April 23, 2017

Dear Fellow Investors,

The fund advanced 13% in the first quarter of 2017. Gains were broad-based, as no single position was responsible for more than 11% of the total NAV/share increase. Our long portfolio returned 13.9%, while the short book lost 1.6%. The balance of the change in value was due to currency fluctuations, which should roughly even out over time. At the end of the quarter the Fund had gross exposure of 155% and net exposure of 78%.

A Word on Performance Measurement

While composition of our portfolio is vastly different from any market index, most indices (including all the major US ones) offer other benefits including ease of access, liquidity, and tax efficiency. These benefits, along with the indices' tendency to outperform many money managers over time, make them a worthy alternative for those deciding where to allocate their capital. Thus, because of the significant opportunity cost associated with deciding to invest in an active firm like Adestella rather than a passive index, I believe it makes sense to use these indices as benchmarks even though there is little overlap in our underlying holdings.

With this rationale in mind, the indices I've selected for benchmarking purposes are the S&P 500 (which is the most readily available alternative for most of our investors), the Vanguard Total World Stock Index (which more closely matches the Fund's geographical exposure), and the Russell 2000 Index (which more closely matches the median size of the Fund's holdings). I will also include the HFRI Equity Hedge Index as a point of reference to hedge funds following a similar strategy to our own.

	1Q 2017	Since Inception[1]
S&P 500	6.07%	27.73%
Vanguard Total World Stock ETF	7.33%	11.64%
Russell 2000	2.24%	20.82%
HFRI Equity-Hedge (Total) Index	3.82%	6.91%
Adestella Investment Management[2]	**12.97%**	**34.65%**

**all index returns include reinvestment of dividends*

[1] Adestella began operations in the third quarter of 2014
[2] Time weighted returns on a gross basis

Exploiting Our Advantages

Given my comment above about the tendency of low-cost index funds to outperform most investment managers over time, it's fair for you to wonder why Adestella should reasonably expect to achieve its objective of beating the indices on a net basis over time. I believe we possess several structural advantages that either cannot or will not be capitalized on by most other investment firms and passive indices, advantages that I intend to exploit to accomplish our goal:

- **Relatively small size.** This greatly expands our investible universe, allowing us to pursue opportunities well off the beaten path. Because smaller companies won't move the needle in the performance of larger funds and don't generate enough interest (i.e. commissions) to receive coverage from sell-side research firms, these stocks tend to fly under the radar, increasing the chances of a mispricing. It also makes us more agile, allowing the Fund to enter and exit positions as circumstances dictate in a relatively short period of time and without affecting the price of the stock.

- **Willingness to concentrate portfolio on best ideas.** This advantage has two elements:
  - Even in less well-followed areas of the market, substantial mispricings tend to be relatively rare. Thus, it's imperative that when one finds one they are willing to make a sizable bet to take full advantage, even if this produces above-average volatility. Managers at large firms are often wary of 'career risk': if they underperform the indices by too much they may be fired, or else lose clients (thus reducing their juicy management fees). Accordingly, many opt to maintain a very diversified portfolio in the aim of reducing volatility and thus protecting against deviation of the benchmark. The drawback against insuring against underperformance, however, is that it also insures against outperformance, particularly after the drag from fees.
  - Fewer holdings also allows me to have a thorough understanding of each company we invest in. This is very useful in situations where a stock declines and I have to decide whether it's an opportunity to add more at a better price, or whether I made a mistake. I believe these situations are among the areas where active management can add the most value if decisions are correct, and being well-informed on the company is a prerequisite to this.

- **Intense focus on research.** Many active managers juggle their research work with frequent client-facing obligations. In a very competitive investment world where the stream of new information and opportunities is virtually endless, being able to "turn over more rocks" for new ideas and focus solely on portfolio management is a small advantage we have that will compound itself over time.

- **Long-term investment horizon.** The short-term myopia of Wall Street is frequently seen through its focus on quarterly earnings, the widespread use of trend-following strategies, and the ever-

shortening average holding period for stocks by retail investors and mutual funds alike. Having the ability to turn short-term problems from stocks we own (or would like to own) into long-term opportunities by adding shares at more attractive prices is a large benefit for a fund, but one that can only occur if it has long-term minded investors. Thankfully Adestella does, so we're able to use volatility to our advantage instead of shying away from it.

- **A global mandate.** A large amount of research documents a variety of mental heuristics individuals utilize that often lead to biases in the way they process information and make decisions. One of these is the familiarity bias, which is the tendency for individuals to be more comfortable with what's already familiar to them. While this has many applications to investing, one particularly interesting one is the tendency of most investors, even those attempting to create highly diversified portfolios, to allocate far more of their money in their home country than would be expected by that country's weight in a global index. One recent study found US investors tend to have 79% of their portfolios in American equities (vs. a 51% global index weight).[3] The US and UK (whose investors tend to overweight domestic equities by 19%) account for nearly 90% of total institutional AUM; applying this total to the home bias amounts and index weights, I estimate that 70% of professionally managed money is chasing 40% of the global opportunity set. The flip side, of course, is that the remaining 60% is underfollowed, increasing the odds of finding equities that are significantly mispriced. Free to invest in any geography, the Fund can go where the value is at any given time. As an extra benefit, the limited correlations between international markets also provide a bit of added diversification at the portfolio level.

Heads I Win, Tails I Don't Lose Much

Each quarter I intend to do a 'deep-dive' into one of the Fund's current holdings. Doing so will hopefully be helpful in understanding my investment process and portfolio management decisions; it should also benefit me as I have to crystalize my thinking before putting the thesis down onto paper.

One of the most important concepts in value investing is ascertaining whether a given security provides the investor with a 'margin of safety' that protects him against permanent capital loss even if things don't go as planned with the investment. This means finding some sort of downside protection, often in the form of a hidden asset or a cheap valuation, which for a patient holder may offer some sort of 'floor' that reduces their downside risk. In even the best of cases, the unpredictability of the future means things won't go exactly to plan – hence the need for a 'margin of safety' with every investment.

It's often said that if you take care of the downside, the upside will work out for itself. But I think we can do one better: take care of the downside, and then work on figuring out the probability-weighted upside potential of a stock as well. Thus comes the second step, which is trying to determine what one might reasonably expect to earn on their investment across a variety of scenarios, including both punitive and optimistic ones.

[3] See https://personal.vanguard.com/pdf/ISGGAA.pdf for more information on the subject

The Fund’s capital (and my personal mental ‘bandwidth’) are both limited, so I believe it makes sense to focus on these criteria in conjunction; plenty of companies fulfill one requirement or the other, but few manage to create a compelling combination of the two. When you do find one though, you have an attractive investment proposition on your hands – one akin to a situation where ‘heads I win, tails I don’t lose much’. If your judgements are correct, this asymmetry should, over time and in aggregate, provide a positive expectation.

One stock that I believe meets these requirements near current prices is called Advanced Emissions Solutions (ADES). ADES has contracted cash flows which, discounted back to the present value, fully cover the current market capitalization (providing the downside protection discussed above). Meanwhile, the company has several other valuable assets, including a fast growing chemicals division, that are essentially free options on significant additional upside. It also just initiated a dividend (12% yield at current price) that provides a catalyst yet to appear on the radar screens of most investors.

I’ve included as an Appendix to this letter a thorough explanation of the ADES thesis for those interested in more detail.

Outlook

I don’t have a strong view on which way the market is headed over the next few months. Reasonable arguments can be made for either side, with plenty of data points available to support whichever particular view one holds. However, as Peter Lynch once said, *“Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves.”* Given the dismal record of market forecasting (by amateurs and professionals alike), I’m inclined to agree with him.

If one accepts that he cannot anticipate market corrections or predict broader stock market performance (and by extension, that of any particular stock) over the short term on any regular basis, I believe the prudent thing to do is to focus instead on the underlying fundamentals of our portfolio holdings. While over short period of time markets tend to be governed by sentiment, over the long term they’re ruled by fundamentals. Thus, it’s correctly ascertaining the intrinsic values of the companies we own that will drive our performance in the long term - which is the time period with which we are ultimately concerned with. And that is what I intend to do.

Conclusion

This is the first quarterly letter Adestella Investment Management has sent out. My goal in doing so is to facilitate a more frequent flow of information to all fellow investors – both in terms of our performance and in terms of our strategy. Our interests remain fully aligned, as the great majority of my net worth is invested in the Fund and I maintain no personal account outside of it.

At the present moment I believe our stocks continue to trade at substantial discounts to fair value, which makes me optimistic about the Fund going forward. There will be bumps in the road along the way, but I do hope and expect it will be a rewarding journey for all of us.

I look forward to writing to you again at the conclusion of the second quarter.

Per Ardua Ad Stella ("Through Struggle to the Stars")

\- ancient Roman phrase

Best Regards,

Andrew Jakubowski

Appendix A: Advanced Emissions Solutions (ADES) Investment Thesis

Advanced Emissions Solutions (NASDAQ:ADES) has declined around 30% in the last few months, and I believe the stock is now highly compelling around current prices. As it has drifted downward on basically no news, I've continued to accumulate shares, taking it from one of the smaller holdings in my portfolio to one of the top 5 largest. I believe its combination of downside protection, upside potential, and a strong catalyst make it one of the best opportunities available in the market today.

Introduction and Company Background

ADES is a unique company that has had a bit of a tumultuous history. It was founded as ADA-ES Inc. in 1997 with a focus on providing technologies and equipment for emissions regulations, but reorganized as Advanced Emissions Solutions in 2011 around the time it expanded a JV arrangement to take advantage of an IRS tax credit (more on this below). But then in 2015, the firm became embroiled in an expensive accounting restatement that also prevented it from filing financials with the SEC or doing any earnings calls. Shortly thereafter, the CEO was replaced, and it wasn't until summer of last year that ADES regained compliance and relisted on the NASDAQ.

However, in the 1.5 years or so since present management took over and the stock was relisted, the company's prospects have improved materially as it has shifted towards an asset-light business model generating positive free cash flow. The company's latest earnings release presentation does a good job depicting the considerable progress it's made, but it's done so quietly and I believe the market has yet to fully appreciate it.

ADES's main source of value comes from its 42.5% ownership in a JV called Tinuum (Goldman Sachs and Nexgen Refined Coal are the other owners) that is awarded tax credits when the JV generates refined coal (RC), an IRS-defined low-emission variety. In 2004, the IRS developed a tax credit (not a deduction - these credits decrease tax expense dollar for dollar) in an attempt to incentivize the creation of these cleaner RC facilities. A total of 4 companies took up this offer and built facilities, with the Tinuum Group being the second largest with a total of 28. The window to build them closed in 2011, and the credits expire in 2021 (except for two facilities placed into service in 2009, for which the credits expire in 2019).

The mechanics of the JV's cash flow generation is a bit complicated, so walking through the steps of the process may be instructive:

1. Tinuum finds a firm (the operator) looking to reduce its tax liability
2. Operator runs at the facility at a cost of around $7.50/ton (this credit increases a bit every year; around half is the cost of operations and half is a payment to Tinuum)
3. For each ton generated, the IRS provides a tax credit worth about $7.50/ton (hence running these facilities is cash flow neutral for the operator)
4. Though net cash flow is $0 for the operator, they are allowed to deduct the cost of running these facilities on their own financials. Thus, each ton of RC produced creates around $2.75 in tax credits (assuming a 38% tax rate)

The completion of this process is known as monetization, and each one completed produces a reliable stream of income to Tinuum (of which ADES gets 42.5%). Even better, there's very little cost associated with these cash flows because most of the capital investment was incurred in the outfitting of the facilities during the 2009-2011 period. In the past, ADES also retained some of these facilities to run itself, but it (wisely) moved toward the asset-light model of monetization-only under the new management team and finally ceased production at its last retained facility in Q1 of 2016.

Operating Tons: Invested vs. Retained

Three Months Ended December 31, 2016	Invested	Retained	QTD - Total
Tonnage [1]	10,068	15	10,083
Count (#)	13	—	13

Year ended December 31, 2016	Invested	Retained	YTD - Total
Tonnage [1]	41,628	890	42,518
Count (#)	13	—	13

Source: Q4 earnings call presentation

So ADES basically receives ongoing tax credits for having built refined coal facilities before the 2011 deadline, then monetizes them by finding an investor that can use the tax credits in full. It also has several other businesses it operates that are not being ascribed any value at the current price. Here are the two key reasons why I think the stock is very compelling at current levels, which I believe creates a situation akin to "heads I win a little, tails I win a lot".

Key Thesis Points

Strong downside protection at current prices via contracted cash flows from facilities ADES has already monetized. From now until 2021, ADES should receive around $251M from the 14 facilities it has already monetized, the PV of which (at a 15% discount rate) is now well above the company's current market cap and EV. This chart from its latest investor presentation depicts this cash flow stream; the company

presents it on an undiscounted basis, but for conservatism, I've discounted it to the present value, which works about to about $10/share in value.

Source: ADES presentation at Sidoti Spring 2017 Emerging Growth Convention

Multiple free options create the potential for significant additional upside. While the aforementioned cash flow stream protects the downside, the company also has several promising growth levers to pull. These include:

1. The ability to monetize its remaining 14 facilities in the future. ADES has currently monetized only half of its facilities after counting the newest one in the first quarter. Other firms offering RC tax credits have managed to lease over 80% of their facilities, and there's no reason ADES can't do the same. Management believes there's the potential for several more deals to go through later this year, although I only model one more in my valuation below.

2. A fast-growing Chemicals division. A few years ago ADES commercialized a line of chemicals designed to reduce coal emissions. Since beginning from a standing start in 2014, the division has grown from $391k sales in 2014 to $3M in 2016, a CAGR of 178%. Even after this growth it has still only penetrated a small portion of its TAM. Management is targeting $20-40 M in sales from this division within the next few years, implying at least a few more years of parabolic growth. EBITDA will grow even faster as operating leverage kicks in, a trend that already started to occur in 2016 when segment EBITDA margins went from 31.3% to 42.8%.

3. A declining equipment and consulting business. All legacy contracts will run off by 2018, at which time I assume the division will be shuttered, but until then this segment also produces positive segment-level EBITDA and is probably worth something.

4. An intellectual property portfolio. The company has 57 patents either confirmed or pending, most in the US, but until recently had never really attempted to monetize them. This is now changing

under the new management team, which is actively looking to unlock some of their value. As stated by CEO Heath Sampson in the 2016 Q3 earnings call:

"...the right way to think about the patents around our portfolio and we have patents across the entire business, the big value are all centered around the M-Prove technology and there's other chemical type patents that would complement that and support that. So, we're currently talking with customers on how we could use some of these other chemicals that would complement the M-Prove technology... So, encouraged about our patent portfolio and we'll see how we monetize that. Either that's through - potentially, people are evaluating us whether or not they want to buy those or how we can sell those current products that are tied to those patents to our current customers. So, early on, but that's how we are evaluating using the necessary experts and the market and our customers to help us value those."

In my SOTP below, I don't ascribe any value to the portfolio yet, but it's another free option that could potentially be very lucrative.

<u>Valuation</u>

First, I'll show all the components to my SOTP valuation. For Tinuum, I assume the company manages to monetize 1 additional facility a year (it has already completed one for this year, hence the 2 for 2017), which would still put its overall utilization upon the credit expiry in 2021 below peers. I assume the chemicals division continues gaining market share and increasing operating leverage, and that sales hit management targets of $20-40M. Finally, I assume that the E&C segment completes its legacy contracts and then is shut down in 2018.

CSS (Tinuum)	*Time Unit*	*0*	*1*	*2*	*3*	*4*	*5*		
	2015	2016	2017	2018	2019	2020	2021		
Remaining CSS Payments	32.2	108.7	116.0	130.0	134.0	123.0	87.0	590	total
								15%	discount rate
NTM PV to ADES	*13.7*	*46.2*	*49.3*	*48.0*	*43.1*	*34.4*	*21.1*	42.5%	ADES share
Cumulative Remaining	*255.8*	*242.1*	*195.9*	*146.6*	*98.6*	*55.5*	*21.1*		
New Facilities Investors	-	-	2	1	1	1	1	<-- monetization closer to AJG percent of total	
x PV to ADES per Facility	16.0	16.0	10.7	16.0	16.0	16.0	16.0	16.0	full yr. PV per facility
Marginal Value	-	-	21.4	16.0	16.0	16.0	16.0	*67.9%*	*of facilities operating by 2021*
								33%	complete of current yr.
NTM Present Value	-	-	*9.1*	*5.9*	*5.1*	*4.5*	*3.9*		
Cumulative Remaining	-	-	*28.5*	*19.4*	*13.5*	*8.4*	*3.9*		
Total CCS Value	255.8	242.1	224.4	166.0	112.1	63.9	25.0		
per share	*11.75*	*10.89*	*10.09*	*7.47*	*5.04*	*2.87*	*1.13*		
Chemicals									
	2015	2016	2017	2018	2019	2020	2021		
TAM	350.0	350.0	350.0	350.0	350.0	350.0	350.0	350	TAM (sales)
x Penetration	*0.3%*	*0.9%*	*2.4%*	*7.5%*	*8.5%*	*9.5%*	*10.5%*		
Sales	0.9	3.0	8.4	26.3	29.8	33.3	36.8	<-- targeting $20-40M in sales next few years	
x Seg. EBITDA Margin	*31.3%*	*43.8%*	*46.0%*	*55.0%*	*50.5%*	*51.0%*	*51.5%*		
Segment EBITDA	0.3	1.3	3.9	14.4	15.0	17.0	18.9		
x Multiple	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0	EV/EBITDA
Segment Value	3.1	14.6	42.5	158.8	165.3	186.5	208.2		
Equipment & Consulting									
	2015	2016	2017	2018	2019	2020	2021	**legacy contracts all run off by mid-2018*	
Sales	61.9	47.6	37.1	12.4	-	-	-		
- Opex	47.0	38.1	31.6	11.1	-	-	-	-38.1%	CAGR
Segment EBITDA	14.9	9.5	5.6	1.2	-	-	-		
x Multiple	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	EV/EBITDA
Segment Value	52.2	33.2	19.5	4.3	-	-	-		

Next is the consolidated totals. I assume, in line with management guidance, that ADES continues to receive around $11M in distributions per quarter, which I apply first toward funding the dividend and then to reducing the net debt. I also apply a conglomerate discount for conservatism.

	2015	2016	2017	2018		
Total Value	311.0	289.9	286.4	329.2		
- ND	16.9	(13.2)	(40.3)	(97.6)	11.0	avg. quarterly distribution (
MC	294.1	303.1	326.7	426.8		
x SOTP Discount	85.0%	85.0%	85.0%	85.0%	15%	discount
Adj. MC	250.0	257.6	277.7	362.8		
/ Shares	21.7	22.2	22.7	23.1	2%	annual dilution
Value	11.53	11.59	12.25	15.68		
by 2021						
Upside	*40.8%*	*41.5%*	*49.5%*	*91.5%*		
IRR	*40.8%*	*41.5%*	*49.5%*	*38.4%*		
	2015	2016	2017	2018		
EBITDA	(39.8)	(34.4)	(6.6)	(0.3)		
- D&A	2.0	1.0	1.3	1.8		
EBIT	(41.8)	(35.4)	(7.8)	(2.1)		
- Interest	8.4	4.8	-	-	<-- no debt remaining	
- Tax	0.0	0.3	0.4	0.4	<-- AMT due to NOLs	
Operating NI	(50.2)	(40.5)	(8.2)	(2.5)		
+ Equity Method NI	8.9	45.6	44.0	44.0	11.0	avg. quarterly distribution
Total NI	(41.3)	5.1	35.8	41.5		
+ D&A	2.0	1.0	1.3	1.8		
- Capex	0.5	0.3	0.6	0.6		
FCF	(39.8)	5.7	36.5	42.7		
Dividend Cost	-	-	22.7	23.1		
Dividend Yield	*0.0%*	*0.0%*	*12.2%*	*12.2%*	$ 1.00	annual dividend

Finally, here's a breakdown of value by segment. Over time, Tinuum's value flows as the total amount of cash flows remaining drops, but it's offset by growth in the other business segments (primarily chemicals).

	2015	2016	2017	2018		
CCS Value	255.8	242.1	224.4	166.0		
+ Chg. in net cash	-	-	21.3	42.2	11	avg. quarterly distribution
Steady State	255.8	242.1	245.8	208.2		
Value of Other Ops	55.2	47.8	62.0	163.1	<-- assumes no value to patent portfolio	
Shares Out.	21.8	22.2	22.7	23.1	2%	annual dilution
CCS Value/share	11.75	10.89	10.84	9.00		
+ Other Biz/share	2.54	2.15	2.73	7.05		
Total per Share	14.28	13.04	13.57	16.05		
x SOTP discount	*85.0%*	*85.0%*	*85.0%*	*85.0%*		
Adj. Value/Share	12.14	11.08	11.53	13.65		
Upside	*48.2%*	*35.3%*	*40.8%*	*66.6%*		
IRR	*48.2%*	*35.3%*	*40.8%*	*29.1%*		

Catalyst: New Dividend Announced With 12% Yield at Current Price!

The cherry on top of all this is that investors will be paid to wait for the market price to come closer in line with the SOTP value. In the first quarter, ADES announced it would begin paying a $0.25 quarterly dividend, or $1/year, which is above a 12% yield at the current price. How many asset light, recurring cash flow generating firms with material upside potential offer anything close to that yield? Because the first dividend won't be paid until Q2, it won't show up on any screens yet, and because this is a small-cap company with very little Wall Street coverage, I doubt many people are aware of it yet, but when they are I'd expect the shares to rerate materially.

The company has also stated it'd consider expanding its capital return program through a buyback, and at current prices, I wouldn't be at all surprised to see that announced as well. That or the announcement of another facility monetization (each one is worth about a $1/share to ADES) are also potential catalysts here.

Why Does This Opportunity Exist?

There are multiple reasons that I think have probably contributed to creating the opportunity today, including:

- Messy historical financials, particularly prior to the past year and a half when ADES was not just monetizing its facilities for the tax credits, but also attempting to run some of them (known as retained facilities). This was a far more capital intensive and unattractive business that some people may still incorrectly associate with the company.

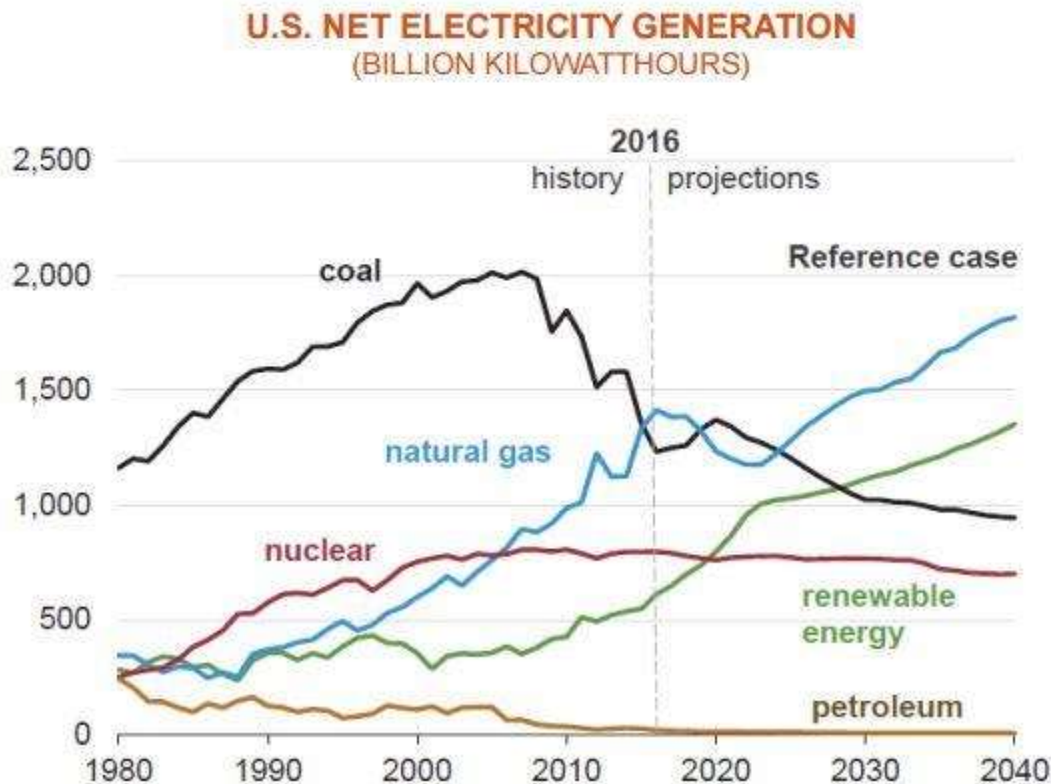
- Legacy issues associated with prior management team. ADES is now free from an accounting misstatement and attendant litigation that plagued it a few years ago, but investors who were burned may not have forgotten.
- Much of the company's earnings are ascribed via the equity method (for Tinuum), which means ADES often doesn't screen well.
- Perceived risks from association to the coal industry - While ADES facilities are indeed connected to coal production, the company itself has no exposure to commodity prices and is much more of a tax credit play than any sort of bet on the outlook for coal.
- No sell-side coverage and small market cap mean the stock is well off the radar of most investors.
- Unique business model means it's not a stock many people would stumble upon accidentally while researching a peer or the like.

Risks

The main risk is that tax reform under the new administration somehow hurts the value of the tax credits for restricted coal facilities. I'm comfortable with this risk for 3 reasons:

1. Trump's comments toward the coal industry have generally been favorable.
2. There's no guarantee tax reform will even go through, if the problems with healthcare reform are any indication.
3. The section of the code dealing with coal tax credits is small, arcane, and unknown to most people. It is hardly something that would take priority given it barely impacts anyone, leading me to believe any amendments to it would be much more trouble than they're worth, particularly since the credits expire in just 4 years anyway

The second potential problem would be such a large drop in coal demand that there's no longer any benefit in running the facility, even for the tax credit. However, coal power won't go away overnight, and indeed over the timeline of this investment, it should be more than sufficient (see chart below), particularly given the current administration's rhetoric on the subject.



Source: ADES presentation at Sidoti Spring 2017 Emerging Growth Convention

Concluding Summary

I think the risk-reward in ADES' stock is highly favorable at current prices, and I've attempted to take advantage of the dislocation by adding materially to my position in recent weeks. Between the continuing cash flows from Tinuum, the long runway for additional facility monetization and chemical segment growth, and the positive tail-risk of the patent portfolio's value, there are multiple ways to reach a favorable outcome from here. Even better, with the new 12% dividend, investors are paid (handsomely) to wait for these events to unfold.

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