# INVESTOR LETTER

## THIRD QUARTER 2020

**3Q20 Results**

During the third quarter of 2020, the Durable Growth Portfolio ("the Portfolio") increased 27.7% net of fees. This compares to the overall increase, including dividends, for the Nasdaq 100 and S&P 500 of 13.2% and 8.9%, respectively. Since inception on October 1, 2019, the Durable Growth Portfolio returned 95.8% net of fees, compared to the Nasdaq 100 and the S&P 500 of 48.8% and 15.1%, respectively.

**Durable Growth Monthly Performance (net of fees)**

| Year | Jan. | Feb. | Mar. | Apr. | May. | Jun. | July. | Aug | Sept | Oct. | Nov | Dec | Durable Growth | QQQ | SPY |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2019 | | | | | | | | | | 2.58% | 4.97% | 1.23% | 9.0% | 12.9% | 9.0% |
| 2020 | 6.57% | -6.37% | -15.21% | 25.39% | 19.99% | 10.56% | 15.45% | 7.80% | 2.58% | | | | 79.7% | 31.7% | 5.6% |
| Cumulative return since inception | | | | | | | | | | | | | 95.8% | 48.8% | 15.1% |

**Interpretation of results**

September marked a return of volatility after a significant summer rally as election season approaches. While macroeconomic factors can have a very real impact on the stocks and earnings power of our companies over the short term, it has no bearing on our investment decisions. Thanks to commission-free online brokerages like Robinhood, it has never been easier to buy and sell stocks. However, we've learned that sometimes the best thing you can do is to do nothing at all. The speed and severity of the March crash and subsequent recovery shocked even the most seasoned investors, and unfortunately caused many who pay too much attention to the headlines to sell at one of the most inopportune times. We can often be our own worst enemy when it comes to making investment decisions, especially quick judgements, as it's all too easy to fall victim to common behavioural biases. One of the most common being loss aversion – losses loom larger than gains; however, in order to achieve anything worthwhile, there will always be some bumps along the way. Short-term volatility is inevitable if you desire significant gains and should not be equated with risk. Take Livongo (LVGO) for example, one of the best-performing stocks this year and a significant position in the Durable Growth Portfolio. It went public last year and promptly entered a severe downtrend, declining over 60% from its all-time highs made shortly after IPO. Nothing in the underlying thesis had changed, yet such volatility would have certainly caused most investors to reconsider their conviction.

However, there is a difference between being patient and being stubborn. It is very possible that our original thesis may turn out to be incorrect, at which point we do not hesitate to sell. There are a number of valid reasons for doing so, whether it be a significant deceleration in growth, if we believe its moat has been breached in some way by competitive pressures, industry headwinds, management changes, etc., if the valuation becomes detached from reality, or if we find a significantly better opportunity.

We try to limit such mistakes by analyzing what made companies succeed or fail in the past, then applying our learnings to come up with four distinct filters to evaluate new and existing positions:

1. Business
2. Management
3. Durable Growth
4. Price

We break down these criteria more deeply on our website, but the core of our process is finding companies with durable moats, visionary leaders, and large addressable markets, that can provide attractive returns with a 10-year outlook. Once we identify a business that fits our criteria, our target holding period is forever ("Forever Investing"). A thesis is rarely made or broken in a quarter, so we zoom out from the stock's day-to-day gyrations and focus solely on the performance of the underlying business, giving our companies time to execute.

You may notice that the majority of our filters are qualitative. While we do believe that any company can be overvalued, the market has historically valued companies with durable competitive advantages below their intrinsic value because it expects the ROIC to trend towards average over time. However, the best businesses can often earn returns far and above their cost of capital for much longer than can be reasonably expected. Therefore, these businesses tend to trade at multiples that would be considered expensive by traditional metrics. However, the market can realize this opportunity and apply a much higher valuation on these companies, hence discounting their future returns to a more average return.

One example of this is Snowflake (SNOW), which recently debuted at an EV/S of over 175x. Although future returns might still be attractive, a significant amount of upside has already been captured. If we assume P/S drops 83% over the next 10 years to 30x with modest share dilution of 3.5%, in order to achieve a 15% annual return, Snowflake would have to grow sales at a ~41% CAGR to a $13B run rate. Snowflake is an exceptional company in a massive market so it might prove to be undervalued even at today's prices, but its future returns have been greatly muted. Coca Cola is another example of a company with a wide durable moat but was so overvalued in the late 90's it provided poor returns over the subsequent decade.

Evidently, every company should be valued differently and screening out or selling companies solely based on high multiples can lead investors to miss some of the greatest compounders. On the other hand, low-multiple companies that appear to be traditionally cheap can be overvalued and produce poor returns because they lack a durable moat. Today, when financial data is easily accessible, the market often values quantitative information efficiently.

That is not to say that it is impossible to find a high-quality business at cheap multiples. In fact, our best performer, Livongo, was trading at just a 14x EV/S multiple at the beginning of the year, and has since quadrupled its multiple, which has contributed significantly to its incredible performance in such a short period of time. These opportunities are rare, and frequently come in the form of misunderstood or unique companies. When you analyze a company in an established market like endpoint security, it's easy to gauge the TAM and forecast an appropriate CAGR by looking at industry reports and consulting experts. When you have a totally new category like Applied Health Signals, especially one at the intersection of two industries, it becomes much harder to estimate its potential. As the company continues to execute and the market better understands its potential, it rewards it with multiple expansion. However, while anyone can be contrarian, it is much harder to be contrarian and consistently right and oftentimes the best opportunities lie in plain sight. Ultimately, growth of intrinsic value is the primary driver of long-term stock performance and multiple expansion is just the cherry on top.

The businesses that meet our lengthy criteria are some of the best in the world. They have significant optionality, wide moats, huge TAMs, great management teams, strong brands, etc. These opportunities do not come often, which is why we take concentrated positions in our best ideas. University of Arizona finance professor Hendrik Bessembinder found in a study of 25,300 stocks from 1926 to 2016, that 4% accounted for all of the net wealth creation with the remaining 96% collectively generating lifetime dollar gains matching those of one-month Treasury bills. Furthermore, just five stocks – Exxon, Apple, Microsoft, General Electric, and IBM, accounted for 10% of total wealth creation. This has led many to embrace index funds as missing the top outperformers that drag the market up can lead to underperformance. However, the lesson for active investors is the importance of holding onto your winners as long as your theses remain intact and that is exactly what we aim to do at Luca Capital with our philosophy of "Forever Investing". We expect that a minority of stocks will contribute to the majority of our gains and the opportunity cost of selling one of these rare companies early on in its story, or even worse shorting, far outweighs what would have been lost (or gained) should the company go bankrupt.

**Positions**

Now that you have an understanding of the basics of our investment philosophy, you may be wondering why we think our companies are so special. I've already written a research article on the health insurance marketplace GoHealth (GOCO) which you can read here. I'd like to dedicate this letter to going more in-depth on another top holding, and one that I am personally the most excited about: Livongo which is merging with Teladoc Health (TDOC) in a deal set to close in Q4'20.

**Livongo (LVGO) and Teladoc (TDOC)**

Healthcare is one of the last multi-trillion-dollar markets to be disrupted, but it is a notoriously hard nut to crack thanks to misaligned incentives, a ton of red tape, and a lack of impetus from the system's main stakeholders. Today, the United States spends more on health care than any other country but is not seeing comparable outcomes. The average premium for family coverage has increased 54% over the last ten years, significantly more than either workers' wages or inflation. No wonder why healthcare is one of the hottest topics in the upcoming US election.

COVID-19 exacerbated everything and in doing so, it laid bare the inefficiencies of the current system. Providers once opposed to telemedicine soon became its biggest champions and regulators followed suit by enacting a number of regulatory changes that made telemedicine and remote monitoring much more accessible. Some pretty simple stuff on there like allowing patients and providers to use/provide telemedicine services from their own homes, paying physicians the same rate as in-person visits, or allowing them to see new patients in all 50 states. And those changes are already in the process being made permanent. Consumer adoption of telehealth has tripled from 11% in 2019 to 46% as of April 2020 and Frost & Sullivan predicts the telehealth industry to achieve a 5-year CAGR of 38.2%. Indeed, Teladoc and the telemedicine industry as a whole have been reborn during the pandemic (though Teladoc still grew sales at an excellent 74% CAGR from 2013 through 2019).

Teladoc as a Standalone Investment:

As bullish as we are on the future of telemedicine though, we acquiesce that it can be difficult to build a durable moat. Although telemedicine is very scalable and an easy sell (everyone is a potential customer), the service itself is a commodity with little pricing power and low switching costs. However, scale is a significant advantage as a larger network of providers confers lower connection times and wider coverage. In addition, different areas of the country have varying access to care at any given time, but since regulations now allow providers to see patients across all states, we can better match doctors with patients under a national network, similar to "load balancing" in computing. Since Teladoc is international too, there also exists an opportunity to see patients across international borders. These are just a handful of reasons why we do not believe off-the-shelf consumer products like Zoom or Twilio will eventually replace the core telemedicine providers. They're not integrated, not on-demand, limited to local physician supply, not accessible at the point-of-care via carts or other hospital equipment, and there's nothing like Livongo to give the providers a continuous picture of patient health. Teladoc also allows white-labelling, which enables health systems to take advantage of Teladoc's additional provider supply while retaining the brand their patients have come to know and trust. However, while this incentivizes health systems to go with specialized platforms like Teladoc or Amwell, it's making it more difficult for end-consumers to differentiate the major telemedicine providers at the product-level.

How Livongo Fits In:

Now, remote monitoring companies like Livongo are a different story. Livongo helps people manage chronic conditions including diabetes, hypertension, prediabetes and weight management, and behavioural health through the combination of a connected devices, AI-enabled nudges, and human coaches. For example, for diabetes, patients receive a connected blood glucose meter and record and upload their measurements (with unlimited, free, and self-refilling testing strips) which are then combined with additional data from third-party devices like Apple Watches or Fitbits, surveys, medical and pharmacy claims, and more to deliver personalized, timely health "nudges". These health nudges aim to spur behaviour change and every time one is delivered, Livongo's AI+AI engine collects valuable data to iterate and further personalize future interactions. If the system detects something is wrong, for example if a patient uploads a blood glucose reading that is out of range, a health coach will immediately call them and guide them to getting back in range. This model empowers patients to take control of their own health by understanding and reacting to the signals their bodies are giving them, rather than relying on expensive, inconvenient hospital visits. Livongo primarily targets self-insured employers, promising better outcomes and lower costs, and charging a per-member-per-month fee.

In contrast with Teladoc, Livongo boasts higher gross margins, a very sticky service with high switching costs because of the hardware and patient data, devices need to be FDA approved, and outcomes and ROI need to be proven through lengthy studies. Furthermore, it takes a lot of investment to cover additional conditions and Livongo's 750 million data points give them a significant head start as diabetes is a significant risk factor with many chronic conditions. Livongo recently expanded into chronic kidney disease (CKD) in a partnership with Fresenius Medical Care which provides kidney dialysis services and has over 38% market share in the US. Because the 2 most important risk factors in CKD are diabetes and hypertension, a large aspect of prevention needs to come in the form of managing these conditions. Therefore, Livongo was able to leverage their existing products to expand into this adjacent market, demonstrating the optionality of its platform.

However, Livongo is a tougher sell, especially to health systems that don't have the same incentives as employers do such as controlling costs. Before the pandemic, remote monitoring was often cited as an afterthought for many providers. Why does this matter? Well, Teladoc has the scale. In January, Teladoc entered the hospital and health system segment in a big way via its InTouch acquisition. As of Q2'20, it's in 60 of the top 100 hospitals in the US and saw 50% more client expansions and over 20% increase in new clients versus previous quarters. Furthermore, CMS recently expanded remote patient monitoring reimbursement codes which has allowed Livongo to be able to easily penetrate into the Medicare FFS market. With Teladoc's existing and expanding footing in the health systems market, it can help Livongo to break into that market faster than it would have by itself. In the HLTH 2020 conference, Glen Tullman gave an update on the merger and announced a partnership with Teladoc health plan client Guidewell Health to bring Livongo for Diabetes to 50,000 Florida Blue members under their new cross-selling agreement. While he notes that they would have been able to sign them by themselves, being under the Teladoc umbrella sped up that process significantly.

Potential Synergies:

On the Teladoc side, having Livongo not only confers an advantage against telemedicine competitors like Amwell (which mainly focuses on the health systems market), but also allows Teladoc to improve engagement without hurting its gross margins. Utilization has always been a problem for Teladoc, which mainly derives over 90% of its total revenues from its PMPM + visit fees model (around $1.02 PMPM + $45 per visit). Pre-COVID utilization was under 10% and in its most recent quarter, rose to 16%, not great numbers compared to its competitors. If Teladoc were to drive up utilization, its gross margins would suffer because they make low margins on the visits. So, although US paid membership was around 51 million members, it could barely monetize them. With Livongo, Teladoc gains a wide moat, a better way to monetize its member base (Livongo charges $75 PMPM for diabetes alone, $35 PMPM for prediabetes, $39 PMPM for hypertension) while Livongo gets the provider network to provide a fully virtual end-to-end experience, and a significantly accelerated go-to-market with only 25% of client overlap.

When evaluating these businesses, it's important to consider where they are able to complement each other and produce a better overall user experience. On the patient side, having an end-to-end virtual care experience brings increased convenience from a single access point, seamless escalation to a Teladoc physician for acute care, who can then refer to the continuous, rich data stream that Livongo provides to deliver better, personalized care. Data from Teladoc's 10 million annual visits (in 2020) can also be combined with Livongo's existing 750 million digital interactions to further fuel Livongo's AI engine. On the client or provider side, having the most comprehensive remote monitoring and telemedicine services under one interface and one brand greatly improves the value proposition of both. Interoperability is still a challenge, with fewer than 50 percent of health systems reporting that they are integrating information with the main issue being with integrating third-party data within existing workflows. Health systems' approach to digital transformation is often as fragmented as the healthcare system itself with many digital engagement tools for various areas of the patient experience, each owned by different stakeholder groups. This results in higher costs to configure and set-up each tool and train employees in new processes. There are further costs with process inefficiencies as providers deal with complicated interfaces and admin work, driving an increasing number of physician burnouts and taking away valuable time that could be spent on delivering care. Bundling several complementary products and producing a superior user experience is a pattern common to many successful companies and the best acquisitions often create significant value for all stakeholders.

The merger also opens the door for redefining care delivery through services like Virtual Primary Care. Teladoc launched a successful pilot in Q2'20 and was met with a promising response - a very wide array of clinical diagnoses were made and patients overwhelmingly recommend it with a remarkable NPS of +95. Additional payment models are also possible, the most interesting of which being risk sharing agreements or capitation payments. Providers are paid a fixed amount per patient, thus aligning incentives and promising better outcomes for a lower cost. With a fully integrated platform, Teladoc can deliver on that promise, empowering patients to take control of their own health using Livongo's connected devices and health coaches with Teladoc physicians (or further escalation to an in-person visit) only intervening when the data indicates it's needed, thus lowering costs. The physician will also be informed by a continuous stream of data that can't be gathered through a single visit and also have more time to dedicate to providing better care. This has broader applications as well, with management recently talking at the Morgan Stanley 18th Annual Global Healthcare Conference of potential opportunity with National Healthcare Systems. In fact, the Singaporean government recently announced a partnership with Apple where they will pay citizens monetary rewards for staying healthy via the Apple Watch. Imagine the potential a fully integrated platform like Teladoc would provide.

Financials:

The combined entity currently trades at 33.8x TTM revenues and 19.8x next year's consensus estimates. On a pro forma basis, both grew TTM revenues 52% year-over-year at a $974 billion run rate with a gross margin of 67% and an adjusted EBITDA margin of 8%. They are projecting 40-45% pre-synergy revenue growth next year and a 30-40% CAGR through 2023, as well as an adjusted EBITDA margin of 15-18% by 2023 expanding at 200-300 basis points annually. They expect $100 million of revenue run-rate synergies by 2022 and $500 million by 2025 which is likely quite conservative. Using estimates from their investor presentation, Teladoc is only estimating 13,000 new Livongo enrollees by 2022 and 147,000 in total in 5 years. Furthermore, only 55% of their $500 million estimate by 2025 includes cross-selling. That's $275 million or 305k (275M / 12 months / $75 PMPM) Livongo for Diabetes members! That's not taking into account Livongo cross-selling into TDOC which make up half of that $275 million. There will be even more synergies from additional upsell of those new Livongo members across more conditions and Teladoc's accelerated market share growth as a result of having a winning value prop with remote monitoring thus beating out point solutions like Amwell.

So how large might the opportunity really be? Looking at Livongo's New Jersey case study and the enrollment numbers they provided in their 2019 annual report, we can extrapolate how the national opportunity might look like: 6% have diabetes, 17% have hypertension and a 35% enrollment rate after 12 months. So, if we apply that the TDOC's 51.5M members* 0.75 to account for overlapping clients *0.06 with diabetes *0.35 enrollment rate = 811,125 additional potential members right now. The enrollment rate is >47% for fully optimized clients and the wider US population with diabetes is closer to 10% so those estimates are likely quite conservative. Even capturing 1.575% of Teladoc's current paid membership nets 811,125 new members which can make a huge difference since LVGO is charging $75 PMPM for diabetes alone. As previously mentioned, their first cross-sale, Florida Blue, is estimated to bring 50,000 potential Livongo for Diabetes members. If we factor in a 35% 12-month enrollment rate, that's already 17,500 more Livongo members which already exceeds their 13,000 2022 estimate.

Risks:

The most common arguments against Livongo and Teladoc are to do with the plethora of competition. I've already explained how Livongo differentiates Teladoc and vice versa from smaller competitors and off-the-shelf consumer products but what about established healthcare giants such as United Health and Epic acquiring their way into the space like Teladoc has and selling into their networks? Managed Care Organizations surely would want to lower premiums they pay out, and it's a very lucrative, fast-growing space that their clients are demanding. Epic recently launched its own telemedicine offering powered by Twilio directly embedded in its own EHR systems and UnitedHealth via Optum also acquired a number of telehealth and remote-monitoring start-ups.

However, these larger players will be hampered by a number of challenges. EHR systems like Epic are notoriously hard to work with and interoperability is still a challenge, meaning data is siloed and it's hard to integrate external information to deliver true whole person care. Furthermore, they won't have the provider network that Teladoc has since they operate on a health system level. Although there has been a great deal of consolidation to achieve economies of scale, there are over 626 health systems in the US. People generally have multiple providers, each with different specialities, and information blocking is still quite common. It should be as easy to change providers as it is to switch banks, after all, it's our medical data. But progress is slow, even with recent changes implemented during the pandemic. Larger, innovative institutes like Kaiser Permanente with many different specialists can certainly provide an adequate level of virtual care but for smaller players, it would be much more efficient to partner and gets referrals for in-person visits from Teladoc's national network. Similar to the dynamics that have made many cloud companies very successful, where smaller organizations often see much better ROI from paying for a managed service.

Imagine you're a small hospital system and you get a surge in telehealth visits. You don't have the staff to perform on-demand consultations while Teladoc can leverage a physician halfway across the country who is online. Also, not all hospitals use Epic and not everyone is covered under Epic, so its patient and provider pool are inherently limited compared to Teladoc. This is especially true for multinational organizations who want to buy one virtual care service across their global operations. Furthermore, as virtual care becomes increasingly normalized, we will be seeing a lot more patients who do most of their visits online, just like online shoppers who buy most of their stuff on Amazon, hence increasing the value of accessing Teladoc's patient pool.

Hospitals also won't be so keen to change because by shifting to a paradigm that focuses on preventative care (via remote monitoring), they will lose revenue under a fee-for-service system. They can make ten or twenty times more if a patient comes into the emergency room for a bee sting instead of going online, even though most consumers would be better off starting with an online visit. It's hard to get big institutions excited about changing something when their revenue depends upon not changing it. So, the healthcare industry failed to transform itself until COVID-19 forced them to. Now that people have a taste of what could be, there's no going back. As more health systems shift to this new model because they lose patients to Teladoc, they will be forced to change though but for many, that means partnering with Teladoc to get referred patients for in-person care. Meanwhile, individual providers who are on Teladoc get to make extra money on the side, much like taxi drivers turning to Uber.

As for health insurance companies like United Health, their massive profits will be their undoing. In 2019, the average family premium for employer health insurance was $20,576, representing a 54% increase over the last decade, according to the Kaiser Family Foundation. During the same time period, the average employee premium contribution has risen by 71% to approximately $6,015. Employers are buying services like Livongo and patients signing up for it because they are sharing a larger burden of the costs and anything that helps them save money and become healthier makes absolute sense. With an ever-increasing number of people without coverage, PBMs and MCOs are increasingly being circumvented by services that provide clear ROI with transparent cost structure.

There was a concern with continuous glucose monitoring companies like Dexcom expanding into the software side as well, but they would have a hard time building their own service because they would only be able to do diabetes and competitors like Abbott would cut them off, an issue common to PBMs, MCOs, and EHR providers as well. What if an employee is covered under United but switches coverage to Anthem, well what happens to their data? Same thing in enterprise software: the big cloud may choose to have their competing solutions, yet the smaller players are still gaining market share because companies are increasingly adopting multi-cloud strategies and want to avoid vendor lock-in and they have more focus and innovation.

Finally, as I mentioned before, there are significant barriers to entry in remote monitoring. Before buying Livongo, Teladoc evaluated building it in-house as well as acquiring three smaller RPM start-ups. But they didn't because they were concerned about missing the market. If TDOC couldn't do it and paid such a premium for Livongo, despite having a massive 51 million member base to distribute into, then there aren't many other companies that I think can come close.

Conclusion:

The Teladoc - Livongo merger has created the single global, consumer-directed virtual care platform. Many of the largest companies in the world began in niches and leveraged their competitive advantages to expand into adjacent markets. Teladoc and Livongo are no exception, tackling urgent care and diabetes respectively. However, both are now capable of providing a true end-to-end virtual care experience and produce better outcomes for a lower cost through services Virtual Primary Care. As the pandemic continues to burden healthcare systems around the world, telemedicine has never been more important, creating a massive, growing base of members for Teladoc's new acquirees to sell into. Although Teladoc has acquired 12 companies over the last 7 years, Livongo is their biggest by far and the integration and effects of which will continue to be felt for years to come. Teladoc has become a dominant category leader with a massive $121 billion TAM, clients coming to them, incredible optionality with the resources and vision to outbid everyone else, and a wide moat and unmatched value proposition with the LVGO acquisition. That's a company we want to bet on.

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