EAGLE
CAPITAL MANAGEMENT

FIRST QUARTER 2024

In 1608, the Dutch eyeglass maker Hans Lipperhey invented the telescope. His device magnified objects threefold. A year later, Galileo improved the device to 20x magnification and pointed it out into the heavens. Today, the James Webb telescope, orbiting the sun since 2021, looks out 13.5 billion light years into the past.

One of Eagle's core competitive advantages is our willingness to bring duration to public market investing. We imagine ourselves as researchers using high-powered lenses to peer into the future. As with a telescope, objects may appear blurry up close but come into focus when looking farther out. Many of our best investment opportunities present this way: a near-term but transitory uncertainty that resolves to a clearer and brighter destination.

During the pandemic, we invested in hotel and aerospace firms with depressed business conditions.[1] Markets were overly anchored on the unknown near term and unreasonably assumed permanent impairment. These were extraordinary businesses with healthy balance sheets. While we didn't know the precise timing or path, we could bound the destination. Today, these companies have record earnings and strong growth prospects.

While the pandemic was an extreme case, we regularly see idiosyncratic opportunities that reward duration. Here are some illustrative examples.

Underwater contracts

We recently invested in Humana, a large managed care organization. Humana's principal business is Medicare Advantage, where it is the second-largest provider with roughly 18% market share. In the decade from 2013-2022, the company's stock compounded at 23.4% annually, dramatically outperforming the S&P 500 at 12.6%. Cumulatively, this translated to growth of 718% compared to 229%. The strong performance was driven by a superior business model, penetration growth of Medicare Advantage, and benign industrywide cost/price dynamics.

Over the past year, Humana's stock declined drastically. Many in the industry, including Humana, mispriced their business and have been on the wrong side of cost/price inflation. There are a few reasons for this: a post-pandemic catch-up in medical procedures, a tighter reimbursement approach from the Centers for Medicare and Medicaid Services ("CMS"), and excessive animal spirits from industry participants hoping to gain market share. Consensus 2024 earnings expectations for Humana, a once-predictable business, have fallen by 50%.

2024 earnings are based on bidding decisions made in June 2023, customer election decisions in late 2023, and healthcare utilization over 2024. The business model means the company commits to a level of service before its costs are set. These lags in the system are the primary reason margins are so depressed. Moreover, because there are regulatory limits on annual benefit changes, we expect 2025 earnings will also be weak, albeit less so.

We believe industry conditions are near trough, with many players operating at a loss. While 2024-25 is hard to forecast precisely, we should be in the early innings of a multi-year recovery in margins and earnings for Humana. Moreover, our range-of-outcomes is tighter in 2028 than in 2025, an attractive setup for our strategy.

Fixable execution mistakes

We've never met a management team that didn't make mistakes. Markets often forget this, exhibiting panic and impatience. Amazon is one of the largest companies in the world. Woodward is a small aerospace and industrial parts supplier. Both saw their P&Ls disrupted by post-pandemic supply chain and cost management issues.

In Amazon's case, management overestimated demand for e-commerce following Covid. The company increased its capacity by far too much, leading to a period of underutilization and inefficiency. The silver lining is that Amazon's investment dug an even deeper moat around its business, which should pay off over the long term.

The company's stock declined by almost 50% in 2022. Investors worried that Amazon's retail business was lousy and would never make much money. Many commentators criticized the new CEO, Andy Jassy, for the failed strategy he was leading. This was an irrational stance since he had come from Amazon Web Services, the part of the business running well, and had inherited these retail issues.

Meanwhile, management diligently approached the problem with a multiyear view. Our analysis convinced us it was fixable, and the changes would drive even greater future profitability. Internally, we speculated that this might be the largest earnings upgrade cycle in the history of capitalism. (It turns out that the trophy was reserved for Nvidia.) Now, earnings are booming. Amazon's consensus EPS expectations for 2024 are up almost 80% from a year ago, and we believe there are years of margin improvement still to come.

Woodward's problems were in the other direction. Demand for aerospace parts plummeted during the pandemic. When business returned, Woodward and its suppliers couldn't rehire the required workforce. Woodward's new CEO, who joined in mid-2022, was transparent with investors about the company's issues. Customer order fulfillment was inconsistent, price/cost was upside down, manufacturing efficiency was uneven, and input costs were elevated. The market didn't like the message.

Each of these issues required hard work but was discrete and solvable. Moreover, the best time to improve a great business is after a stumble. It is harder to enact change during good times. Over the past 18 months, the company has made steady progress. We expect Woodward to produce record margins and earnings this year. Because of the company's share gains on next-generation commercial aircraft, we expect it to grow revenue and earnings above industry peers for the next decade.

Path versus destination

Occasionally, the market gets so focused on the path of a business that it misses the destination. Over the past year, recent investments exploiting this phenomenon are SAP and Taiwan Semiconductor ("TSMC").

We invested in SAP last year because it is in the early stages of transitioning its massive installed base of Enterprise Resource Planning ("ERP") customers to its modern cloud-available product, S/4HANA. Cloud transitions are long, expensive, and uneven. Initially, revenue growth declines while costs increase. And then forecasting the pace of transition is difficult because customers move at uneven rates.

While any given year may be lumpy, we believe the overwhelming share of the company's installed base will migrate, driving higher monetization through pricing and bundle attachments. This should drive above-trend revenue growth against a cost structure that grows more modestly. SAP has operating margins in the low 20s, compared with margins in the 40s for comparable best-in-class firms. Strong topline growth and high incremental margins mean bottom-line earnings should increase by a multiple over the next decade.

TSMC is the world's leading semiconductor foundry. It manufactures chips for fabless firms like Apple, Nvidia, Qualcomm, AMD, and Broadcom. It is in a category of one. Its closest peers, Intel and Samsung, lack its scale, process technology leadership, and 100% focus on serving third-party chip designers. TSMC's production capacity is almost four times that of Intel.

We invested in TSMC last year when the company had its worst revenue growth since the 2008 financial crisis. TSMC faced declining revenue across much of its portfolio, as maturing smartphone sales, declining PC sales, and inventory adjustments across much of the economy weighed on results. While enduring industry headwinds, TSMC continued to gain market share and generate solid margins and returns on capital.

Instead of parsing through every little indicator of channel inventory to time the precise cycle wiggles, our analysis is focused on the normalized earnings power of the company over the next 5-10 years. The smartphone market is mature and will have modest expansion from here. However, TSMC has large opportunities in growth markets such as AI and automotive silicon.

The company's earnings also have less risk than fabless semiconductor firms because TSMC is not dependent on a particular technology or market. TSMC is a toll on the entire industry; winners among its customers should largely offset losers. Moreover, we believe higher industry profitability may lead management to exercise more pricing power than it has historically.

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With the overall indices at all-time peaks, we have elevated concerns about valuation risk. That said, market dispersion is high, and we're still finding attractive new investments. Popular themes or companies are trading at wide premiums to those with controversy. As the opportunity set changes, our portfolio turnover should correspondingly increase. That is already happening, with Eagle steadily recycling capital into positions with higher expected returns. We're grateful for your ongoing support and trust.

As always, if you have any questions or would like to discuss anything herein, please call us at (212) 293-4040. Also, if your financial situation or investment objectives have changed, if your IPO eligibility or U.S. Person status has changed, or if you would like to modify or discuss any investment restrictions or guidelines, please reach out to your contact on the client team or email ClientServices@eaglecap.com.[2]

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[1] Eagle Equity Composite holdings during the period from March 1, 2020 to March 31, 2022 were as follows: **AER**; ABNB; GOOG/L; AMZN; ANTM; AON; BCS; BRKA/B; COF; CHTR; C; CMCSA; DAL; DISH; ECL; EVVTY; FISV; FOX; GLIBA; **GE**; GM; GS; **HXL**; **HLT**; IAC; LBRDA/K; LBTYA/K; LTRPA; LYB; **MAR**; META; MSFT; MHK; MS; NPSNY; NFLX; ORCL; PROSY; **RTX**; **SAFRY**; TRIP; UAL; UNH; V; WAB; DIS; WFC; WLTW; and **WWD**. Companies noted in **bold** are in the hotel or aerospace industries.

[2] Eagle Equity Composite holdings during Q1 2024 were as follows: AER; GOOG/L; AMZN; AON; BAYRY; COF; CHTR; C; CMCSA; COP; DFS; ELV; GE; GS; HLT; HUM; LBRDA/K; MAR; META; MSFT; NFLX; OXY; PROSY; SAFRY; SAP; SHEL; TSM; UNH; V; WFC; and WWD. The following entities are not currently held in the Eagle portfolio, and reference to these entities is included solely for informational and discussion purposes: Nvidia, Apple, Qualcomm, AMD, Broadcom, Intel and Samsung.