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A Constellation of Worries

Will Valuations, Rising Interest Rates, Fewer Stimulus Payments, Labor Shortages, & Inflation Stop the Consumer and Wreck Returns in 2022?

After nearly two years of uninterrupted new highs, the market is running into interference as we close out 2021. One sign of a market top that we look for is stocks going down on good news. We're seeing that a lot right now, especially for consumer names that are reporting exceptionally great figures. However, we don't think it's the warning that it has been sometimes in the past. Why? First, we believe the calendar is a factor. In December, professional investors, many of whom get paid on a calendar cycle, are trying to protect the year's gains by exiting positions. Simultaneously, this group is averse to committing new capital. (They want to take the last few weeks of the year off, who wouldn't?)

But there is a bigger constellation of worries hanging over the market. The calendar is not fully to blame. Investors are also concerned that the consumer (2/3 of U.S. economic activity) will weaken following a year of record spending. Why would this happen? Inflation (higher prices) across a range of goods and services is anticipated to eat into discretionary spending. There will be fewer stimulus payments flowing from Uncle Sam. Interest rates are expected to rise, hurting access to capital, and slowing refinancing of mortgages. But the number one worry, in our opinion, is a sneaky suspicion that a structural lack of labor availability will slow overall economic growth. (Click here for an investment we wrote about last month that is designed to benefit from an environment of wage rate growth.)

Where have all the workers gone? This is the big question that professional investors (and hiring managers) are asking themselves and any poor soul who will listen. Previously it was believed that overly generous extended unemployment payments were keeping people at home. These have since been exhausted without much improvement. Another explanation is therefore needed. We know there are also covid-related after-effects. Some people who aren't working because they can't find adequate childcare. Others fear for their health or the health of family members and don't want to be exposed to omicron or whatever Greek letter comes next. But it's not adding up. Jobs and signing bonuses are going wanting. Don't people need incomes?

We believe official unemployment figures are undercounting wage-earners. A recent Wall Street Journal article called out a record number of unincorporated self-employed workers and a record number of workers quitting their jobs. Our hunch is that some of these potential employees have found new ways to earn a living, which we discuss further below. The point we want to make is that new ways of earning a living outside of traditional corporate structures suggests that these individuals may not be showing up within the workforce, even though they are working and spending. If true, there is an important implication for stocks.

What's The Most Important Factor for U.S. Economic Growth?

Consumer spending is 2/3 of U.S. economic activity. Other things can blow-up the economy, but provided the consumer is healthy, we believe a bullish outlook for U.S. stocks is justified. What is the most important factor determining consumer spending? It is employment and wage growth. Wages are growing at the fastest rate in decades. Employment is already back to very strong pre-pandemic levels and may be even better than the data suggests, based on the reasoning we outlined. Other factors including home values and the stock market are positive. A small increase in interest rates and higher prices for gasoline and bananas are not going to stop the consumer from spending.

Charlie Munger Says Valuations are "Crazy"

Even if stocks, on average, are overvalued, there are plenty of attractively valued companies in the market. Charlie Munger is the right-hand man of Warren Buffett and a renowned value investor. People pay attention to what he says. He may be right that valuations of the market in general and select companies are too high. However, this only matters if you are buying or investing in the over-valued companies. The market can be crazy and there can still be plenty of stocks that are attractively valued relative to their future cash flows and growth prospects. There are even high-quality stocks that can be described as downright cheap.

If your only investment strategy is to buy S&P500 funds at prevailing prices then you have no mechanism to avoid the overvalued stocks. In contrast, our strategy is to own a small number of high-quality companies that can grow over the long-term. The price people are willing to pay for money-losing EV truck companies or for dodgy crypto-"assets" with no known use is not relevant. We therefore spend little time thinking or worrying about the overall market multiple, which is also not a meaningful economic risk factor, in our opinion. There is no ominous alignment of stars.

Recent Purchase in Client Portfolios: Upwork, Inc. (UPWK)

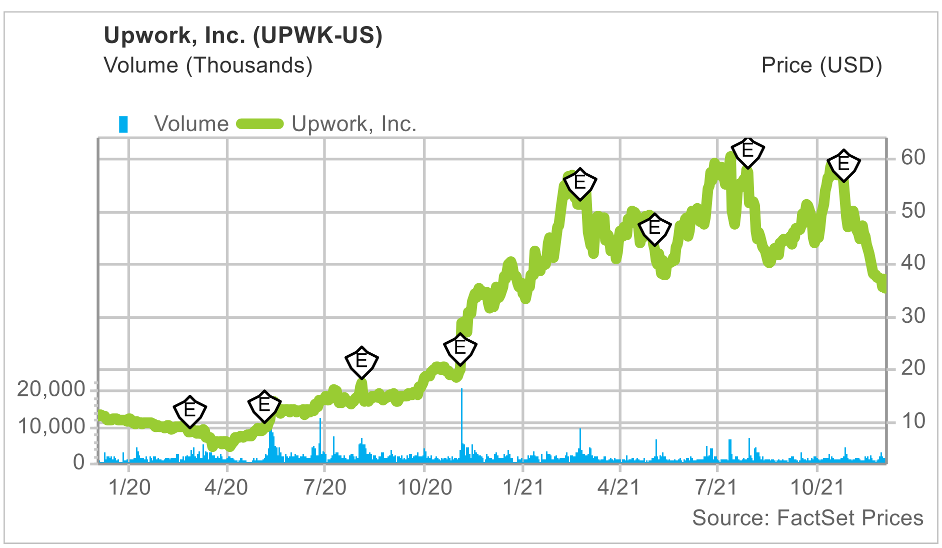
The Airbnb of work. Upwork Is a digital platform for connecting skilled workers with employers for short or limited duration projects. Some of the professional competencies featured on the Upwork marketplace include website and app development, creative and design, finance and accounting, and consulting among others. Upwork's simple business model is like that of Airbnb (ABNB). Airbnb's highly profitable model generates fee-based revenue through connecting renters with owners of apartments and houses, without having to own or manage the properties. Upwork earns a fee by connecting workers with companies without having to develop the skills, deliver the services, or hire anyone. One big difference is that everyone has heard of Airbnb, but awareness of Upwork is still in the single digits.

At the nexus of structural changes in societal values, attitudes towards careers, and corporate needs, enabled by still-developing digital platforms and accelerated by Covid19 and its many variants. Prior to the pandemic, there was already a "gig worker" trend, enabled by technology, that was opening jobs for individuals outside the traditional corporate executive-manager-worker paradigm. Post-vaccine, two factors are accelerating this shift in work and life objectives for professionals. First, remote work is now accepted and not going away. Second, personal *well-being* has thankfully been elevated as a value. In combination, these factors have dramatically reduced the appeal of a time-sucking daily commute to a covid-invested city center and provided a viable alternative. Professionals and entrepreneurs are turning to digital gigs or side-hustles to earn a living in a location that suits their lifestyles.

UPWK should grow and become a highly profitable business. Upwork will produce approximately one-half billion dollars in revenues in 2021. This represents about 33% growth. Analysts are modeling 24% revenue growth in 2022. Longer-term, the company has provided a credible target of $1B in revenues by 2025. To generate this growth, the company is aggressively ramping its marketing spend, which currently represents about a third of revenues. This and other investment spending mean that current profitability is minimal. However, gross margins are near 80%, which is very high. The robust gross margins reflect that Upwork revenue is a fee on the value of work exchanged by others. (Note that UPWK gross margin is consistent with that of ABNB.) Normally, a company that enjoys 80% gross margins should be very profitable. Consistently with our thinking, the company has published a public long-term target of 30%-35% for EBITDA margins, which would be exceptional. (Continuing the comparison, ABNB EBITDA margins are over 25% today, with expectations of increases in the future.)

So, what is UPWK worth? If Upwork can grow as we expect and demonstrate a path to much higher structural levels profitability, we believe the stock will get a multiple to match, which is to say a very large one. Using a 10x multiple to revenues the stock could be worth a cool $10B by 2025, which compares to $4.5B today (the current price to sales multiple is 7x) which represents more than a double over four years. We recognize that any value investors reading this are howling at the heresy of using a double-digit multiple to revenues to set a price objective. So be it. We believe this is the multiple the market will assign a company that can grow quickly and ultimately covert $0.30+ of every dollar of revenue to cash flow. That said, this investment does carry a higher risk profile (due to the valuation) and we have sized it appropriately in our client books.

Figure 1: Upwork, Inc. (UPWK) two-year chart. Shares are still up considerably from 2020 levels but have corrected more than 50% from a July peak above $64.



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Yours,

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Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and the University of Oxford. He has followed U.S. consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor (RIA) and research consultancy, in 2017 and works from New York, NY and Paris, France or wherever he has his laptop.

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