial properties.
- **Apartments.com:** Along with related subsequent acquisitions, a collection of online consumer marketplaces serving the U.S. apartment rental market.

Prior to its 2012 acquisition, LoopNet (at least tangentially) competed with the group's original service, CoStar Suite. Now under the same roof, a delineation of purpose exists, and the two can invest and grow without collisions of effort.

Weathering the Storm

Before we delve any deeper into the businesses themselves, let's give reality its due. COVID-19 will likely exact payment in some form from nearly every business we could own. This period of upheaval will undoubtedly impact CoStar's customers, and their renewal rates – normally above 90% – are unlikely to be spared in the coming year. But as we look at what the business could become over the next decade, we and other owners have several things working in our favor. CoStar has over a billion dollars in cash on the balance sheet and no debt. While management has a history of creating value through acquisitions, they have never mortgaged the company's future to do so. Each of the group's three primary businesses dominates its field. They are all plumbing massive, growing markets. They enjoy high incremental margins and earn very attractive returns on capital. Each business has exhibited great operating momentum coming into this period, and none lies directly in the crosshairs of the virus itself.

CoStar Suite

The group's original data service, CoStar Suite, began as an outsourced research department serving commercial real estate brokerages in the Washington, D.C., area. Over the decades, it expanded along two axes: deepening coverage within existing markets and expanding to new ones. As coverage grew, so too did CoStar's universe of users, starting with brokers and expanding to lenders, owners, and service providers. New market expansion requires an upfront investment in data gathering, which is expensed through the income statement. Thus, any period of CoStar's accelerating coverage has taken a chunk out of reported earnings in a way that misrepresents underlying value creation. This may well happen again with an acceleration in Europe, and we would welcome it.

The beating heart of CoStar's subscription business is a research department some 1,600 strong, tracking 110 billion square feet of real estate across 400 markets and 1,400 submarkets. The annual research budget alone dwarfs the relevant revenue of any competitor. Additionally, CoStar's own investment in data collection is effectively doubled by input from its subscribers themselves. That user effort is unlikely to be duplicated on a second network, especially one offering only a fraction of CoStar's audience. This inexorably growing layer cake of data uniquely offers comparability



JONATHAN BAKER, CFA
Research Analyst

Jon joined Weitz Investments in 1997. Prior to joining the firm, he audited equity funds (including the Weitz Funds) as a certified public accountant at McGladrey & Pullen. Jon has a bachelor's in accounting and computer applications from the University of Notre Dame.

across both geography and time – something no upstart could approach without immense losses over a period of many years. CoStar Suite’s cost to serve each new subscriber is effectively zero, and the cost to research its next geographic market can be leveraged over the largest user base in the industry. With a management team intent on continually growing both subscribers and coverage, we believe CoStar Suite has a global glide path and will never be caught from behind.

LoopNet

Whereas CoStar Suite is a ‘free to submit, pay to view’ subscription-based information service, sister company LoopNet is a ‘pay to submit, free to view’ marketing venue. LoopNet has aggregated the largest audience of commercial real estate professionals in the U.S. To put the tremendous size of its audience in perspective, LoopNet’s web traffic is 22x that of its 50 largest competitors combined. Anyone wishing to put for-sale or for-lease opportunities in front of that audience must pay the ferryman.

While only about a quarter of CoStar Suite’s size, LoopNet boasts higher margins, has been growing more quickly and is about to benefit from a widened marketing aperture. As international expansion continues, we believe management will want to own information services as well as marketing venues in each geographical region it serves.

Apartments.com

Lastly, and perhaps most importantly, we have 2014 addition Apartments.com and related subsequent acquisitions. These are websites that allow apartment owners to advertise vacancies to apartment hunters. The business reminds us of online travel agent Booking.com’s early years in Europe. Both of these online marketplaces serve as an intermediary, helping two ultra-fragmented groups make sense of one another in a highly efficient manner.

While Apartments.com has large fixed costs, its marginal costs to serve each next renter or landlord approach zero. Thus, topline growth falls disproportionately to the pre-marketing income line, creating additional capacity for marketing investment, which spurs further growth and so on. As the largest player in the U.S., Apartments.com is the only apartment listing platform that can efficiently buy national television advertising. Along with a scaled investment in user experience, the business’s greater branding increases conversion rates on **search-engine marketing (SEM)** investment. Higher conversion means higher returns on SEM and – for an aggressive management team that is not remotely solving for near-term margin maximization – perhaps the ability to tip nearly all other players off the board.

In 2019, Apartments.com and CoStar Group’s other apartment rental websites already had two-thirds **click share** in the U.S. In second place was the highly leveraged, and now bankrupt, RentPath with 17% share. While RentPath had been aggressively shopped for 18 months, a stalking-horse bid from CoStar Group was the only interest surfaced. It’s likely that CoStar’s acquisition of RentPath will either be approved by the Department of Justice, or RentPath will evaporate (and its volumes potentially move to Apartments.com regardless). If this set of circumstances doesn’t already trouble competitors, they should consider the additional \$100 million in marketing expenditure, on top of an already industry-dwarfing \$150 million in 2019, that CoStar Group intends to spend this year.

About two-thirds of large apartment communities already advertise on CoStar Group’s rental websites. But as the company continues to invest in both consumer awareness and utility, their share of assisted transactions can continue to deepen. There is also a massive, yet largely untapped, population of smaller communities and independent owners to which CoStar is turning its gaze.

Biggest Threats

As is the case with the online travel agents, Google will be an ever-present threat to the apartment rentals business. However, like Booking.com, Apartments.com’s approach to customer acquisition is SEM-heavy and more closely aligned with Google’s goals than free-riding marketing models. In addition, Apartments.com has access to real-time market data from both CoStar Suite and

Search-engine marketing (SEM) is the practice of marketing a business using paid advertisements that appear on search engine results pages.

Click share is the number of clicks received compared to the estimated total number of achievable clicks in a search or marketing campaign.

the apartment rental sites that can be shared with paying landlords. And unlike Booking.com, Apartments.com is already looking to get its hooks deeper into both renters and landlords via other convenient services, offered at no additional cost.

Regarding other players in real estate services, including household names such as Zillow and Redfin, we believe CoStar Group's industry-leading research investment and marketing budget will allow the company's data services and marketplaces to remain unrivaled.

Despite CoStar's dominant position, we don't currently see any cause for anti-trust concern. The ongoing RentPath acquisition aside, we believe the company's future acquisition activity will focus upon complementary – rather than competing – markets and services. Because of this, we believe CoStar is unlikely to raise alarm bells with regulators.

Competent Hands at the Wheel

None of the futures discussed here are given. Each of these businesses may need to pivot somewhat from the approaches that have earned each so much success to date. But CoStar Group is governed by a rarity – a founder and team that have managed adaptably for decades, with a balance of both prudence and aggressiveness. With respect to discretionary investment – both organic and acquired – CoStar's management team has hit for both power and a high batting average. They also have the means and mindset to continue to invest through this period of uncertainty. If all is right in the world by next year, there will certainly be stocks of less advantaged companies that will outperform CoStar's. But for the coming decade, we believe the qualities of CoStar Group's businesses can make it a meaningful creator of wealth for the Funds' shareholders.

IMPORTANT DISCLOSURES

Past performance is not a guarantee of future results. All investments involve risks, including possible loss of principal.

As of 03/31/2020, each of the following portfolio companies constituted a portion of the net assets of Balanced Fund, Hickory Fund, Partners III Opportunity Fund, Partners Value Fund, and Value Fund as follows: Alphabet, Inc.-Class C (GOOG) 1.9%, 0%, 5.2%, 6.4%, and 7.1%. CoStar Group, Inc. (CSGP) 0%, 2.8%, 0.7%, 2.8%, and 2.7%.

As of 03/31/2020 Booking Holdings, Inc. (BKNG), Redfin Corp. (RDFN) and Zillow Group, Inc. (ZG) were not held in any Weitz Funds.

Holdings are subject to change and may not be representative of current or future investments.

The opinions expressed are those of Weitz Investment Management and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions are current through 05/04/2020, they are subject to change at any time based on market and other current conditions, and no forecasts can be guaranteed. This commentary is being provided as a general source of information and is not intended as a recommendation to purchase, sell, or hold any specific security or to engage in any investment strategy. Investment decisions should always be made based on an investor's specific objectives, financial needs, risk tolerance and time horizon.

Investors should consider carefully the investment objectives, risks, and charges and expenses of a fund before investing. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com or from a financial advisor. Please read the prospectus carefully before investing.

Weitz Securities, Inc. is the distributor of the Weitz Funds.