Yellow Tree Fund

Fair Isaac Corp

FICO | $1720.55

Buy | Target Price: $2422.00

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Strong momentum weighed down by overreaction FHFA rule changes

Our view: We recommend a BUY with a $2422 price target for FICO. FICO exhibits continued strong performance, its high-margin Scores business continues to perform well, and we see tailwinds that will continue to drive performance in the coming years. Q4 results were strong. Income was $155MM, up 14.2% YoY and revenue was $515mm, up 13.6% YoY. This performance was driven by the Scores business which includes the B2B and B2C scoring businesses, delivering 25% year on year growth while the Software business was largely flat. Forward looking guidance for 2026 is equally strong calling for 18% revenue growth. With the stock down 13.5% YTD we believe there is upside potential.

Our investment thesis has 3 main elements: (1) The **market has overreacted** to the FHFA ending Fannie Mae and Freddie Mac's sole reliance on FICO for mortgage credit scores. FICO has reacted aggressively by launching the FICO Direct License program and has recently entered into a license and distribution agreement with Zactus, the largest credit verification and tri-merge provider of FICO scores. Lenders now have the choice of paying $4.95 per score plus a funding fee at closing which is a 50% reduction of average fees per score. This opens a competitive battle between FICO and VantageScore 4.0 but we believe FICO is significantly advantaged in this fight. FICO's latest score, FICO 10T is the most predictive scoring model on the market and appears to have the edge versus FICO Classic and competitors. (2) **The software business shows significant potential**. FICO's SaaS software, FICO Platform, supports AI driven decisioning solutions and experienced 16% growth in annual recurring revenue in the last year. More recently FICO announced the availability of next generation enterprise fraud solutions on FICO Platform as well as the launch of FICO marketplace. In recent days FICO announced a new partnership with PostFinance in Switzerland leveraging the FICO Falcon Fraud Manager. Over time these investments will drive greater earnings predictability and margin expansion in the software business. (3) **Home sales in the US are at a 30-year low** with the turnover rates at 28 sales per 1000 homes which is 30% lower than the average turnover rate from 2012 to 2022. We see this as an upside opportunity in the medium term. FICO will benefit as the cycle turns.

Risks: VantageScore has increased competition with 27bn scores in 2023 (42% y/y), but this is still a tiny fraction of the market and represents mostly consumer-access scores, meaning they are free. FICO's main risk is simply macro-economic condition and depends mostly on how quickly the mortgage market recovers, or if it slows even more. This has to do with rate decisions and strength of the economy (job market, consumer). **Bi-Merge:** It has been the intention of the FHFA to implement a bi-merge model as opposed to the precedent tri-merge model. If this happens it will certainly impact FICO's revenue however it is likely some lenders will still prefer the tri-merge method. FHFA has postponed the switch indefinitely and it is seen as a major change that could negatively impact the strength of loan quality. Thus, it is uncertain if it will go through.

Valuation: We give FICO a price target of $2422.00 for FY2026, using a 25x '31 terminal EV/EBITDA multiple, an 18.9% revenue and 27.5% EBITDA CAGR, for the next 6 years. The multiple is very conservative considering FICO usually trades from 33-40x EBITDA, but this is to boost the integrity of the model and is more in line with peers. Margins will continue to expand with increased prices and more momentum following the platform shift.

Variant View: The market has long understood that FICO would face pressure from VantageScore yet reacted negatively when the news was confirmed. This reaction looks overdone. We see the strong performance of 10T Score and growing software business as long term value drivers. Even if VS gains wider adoption, the credit scoring industry will still be a duopoly.