April 23, 2020

Building a Bridge to Normal

All the lonely people
Where do they all come from?
All the lonely people
Where do they all belong?
--Paul McCartney (sorry, not sorry Yoko)

Dear Client,

We hope you all are staying safe and well through these challenging times. COVID-19 is something personal and scary for us all. Our team and most of our clients live in the tri-state area, our nation's most frightening hot spot. We have clients on the front lines, heroically fighting this virus in the emergency rooms of the region. Irrespective of geography every one of us likely lost or knows someone who lost a loved one to COVID-19 already. These are sad, hard times, but we as a family, a group, a country, a society, and a world will get through this. Crises have a way of bringing people together, even if we must temporarily stay apart. While there are emerging rifts over whether the economy should open up, or lockdowns should remain in place, this is truly one of those rare moments in history where every human on Earth is in a unified battle against a singular and common enemy. Such situations bring out the best in people and while a quicker healthcare policy response would have helped lessen the blow, the economic policy response has been powerful and swift evidence of the communal spirit in action.

It seems like once a decade, significant events of global consequence occur that immediately change the contour and trajectory of history. COVID-19 is this decade's 9/11. From 2020 onward, the world will look very different than it has in the recent past. Some things will not change, much change will occur from acceleration of events already underway and some change will be more temporal in nature. Eventually, this epoch will be a major chapter in history books and the conclusions remain undrawn today.

March was an exceptionally volatile month. Two of the ten largest percentage losses in the history of the Dow Jones Industrial Average and one of the ten largest gains occurred in the month.[1] One day on each side of the ledger narrowly missed cracking the top ten. The VIX hit levels unseen since the Great Financial Crisis (GFC), registering its highest close ever along the way.[2] In our March letter, we expressed our belief that a "return to normalcy will be swift." We have revisited and quickly backtracked from that assumption, though we do believe the right policy measures are in place to mitigate worst case economic scenarios.

[1] https://en.wikipedia.org/wiki/List_of_largest_daily_changes_in_the_Dow_Jones_Industrial_Average
[2] https://www.cnbc.com/2020/03/16/wall-streets-fear-gauge-hits-highest-level-ever.html

At the time, we took comfort in how China, South Korea and Taiwan showed the world a playbook to react and adapt to a world threated by COVID-19. While our leadership was starting to grasp the magnitude of the situation, by and large, the reaction was far slower than we hoped for. New York City was especially slow to react, taking an extra five days after our letter to announce school closures. This has proven to be a costly mistake and consequently, New York City has since emerged as one of the globe's most vulnerable hot spots. With the extent of community spread in the US, the idea of a quick one-month lockdown with ramped testing facilitating a "test and trace" reopening thereafter was entirely precluded. Not only will reopening take a long time, but "normal" from here on after will be incredibly different than what we knew before.

Building a bridge to "normal":

Markets reacted swiftly to the harsh realities of prolonged lockdowns in the US. Businesses are simply not built to withstand zero revenues for short, let alone prolonged periods of time. Since our March letter, we became especially concerned about the potential ripple effects in commercial real estate. Consider landlords who rents space to retailers and restaurants, all of which were forced to close as "non-essential businesses." The retailers and restaurants earning $0 revenue have no money to pay rent. Landlords meanwhile still have overhead including property taxes and mortgages of their own (leverage is beyond merely common; it is the natural state in commercial real estate). Landlords thus have little cash flow to cover mortgage payments. The lenders behind these mortgages are either banks or shadow banks, each of which deploy leverage. Lenders who cannot pay now leave the banks behind the mortgages without cash flow. Effectively, the entire edifice of running a business in a property owned by a landlord with a loan from a bank looks like a Ponzi scheme when the cash stops flowing, with a cascading pyramid of obligations that snowballs as you climb the ladder. How does the system work and get through to the other side? There are three important constituencies and their respective responses we must consider.

First, there is a human element. Were the landlord to evict the restaurant or store who cannot pay right now, there is no chance they can fill that space anytime soon. For the landlord's lender, were they to foreclose on the landlord, there is little chance they could sell the property for a reasonable price and recoup their costs in doing so. This is a non-zero-sum situation and a prisoner's dilemma with real consequences. Effectively, everyone in the system has incentive to work out a solution with one another in order to survive these tough times. In speaking with people and businesses involved in all layers of this situation, we have seen strong evidence that the players are all attempting to forge mutually beneficial postponements and, in some cases, outright reductions in future obligations. The willingness to work together and build a bridge to normalcy is extremely optimistic and helpful and we are presenting this story because it is specifically relevant and in a general way sets the backdrop for the extent of the support the Federal Reserve Bank and the government stimulus are providing for the economy.

Second, the moves from the Federal Reserve Bank came with unprecedented speed and scale. The Fed started by digging into its Great Financial Crisis toolkit: cutting rates to zero, recommencing quantitative easing and buying commercial paper to support money markets. Next, the Fed went even further with support for municipal debt markets, a program to lend to banks standing behind the government's Paycheck Protection Program loan program (PPP) and a special bond buying program aimed at easing corporate credit through direct purchases of corporate debt. The sum total of these Fed measures will inject over $6 trillion into the financial system.[3]

Third, is the government stimulus program. Society is undergoing the ultimate stress test-no company was built to survive a prolonged period of $0 in revenue. For many, especially small businesses, there is no way to have built a balance sheet to weather this kind of storm. In effect, society has an obligation to pay people and businesses not to operate and not to work, because everyone is better off with that. The CARES Act is being called a $2.2 trillion stimulus package, though some aspects of the disbursed expenditures likely overstate the total cost.[4] Following 9/11, our country underwrote two wars at what is in hindsight estimated to be a $6.4 trillion total cost.[5] In war, price tags are perceived differently than in economic crises; however, we think the response to COVID-19 should be treated as a massive war-like effort. This simple reframing of the debate from stimulus to a war-like effort will stop people from wondering "how do we afford this?" today and focusing on actually building the bridge. We can worry about paying for it all once we are on the other side. Right now, we need mobilization of healthcare and productive capacity geared towards this situation in rapid fashion, much like we would in war, alongside massive economic support to counteract job loss and business closures.

The $2 trillion CARES Act is a well-designed starting point in waging the economic battle against cCOVID-19. The unemployment insurance offered by the act is well designed and well targeted towards, though likely needs to be extended farther into the future. The PPP is well thought out; however, at $349 billion, it is proving to be far too small given the scale of the problems small businesses are dealing with.

One important factor that must be addressed is how much better capitalized our banking system is in today compared to 2008. U.S. banks in aggregate boast strong balance sheets, high liquidity, and are in a position to lend into the crisis instead of retrenching. The inability of banks to lend in 2008 is what amplified the magnitude of the GFC. Stated another way, bank behavior was procyclical in the GFC, while here it has the potential to be countercyclical and help build that bridge for the economy to the other side of the virus.

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[3] https://www.cnbc.com/2020/04/13/coronavirus-update-here-is-everything-the-fed-has-done-to-save-the-economy.html
[4] https://thehill.com/policy/finance/economy/493218-cbo-projects-cares-act-will-cost-176-trillion-not-22-trillion
[5] https://www.cnbc.com/2019/11/20/us-spent-6point4-trillion-on-middle-east-wars-since-2001-study.html

One of the more interesting wrinkles on the economic policy side emerged when some Europeans who had formerly been resistant to the idea of a Eurobond spoke in ways that opened the door to its possibility.[6] This would be a powerful step forward in John Monnet's vision for a "United States of Europe." Much in the spirit of Monnet's architecture, crises spearhead further cohesion and unification. We certainly do not view Eurobonds as an inevitability; however, the softening of former stances is how something formerly impossible becomes possible. Crisis has a way of bringing people closer together and building the bridge to normalcy requires a greater degree of cooperation and sacrifice from everyone in every community around the world.

What the other side of the bridge looks like (it's not normal):

COVID-19 will kick off one of the most profound reshaping of our world any of us will see in our lifetime. We have spoken with people young and old who already grasp that this is the most significant global event many of us have ever and possibly will ever experience. Below we address ten big changes that we expect to see. There are common threads to many on this list, though each line is unique. Some of the changes we are contemplating are different than the obvious ones, though others are likely things that have crossed your mind in the past month.

1. A greater societal focus on hygiene and cleanliness—with those most vulnerable dealt the harshest COVID-19 outcomes, people will do more to be less "vulnerable" in the health sense. Behavior changes that are forged over weeks and months tend to persist. Restaurants and other service establishments will be expected to maintain a higher level of cleanliness. New jobs will be created and industries that have been relatively consistent but lacking in growth will need to scale capacities in order to supply the needs of these new, cleaner industries. We also expect some kind of national sick leave program which changes the incentive for hourly workers in particular, who in the recent past would work when sick in order to make ends meet, but now owe it to society to stay home.
2. A move from cities to the burbs—dense, highly urban cities like New York are especially tough to be in right now. The per capita infection rate is higher than in non-city environments and the challenges of locking down in a small apartment, accessible only by elevator, with limited outdoors space are especially daunting. The appeal of a single-family residence with green space will grow for many young urbanites.
3. Everyone who can afford to will want to own a car—remember just a few months ago when popular Silicon Valley lore believed everyone would ditch their car for Uber? That story is ancient history. As people move out of cities into the suburbs, they will need cars. Car sales in China,

[6] https://www.ft.com/content/8da39299-b257-4e8f-9b83-a84a8930f1c1

particularly Wuhan, are recovering quicker than anyone expected as people are reluctant to take mass transit and the government, dealers and OEMs are handing out incentives to sell more cars.[7]

4. Experiential spending > things—this trend will gain speed once a new normalcy emerges as people will be craving doing what could not be done in lockdown. Some elements of experiential living, like going to concerts, will be on pause for the foreseeable future; however, other elements, like experiencing the great outdoors will likely accelerate quickly. Outdoors are largely free (aside for the equipment we need to experience them) and are a natural formal of social distancing.
5. All content viewing will start in an OS. Without sports, the demise of the linear bundle will accelerate, and ad budgets will shift even quicker to digital channels. Alongside this reality, we expect AVOD to continue its emergence as a way to view and monetize content. This is already becoming evident just one month into the widespread lockdowns.[8]
6. Buy online, pick up in store—PayPal had been trying to stoke this trend for years, to no avail. Now it is being offered across the retail landscape from groceries, to electronics to microbreweries and beyond. The experience is great for consumers and simple. This will require new kinds of employment and a rethinking of some parking lot space, but once behaviors are shaped, there is no going back.
7. Contactless payments—this is a cousin of buy online, pick up in store and boasts its own broad ramifications. Cash itself is a means through which the virus can spread, as is the handoff of a credit card for a swipe. The infrastructure for contactless has been in place for a little time, though a catalyst for change had been lacking.
8. Infusing technology into more of our lives—virtual education, work from home tools and telemedicine have been seeing slow-rolling adoption in recent years that has now accelerated beyond the point of no return.
9. Biotech—for much of the past decade, biotech has been a popular political punching bag with both parties scoring points complaining about the high price of some modern drugs. With society having this great need for a vaccine, biotech will likely reemerge as a revered industry.
10. Leaders stepping aside—from the first days of the lockdowns, our email alerts were flooded with board members and c-suiters stepping aside to "spend time with family" or something like it. We think this could accelerate the passing of the torch from the Boomer to Millennial generation in corporations around the world.

What will not change?

[7] https://www.japantimes.co.jp/news/2020/04/09/business/car-boom-wuhan-lockdown-recovery/#.Xp2wXshKiUk
[8] https://adage.com/article/video/rokus-scott-rosenberg-breaks-down-covid-19-viewership-trends-ad-age-remotely/2251446

- Travel will go on and come back. After 9/11 it was flying itself that was perceived as unsafe, today flying itself is safer than ever on multiple fronts. Flying will come back in stages. Some will resume limited travel once we get to a looser phase of social distancing. Once we have a vaccine, we think desire to travel will re-accelerate to pre-COVID levels.
- Events will eventually resume to much fanfare. We expect a return of sports sometime soon with fanless competition, but longer-term, people still crave the communal nature of big live events from sports to music to industry tradeshows. When these events resume will be on the virus' schedule, not our own; however, they WILL resume.
- Work from home will not be widely embraced. While those who can work from home are doing so right now and initial reports suggest there is no productivity loss associated with doing so, the long-term desirability of such arrangements will lose some of its luster over time.[9] We do think there will be more flexible work from home time in the jobs that can afford it; however, people need personal contact, the capacity to take non-verbal social cues and make group communications far more productive than they can be on Zoom, and the boundaries that a home vs office divide offer psychologically. In a work from home world, the reality of David Foster Wallace's "videography" would evolve far too quickly: "…it turned out that consumers' instinctively skewed self-perception, plus vanity-related stress, meant that they began preferring and then outright demanding videophone masks that were really quite a lot better-looking than they themselves were in person."[10]
- Kids will still go to school. Education is simply better in person, especially for little kids. Socialization is extremely important in development and kids rely on leadership from teachers alongside social cues from their peers to hone in on their work and eventually unwind when it is time to play.

As for markets:

Right now, it is obvious that there will be hard economic times ahead. For opportunity, you must be willing and able to look out several years and you cannot anchor to 2019, nor can you anchor to where things are today. We expect high dispersion from here, with some large winners and losers emerging. The obvious losers from COVID-19 are already down considerably in the stock market, consequently, some of the biggest losers from here will be companies where the impact of covid-19 related shutdowns is non-obvious. Far too many people are assuming all kinds of software are safe. One way we will see the risks to these non-obvious companies emerge is a growing divide between revenue and receivables. These

[9] https://www.brookings.edu/blog/up-front/2020/04/06/telecommuting-will-likely-continue-long-after-the-pandemic/

[10] Foster Wallace, David. *Infinite Jest*. New York, Back Bay Books, 1996, page 148.

companies might still be billing their customers, but their customers will be increasingly unable or unwilling to pay.

When the Fed cut rates back to zero, we sold all our financial stock positions. *While we are generally sanguine on the sector and its ability to withstand the crisis, the earnings outlook will be under pressure from the dual forces of rising defaults and low net interest margins.* We reallocated some of the sale proceeds to new positions and left the rest in cash. With our expectation for high dispersion over the next few months, we think it is prudent to carry extra cash in order to have dry powder to deploy into some of the inevitable hiccups along the path towards normalization and ultimately recovery.

We stress-tested every single portfolio company we own for their ability to withstand a prolonged period of lockdowns, social-distancing thereafter and a slumping economy. Resilience is of the utmost importance today. Beyond testing for resilience, we are keenly focused on earnings power both during this bridge period and after. You will also notice that as you look through your portfolios, the companies are positioned to benefit from the areas that we do and do not see changing. Companies with the right combination of resilience and earnings power will emerge from this period much stronger than when it began. In fact, this might be one epoch in time where the strong get stronger at a faster rate than ever before. This has consequences and inevitably there will be backlash, but it also portends great opportunity in the investing world.

The Dragon in the Medical Exam Room

Early in the first quarter, we made a new investment in Nuance Communications. Nuance provides conversational artificial intelligence to healthcare (two thirds of revenue) and enterprise end markets. Within healthcare, in addition to owning a functional monopoly in radiology documentation with PowerScribe, the company has a strong suite of products powering the digitization of the industry. Nuance is best known for its Dragon medical dictation product, used by 55% of doctors in the United States.[11] They are currently transitioning Dragon medical dictation into a high margin, recurring revenue, cloud-based product called Dragon Medical One. Dragon Medical One grew revenue 54% last quarter, showing clear progress in the transformation.

Beyond Dragon Medical One, Nuance is developing a more disruptive product to evolve and enhance the dictation industry—Dragon Ambient eXperience (commonly referred to as "ACI"), built in partnership with Microsoft.[12] ACI "uses ambient sensing technology to securely listen to clinician-patient encounter conversations while offering workflow and knowledge automation to complement the Electronic Health

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[11] Nuance Communications Inc at Leerink Global Healthcare Conference

[12] https://news.microsoft.com/2019/10/17/nuance-and-microsoft-partner-to-transform-the-doctor-patient-experience/

Record ("EHR")".[13] ACI is compatible with all major EHR and telehealth platforms, but has an especially promising relationship with Epic Health Services. Epic, who boasts 80% market share amongst the largest hospital networks in the US and has partnered with Nuance to bundle ACI as an add-on to all its EHR customers. This has effectively unburdened Nuance of distribution to a huge installed base. Based on conversations with industry experts, ACI is revolutionary, possesses capabilities far beyond competing software, and is expected to have high levels of physician demand. These sources validate Nuance's estimated serviceable addressable market for ACI of at least $6.6 billion in the United States.[14] For context, this is over four times larger than FY 2019 sales for the entire company (excluding discontinued operations).

The world has drastically changed since we initiated our position in Nuance early in the first quarter. Despite COVID-19, the company affirmed that it had "not experienced any significant changes in our business" as a result of the environment.[15] Nuance is well positioned to continue avoiding significant negative impacts as it provides mission critical software to busy healthcare professionals and Fortune 100 enterprises. Although cCOVID-19 could delay uptake of Nuance's products by new customers, it could accelerate the adoption of ACI by existing ones when physicians and hospitals get past peak resource utilization from COVID-19. Accelerated uptake of ACI would fuel faster revenue growth and a better margin profile for Nuance and most importantly, for clients, ACI helps solve two major problems exacerbated by this present crisis: physician burnout and large patient backlogs. The COVID-19 crisis has undoubtedly increased physician burnout. ACI measurably decreases the time physicians spend on documentation, while improving patient throughput. In beta mode, a major orthopedic clinic reported "their providers were not only happier and more focused, they were also able to see 24% more patients and brought in an additional $1.35 million in revenue during one quarter".[16] Helping clinics meaningfully grow revenue is another positive side effect from ACI.

Mark Benjamin has demonstrated strong strategic vision and execution since he joined the company as CEO in April 2018, and we expect that to continue with the ACI rollout. Strong execution will be critical for realizing the full potential of ACI. In his first two years, Benjamin has revitalized the culture by simplifying the company's business and strategy around a few core verticals. He improved the capital structure while aggressively repurchasing shares and investing in research and development. He divested and spun off non-core business. Benjamin has built a reputation for providing conservative projections, best evidenced by the 2019 Investor Day guidance through 2023 which ignores all potential ACI revenue streams. Nuance

[13] https://www.nuance.com/healthcare/ambient-clinical-intelligence.html
[14] Nuance Communications Inc 2019 Investor Day Presentation
[15] Nuance Communications Inc Form 8K dated March 20, 2020
[16] https://www.healthcareitnews.com/news/epic-debut-ambient-voice-technology-assistant-himss20

currently trades at a 5% FCF yield and a 30% discount to a DCF based on Benjamin's guidance. It is not unreasonable to argue investors are getting potential upside from ACI for free at current prices.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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