

NOMADIC VALUE PARTNERS

November 5th, 2021

To partners and friends,

A representative account invested in the Nomadic Value Partners equity strategy decreased -6.5% net of fees in Q3 versus +0.6% total return for the S&P 500 Index.¹ Most dollar losses in the quarter came from Oak Street Health and IAC Corp, and slight gains came from Charter Cable. This drawdown in Q3 was painful but short. As of this letter, our portfolio has recovered and is above the year-to-date high point seen in early Q3.

	Q3 2021	YTD 2021	Annualized	Total Return
Nomadic Value Partners	-6.5%	5.3%	26.5%	45.0%
S&P 500 TR	0.6%	15.9%	29.0%	49.6%

Performance presented is a single representative account net of management fees. Individual client performance may vary. Inception date of 3-2-2020

Our healthcare exposure was a major detractor in the quarter with the market hitting the sell button on any company in the sector. Our holdings were not immune and their peak-to-troughs in the quarter were quite large. United Health was down -10%, Oak Street Health was down -44%, and Bright Health Group (new position detailed below) was down -53%. Your manager is not wired to stubbornly sit back in a scenario like this and arrogantly conclude that the market is wrong. As your fiduciary, anytime the crowd significantly sells down a company we own, I am reviewing every assumption. What could I be missing?

My work suggests the market's sudden hatred was focused on two issues: higher Medical Loss Ratios (MLRs) from the combination of an intensifying COVID pandemic and increased system utilization, as well as feared regulation changes around the Center for Medicare and Medicaid Services (CMS) process of risk adjustment.²

I highlighted the MLR concerns in a special August letter. I hope y'all found time to read it.

The risk adjustment concern is harder to ring-fence as there is always evolving chatter, but on September 20th the Department of Health & Human Services Office of Inspector General (HHS OIG) released a report highlighting bad actors within risk adjustment.³ This report launched a debate within the analyst community and I believe it could be spooking some investors. Healthcare is fraught with "improper" actors. Unfortunately, this isn't anything new. The risk adjustment process has frequently been in the eye of regulators, but in 2021 there have been no legislative changes or executive action regarding the process. We cannot trade on rumors with no identifiable economic outcomes.

Of course, to think there won't be any tweaks to the program over time is naive, and I believe the market is likely signaling a high probability of changes, but we must not miss the forest for the trees. Risk adjustment is a necessary

¹ Please see important disclosures at the end of this letter regarding performance presented here.

² Risk adjustment is an annual process by CMS where they take into account recent changes in a patient's overall health (e.g. did they get diagnosed with diabetes?) and adjusts the annual payment to an insurance carrier or physician to compensate for the future medical expense burden. The point is to fairly care for patients while compensating health insurers and providers regardless of morbidity.

³ <https://oig.hhs.gov/oei/reports/OEI-03-17-00474.asp>

process in order to have a fair and functioning value-based healthcare system. After reading the CMS's 10-year strategic overview released on October 20th, I think any potential changes to the process will ultimately come as a massive benefit to the right companies.⁴ For example, by 2030 the CMS wants to see ALL Medicare beneficiaries receiving care from providers that are held accountable for the patient's outcome and the total cost. This requires risk adjustment (whatever the method) and pay for performance (not volume). Most excitingly, it creates a market 2x the size of today's addressable patient base for risk-bearing primary care models like Oak Street, or the MA plans we own, United Health and Bright Health.

We are long-term holders of innovative healthcare companies solving problems for every stakeholder.

Portfolio activity

Our second largest detractor for the quarter became our largest position in early September, **IAC Corp** (IAC). The stock is a sector-focused holding company with four at-scale media and marketplace businesses, a growth/venture program, and two minority investments. We originally bought shares in IAC early this year after the company announced a spin-off of one of its fast-growing portfolio companies, Vimeo. We have since been increasing our exposure, doubling our position size in Q3. Something to note is that our "look through" exposures to IAC's various segments are in-line with our position sizing framework.

Known on the street as the "anti-conglomerate", investors still trade IAC around corporate events, even if the shares are trading at a significant discount to the sum-of-its-parts.⁵ Why hold the shares when one could wait for a deal announcement to quickly drive the price higher? This logic contributes to large swings in share price year in and year out. I have also fallen into this thinking. After closely following IAC for over a year we didn't initially buy the shares until they announced the spin-off of Vimeo. In the six months prior to buying our first shares, we left close to a 100% gain on the table.

After Vimeo was spun-out and the dust settled, IAC began to sell down again. We began buying larger amounts. IAC's businesses each have their own risk/reward and valuation a rational owner would pay. The valuations implied at our various purchases were simply too cheap in my view, but without a "catalyst" to attract other investors, we rode the shares cheaper and cheaper. This is what time arbitrage feels like.

A week into October, IAC announced a deal to merge Meredith Corp's magazine segment (think Better Home & Gardens and many more brands) into its DotDash segment, a portfolio of online media properties. This is a transformational deal for DotDash and the market has already begun to reflect this value in IAC's shares. We are long-term holders and believe in IAC's ability to drive value from here across the portfolio. I will discuss IAC's portfolio companies in future letters.

In the first week of August, we made a farm team investment in **Bright Health Group** (BHG), a health insurer with a similar payer/provider integration strategy as United Health. On September 30th we upsized our position to a 5% weighting. Our averaged cost basis of \$8.16 per share creates the company at a valuation slightly over 1x 2021's expected sales. This valuation may be appropriate for a low growth, old world health insurer, but it is too low in my

⁴ <https://innovation.cms.gov/strategic-direction>

⁵ Ironically, IAC frequently displays the "conglomerate discount", which is a price-to-fair value discount historically placed on holding companies because lack of focus and/or poor governance keeps minority shareholders from realizing potential value. IAC has a track record of realizing full value for shareholders, hence the "anti-conglomerate". Leave it to investors to nit-pick certain holdings to the nth derivative and not ascribe any value to management's track record.

view after adjusting for the company's position in the market, various lines of business, and its expected sales growth over the next few years.

To understand why BHG trades at a low valuation today, let's look at the history and current state of the core market it competes in.

In 2014, as a major program of the Affordable Care Act (ACA), healthcare.gov and numerous state-led sites were launched to create a marketplace for individuals and family insurance plans (IFPs). The idea was to offer affordable insurance to the working age population that didn't have access to employer-sponsored or Medicaid coverage. Unfortunately, healthcare.gov was doomed from the start. Partisan politics and website glitches were large drivers for both generating unaffordable plans and disincentivizing brokers from directing consumers to the exchanges. By 2018, there had been a mass exodus. Total patients decreased from 12.7 million to 11.8 million, and total Qualified Health Plan (QHPs) offerings decreased from 252 to 132. Many counties across the country were left with less than 3 insurers, and over 30% of counties were left with only 1 insurer offering plans. Average monthly premiums also doubled over this period.⁶

Despite the marketplace's de-emphasis and decline, it was still very large at around \$50 billion in premiums in 2018. This was a major opportunity for a health plan with the tools and skills to profitably offer plans to underserved patients. Bob Sheehy, ex UNH CEO, founded BHG in 2016 with this in mind. BHG also attracted a respectable early-stage venture investor, Bessemer Venture Partners, who provided the capital and patience to build a health insurer from scratch. The distilled thesis laid out in Bessemer's 2017 Series A investment memo was, "the investment thesis here is simple – huge market, great team, and a strong initial health plan product with many expansion opportunities." ⁷

BHG initially launched in Colorado, a market familiar to Sheehy, and partnered with a prominent health system to finance and deliver care in a tightly integrated way while staying focused on the consumer experience. After a couple of successful years, BHG launched a geographical expansion strategy, targeting similar patient cohorts as their original market and in counties with 2 or less insurers. Interestingly, BHG often partnered with the same health system the incumbent had in-network, but their mouse trap was better. With tighter clinical integration and a focused set of actuarial data, BHG could profitably underprice and take share. BHG went from Colorado in 2016; to Alabama in 2018; Arizona and Tennessee in 2019; Florida, Nebraska, North Carolina, Oklahoma, and South Carolina in 2020; and have announced select counties in California, Texas, Utah, and Virginia for 2022. Commercial membership went from 22,000 in 2018 to more than 550,000 expected for 2021.

This growth has had some help from the macro. Spurred by COVID, Congress passed the American Rescue Plan in 2020, which allowed a "special enrollment period" throughout the year and provided significantly more tax subsidies offered to consumers, resulting in the exchanges have returned to growth with 12.2 million patients purchasing a plan in 2021. Specifically, 2.8 million patients were new to the exchanges and 48% of these new patients pay premiums of \$10 or less.⁸ Additionally, employer programs like the newly enacted Individual Coverage Health Reimbursement Arrangement (ICHRA) could grow the marketplaces from today's 12.2 million to >20 million patients over the next several years.⁹ The driver is an increasing preference for "defined contribution" healthcare versus "defined benefit"

⁶ <https://www.cms.gov/CCIIO/Resources/Data-Resources/Downloads/2020QHPPremiumsChoiceReport.pdf>

⁷ <https://www.bvp.com/memos/bright-health>. The whole memo is a great overview and snapshot of the market's risks and opportunities in 2017.

⁸ <https://www.hhs.gov/about/news/2021/09/15/biden-harris-administration-announces-2-8-million-people-gained-affordable-health-coverage-during-2021-special-enrollment.html>

⁹ <https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/faqs/health-reimbursement-arrangements.pdf>.

plans, as well as ongoing employee turnover and remote work resulting in large spreads in health expenditures across multi-state employers.

BHG is in the sweet spot for all this renewed focus and growth. So, why is the stock market not buying it?

The biggest concern is competition. BHG grew through picking unfair fights, but today the marketplace is on a different battlefield. The exchange's growth has convinced insurance companies to re-enter the market in a big way. For the 2022 plan year, there are now over 213 QHPs (from 132 in 2018) and 90% of counties offering three or more QHPs. This competitive intensity has forced monthly premiums lower since their high point in 2018. Today, the average monthly premium (before tax subsidies) has decreased -10% from \$411 (in 2018) to \$368.¹⁰ It seems the carnival game of shooting fish in a barrel has morphed into a knife fight in a coliseum. The market views BHG as weakly positioned as its slow growing competitors.

If BHG was a one trick pony I would agree, but BHG has been training for this fight for some time. Bob Sheehy was the CEO of UNH's health plan business back when OptumHealth and its provider integration strategy was formed. He knows how to compete like the best. In 2019, Bob Sheehy replaced himself as CEO with Mike Mikan (also a United Health/OptumHealth veteran) and brought in a new CFO, Cathy Smith (ex-Target CFO), while maintaining his involvement as Chairman. Reference checks on both Mikan and Smith were very positive. These folks are "execution-ists", and since hiring they haven't wasted any time. Shortly after Mikan became CEO, BHG purchased two MA plans in California (counties they are now launching IFP products in), a provider-led commercial health plan in New Mexico, two provider groups in Florida (adding integration to IFP and small group employer plans), and a telehealth platform. In 2022, BHG plans to build >25 de novo primary care clinics in select counties in Florida, North Carolina, and Texas that have commercial membership. The "pay-vider" transition is in place, and it seems we could have the right team to push BHG squarely into this second act.

To get our hurdle rate with BHG we must believe they can maintain a growth rate in excess of the industry's 6-7% over the next few years. However, BHG's growth rate can be much less than its past and our return will still pencil out. Between the strategy shift described above, the fact that BHG is still only in 18 states, and growth levers created by new business lines (Medicare Advantage and wholly owned providers), I think the company has a very good shot at outperforming the current expectations implied by the market. Overtime BHG should re-rate to a valuation more reflective of its long-term potential.

Conclusion

In the last week of August, I walked the 103-mile ridgeline of the Uinta Range in Utah. While consistently above tree line, dodging hail and thunderstorms, I thought of a wonderful set of parallels between the reality of thru hiking and investing as a concentrated stock picker. Unfortunately, this letter is much delayed and longer than most, so I have decided to delay this essay for another time. Perhaps Q4.

I want to thank all of you again for being convicted, patient partners in a turbulent quarter. As always, please do reach out with any questions you'd like answered directly.

All the best,

Joshua Collinsworth

¹⁰ <https://www.cms.gov/CCIIO/Resources/Data-Resources/Downloads/2022QHPPremiumsChoiceReport.pdf>

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