Relationship George, Or: Why We Learned to Stop Worrying and Love Match Group

George*: You see, right now, I have Relationship George, but there is also Independent George. That's the George you know the George you grew up with - Movie George, Coffee Shop George, Liar George, Bawdy George.*

Jerry*: I love that George.*

George*: Me too! And he's dying Jerry! If Relationship George walks through this door, he will kill Independent George! A George, divided against itself, *cannot* stand!*

Romantic relationships are one of the core functions of human existence, and picking a romantic partner is one of the most important decisions you will make in your life. Relationships have gone on for tens of thousands of years and will continue as long as, well, there are still humans around. This “industry” is highly predictable, and is one of the few things you can have confidence will still be around 50 or 100 years in the future, making it an optimal place to hunt for potential investments.

How are people finding romantic partners these days? In 2022, with more and more communication moving online, searching for a romantic partner has moved from the bar and coffee shop to dating apps. This is a well-known phenomenon, and has helped services like Tinder, Bumble, and Hinge become vital intermediaries in the relationship process.

We are long **Match Group** stock because it is the dominant player in online dating, giving it immense and growing power over the population of single people worldwide. This may seem like a callous way to describe the business, but it is the proper way to look at it from an investment lens.

For those that are unaware, Match Group owns every popular online dating property outside of Bumble, Badoo, and Grindr. Its apps and services include Tinder, Hinge, Match.com. BLK, Chispa, and many others. You can find more specific information on its corporate website: https://mtch.com/

We believe that, at the current price of ~$117 a share, Match Group can deliver ~15%+ total returns for shareholders over the next three to five years. With an enterprise value to free cash flow (EV/FCF) of approximately 37, this will require above-market rates of free cash flow per share (FCF/s) growth, as at least some multiple compression is in the cards.

Our expectation is for Match Group to grow revenue by 20% annually through the end of 2025, expand its adjusted EBITDA margins from 35% to 40%, maintain a free cash flow conversion of

90%, maintain a 3x leverage ratio, and start returning excess cash to shareholders through share repurchases[1]. If that happens, and at the end of 2025 the market assigns an EV/FCF of 25 to Match Group stock, we'll return approximately 15% on our investment from these prices. This would be a 4% free cash flow yield, which is what we believe is a reasonable multiple for a business of Match Group's quality.

While all those numbers sound neat and perfect, in reality predicting 2025 profit margins and future cash flow multiples is an exercise in false precision. Just because our basic model says free cash flow will be X amount in 2024 does not mean it will come true. In all likelihood, it won't. But we are confident in the *direction* of our predictions, which is why we are comfortable owning the stock right now.

Our reasoning for our assumptions is outlined below, along with an analysis of Match Group's competitive advantages.

Sustainable double-digit top-line growth

Our thesis starts with a prediction that Match Group can sustain above-market revenue growth (20% in our model) through 2025. There are many ways to divide it up, but we put Match Group's revenue into four buckets: Tinder, legacy services, Hinge and emerging, and pricing power. We are ignoring Hyperconnect with this analysis, as we have little insight into what that segment will look like at the end of 2025.

Tinder is the majority of the business right now, with 10.4 million paying customers last quarter. The app targets more casual relationships and a younger audience (18 to 29), and is present in almost every major market around the globe. Last quarter, Tinder's direct revenue grew 20% year-over-year and makes up over 50% of the company's overall sales. We believe Tinder can grow at 10%+ for the foreseeable future through continued adoption of online dating and sustained pricing power. In 2020, only 48% of 18 to 29-year-olds in North America had used a dating app. Given that this is one of online dating's most mature markets, penetration globally is much lower. While the percentage of young people who use dating apps will never reach 100%, we believe it can get much higher than 50% around the world, which is a tailwind that Tinder can ride over the next five years.

Legacy services don't need to get talked about much. It should generate stable revenue and cash flow, but has minimal growth potential. This segment includes Match.com, Plenty of Fish, and OkCupid. In Q2 of 2021 (the last update we got on the division) revenue grew 13%

[1] Repurchases is used as a placeholder for what management chooses to do with excess cash on balance sheet. It is unclear what they will actually do with the cash.

year-over-year, but that is coming off of an easy comparison in 2020 and 2019 when revenue was declining year-over-year.

Hinge and emerging is the most exciting segment within the Match Group portfolio. Hinge is the second biggest dating app under the company's umbrella and is the third highest-grossing dating app in the world (Bumble is 2nd, but Hinge is gaining quickly). The app has unique aspects, but it is more relationship-focused and serves a slightly older audience than Tinder, typically the 25 to 45-year-old age bracket. Revenue is growing over 100% for the app right now, and that is while it is focusing on user growth instead of monetization. In 2022, Match Group plans to scale Hinge to non-English speaking countries and focus on refining monetization within the app. If the app can go global, it has a chance to become the *second Tinder for Match Group*, bringing in north of $1 billion in revenue each year. It is a key reason why we think Match Group can sustain 20%+ revenue growth through 2025. Besides Hinge, BLK and Chispa are doing well for the emerging segment, with the apps ranked fourth and sixth, respectively, in the Google Play top-grossing dating apps category at the moment. These apps are small and serve specific cultural niches (black for BLK and Latino for Chispa), but provide optionality for Match Group if they catch fire over the next few years.

Match Group has phenomenal pricing power across its portfolio due to its competitive advantages (discussed below) and the value of providing access to potential mates. For most, romantic relationships are a need instead of want. To us, that signals that some of Match Group's apps will have the pricing power of addictive consumer products like cigarettes and coffee. It will be a bit more difficult to manage the brands and platforms compared to just pumping out Marlboros every year, but the principle still applies. It doesn't matter if you charge $30, $60, or even $1000 for dating app services. The customer is going to pay up in the end if it is the only viable way to get a romantic partner.

Margin expansion and app store call option

We expect Match Group's adjusted EBITDA margins to expand from 35% to 40% by 2025. These apps have minimal upkeep costs, with costs of goods sold all coming from computing (i.e. paying the cloud provider), app store fees, and customer support. As the company scales its revenue, we expect all three operating expense lines (R&D, sales and marketing, G&A) to slowly decline as a percentage of revenue. Each incremental subscription/product sale has a 72% profit margin (Match Group's gross margin). Given the asset-light nature of the business, we are comfortable underwriting margin expansion up to 40% by 2025.

If you're offended by the use of adjusted EBITDA, don't worry, because Match Group has a strong conversion of this fake profitability metric to free cash flow. We are assuming 90%

conversion to free cash flow in our model, which is around what Match Group has historically done.

On top of slow margin expansion, there is an app store “call option” that comes with a Match Group investment right now. App store fees from Apple and Google are under fire around the world and are at risk of being legislated away. We are not banking on this happening, but if legislation occurs, it will likely benefit Match Group substantially. For every percentage that the app store fee is dropped, that is a direct increase in Match Group’s profit margin. If store fees fall to 10%, Match Group has an easy path to 50% profit margins, even while revenue grows in the double digits.

Distinct competitive advantages

Match Group has three competitive advantages that we’ve identified. Two (network effect and “Relationship George”) are powerful, while one (brand) is helpful but not crucial.

Dating apps have some of the strongest network effects in the world. Each incremental user makes it more valuable for existing users on the app, as it helps increase the chances of finding a potential mate. This is why apps can gain rapid momentum in cities once they hit a certain adoption level among their target demographics. Tinder did this five years ago and it is happening to Hinge today. Network effects, especially when powered by the internet, create winner-take-most scenarios where the established players (in this case Tinder, Bumble, and increasingly Hinge) have an easy time fending off potential competition. Why would anyone switch to a competing application if it has 5% of the user base as Tinder? It is not likely.

The least important but still relevant competitive advantage for Match Group is the brand value of its services. Creating an online dating profile takes a big leap of faith, and comes with some risks of fraud and/or someone misleading you. Most people will not head down to the 40th ranked dating application on the app store unless it caters to something specific to them. Tinder and other established brands have an advantage being the top of mind among consumers and by likely having someone they know using the service before.

Lastly, and most important, is what we are calling the “Relationship George” effect with online dating (if you don’t know the reference, watch this video: https://www.youtube.com/watch?v=3afZip4BTRc). You almost assuredly haven’t heard of this competitive advantage before, since we made it up just for this write-up. But we think it is the key to why Tinder, Hinge, and other top dating apps will have staying power for many years. Dating is personal and operates in a separate realm than friends/family unless the relationship gets serious. Things are no different online. People want to keep “relationship George” (their online dating profiles) completely separate from “independent George” (their online social profiles/personas). If you are a company that caters to “independent George,” like Facebook, good luck convincing “relationship George” to join the party. Any consumer company that does anything that *isn’t* a dating app already will find it almost impossible to succeed with an online dating product (Instagram and Snapchat work as pseudo dating apps, but could never succeed pushing an independent dating product). This conflict creates a huge moat for Match Group to fend off competitors. Remember Facebook Dating?

Conclusion and risks

There are two big risks with an investment in Match Group: company execution and multiple compression. Execution risk is something we are okay taking, and multiple compression is always a risk when something trades at a current earnings multiple above the market average.

Given these risks, we have sized our Match Group investment at the smaller end of the portfolio. If the stock continues to fall and the business continues to perform well, we have no problem increasing our position sizing, as we believe this is one of the best businesses in the world.

But we also think there’s a chance Match Group could surprise us to the *upside*. Margins have a chance to be higher than 40%, and revenue growth could compound at north of 20% a year. While not likely, we think the potential of this scenario is not zero, and gives us comfort even though we are buying shares of Match Group at close to 40 times trailing free cash flow.

Questions? Comments? Contact us at *archcapitalmanagement@gmail.com* to talk about Match Group or anything else investing-related.