Adestella
Investment Management

August 3, 2018

Dear Fellow Investors,

Adestella lost 8.3% in the second quarter of 2018. Overall, our long positions lost 9%, while our short book produced a 0.8% return. Our domestic holdings were basically flat; it was the losses from our international stocks that set us back over the period. While foreign exchange had a small impact nominally (-0.1%), its effective influence was much larger since several of our dollar-denominated emerging market ADRs were severely hurt by the falling value of their home currencies – I estimate that the aggregate real impact was -3.5%.

Following the third quarter of 2017, in which Adestella produced a 21% return, I stated that the timing of our returns would not always match up neatly with the quarterly cutoff, and the fact that it worked to our advantage during that period didn't mean that it always would. This prediction came to fruition this past quarter, in which market value losses exceeded intrinsic value losses by a large margin. However, divergences such as these should be expected, as Mr. Market's whims mean that price and value do not move in lockstep. Knowing this, our best solution is to capitalize on the opportunities created from the short-term pain to improve our long-term prospects. That is what we attempted to do this quarter, though only time will tell if these efforts will pay off.

An updated performance summary is provided below:

	2Q 2018	YTD 2018	Since Inception
S&P 500	3.55%	5.66%	50.48%
Vanguard Total World Stock ETF	0.39%	1.81%	29.37%
Russell 2000	7.86%	10.47%	45.77%
HFRI Equity-Hedge (Total) Index	0.85%	1.16%	20.94%
Adestella Investment Management	**-8.25%**	**3.07%**	**80.85%**

**all index returns include reinvestment of dividends*

Career Risk and its Consequences

Analyzing an investment opportunity requires a thorough review of the risks involved. Everything from valuation assumptions to industry structures to management's capital allocation priorities must be thoroughly vetted before a final decision is reached. However, for many institutional investors, there is also another potential hazard that must be considered: career risk, or the chance that you might be forced out of your job role because you purchased a stock or designed a portfolio that others may not be comfortable with.

Career risk stems from a misalignment of incentives between a fund manager and his investors. I've discussed the importance of incentives before in the context of public company CEOs, but its applications also apply elsewhere. Take the example of a hypothetical fund manager at a large mutual fund house. The fund company earns money from the expense ratio charged to investors in the fund, which tends to be a percentage of the fund's assets. Meanwhile, the manager earns a base salary but often does not maintain a significant investment in the fund itself – in short, he doesn't "eat his own cooking," because the financial return from his efforts comes from a different source than that of investors.

Like most humans, this manager responds to the incentives that benefit him the most. So, to keep the top executives at the company happy and thereby retain his cushy job and lucrative salary, the manager's personal target shifts from excellent investment performance to maximizing the fee-generating assets in his fund. He accomplishes his goal by harnessing the power of inertia – which has a powerful effect on both his superiors and the investors in his fund. He knows that as long as his performance is close to the average, it will be viewed as "good enough," and his bosses won't have a strong incentive to replace him. Conversely, if he trails the market indices by a large enough margin, it will inevitably catch the attention of those around him, and they may feel obligated to replace him for fear of looking irresponsible otherwise. His investors follow a similar thought process. If the returns they see when they open their statements are within a few percentage points of the market, they view them as being within a normal tracking error range – "good enough" – and simply go on with their day. It is only if they are substantially worse than the average that they become alarmed and consider whether they'd be better off transferring their money to another manager.

So what does the manager do to ensure that his employer's management and his investors both view his work as "good enough"? He designs a highly diversified portfolio, characterized by safe ideas and small position sizes, for which it is nearly mathematically impossible to deviate much from the broader indices thanks to the similarity of their composition. As the old saying goes, "no one gets fired for buying IBM." By following this strategy, he can credibly blame any performance shortfall as a consequence of bad luck or timing, and not as a result of his competence or decision-making ability. And, because the simplicity of the status quo is preferred to the extra work required to find a new manager/fund that may or may not be able to add a few extra percentage points of return, this explanation is accepted on both sides, and the manager retains his role (and salary). In an ideal world, he would be able to aim for superior performance while maintaining his job security – but when push comes to shove, his personal incentives compel him to avoid the risk associated with seeking both.

This phenomenon applies in the hedge fund industry as well. Many sophisticated institutional investors like the security of a brand name fund with dedicated risk management department – much like with fund managers and IBM, no one gets fired for allocating to a fund with $10 B in assets. To that end, allocators often seek large, well-established entities, even if they've grown to a size that makes it difficult to replicate their past successes. To them, it'd be better to get mediocre returns in a famous, bloated fund than to risk losing money with a manager no one has heard of. As a result, most money tends to flow to the largest funds, even though research consistently shows that smaller funds tend to perform better. Thus, for many mutual funds and hedge funds alike, the rule is the same: it's better to fail conventionally than to succeed unconventionally.

So how can one avoid situations in which one stakeholder's career risk creates suboptimal outcomes for all the others? The key is to ensure incentives are aligned among all parties in an arrangement – everyone must be driving toward the same outcome that will maximize the personal reward for their efforts. When it comes to stocks, look for situations in which there are high amounts of insider ownership, ideally with owner-operator management. For funds, ensure manager compensation only increases if investor returns do as well. Such measures do not guarantee success, but they do ensure that everyone will have the same definition of it, and that's half the battle.

I cannot guarantee that Adestella will accomplish its goal of beating the market indices, or even that we will generate positive returns in the future (though I very much think we will!). What I can guarantee, though, is that whether we succeed or fail, we will do so unconventionally, and that our interests will remain aligned – both between myself and investors, and our stocks with their management teams. One of our unusual holdings is Grupo Supervielle, the subject of this quarter's appendix. As is the case with many of our other positions, insiders own a large percentage of the equity, thus ensuring that their success here will be based on the same metric that ours is. Please refer to the end of this document for an in-depth investment thesis on the company.

Putting the "Hedge" in Hedge Fund

In my experience, when many people think of hedge funds, they tend to view their defining characteristic as their ability to make money regardless of the broader market's direction by betting against stocks just as readily as they bet on them. Short selling, which most mutual funds are barred from, is seen as a key differentiator between traditional and alternative investment vehicles. Profiting on both sides while simultaneously decreasing market exposure sounds great to anyone, which is probably why many investors perceive shorting to be a key factor in alpha generation.

It seems as though some managers feel compelled to live up to this image by maintaining large short books that greatly limit their net exposure. And perhaps for some funds, this is a sensible decision if their investing goal is limited market correlation or low volatility. But for a fund like Adestella that strives to outperform the market over time, having a large short book that creates low levels of net exposure tends to be incompatible with our objective.

Let me explain further. In theory, a long-short portfolio that retains upside volatility while nearly eliminating downside volatility would be great; in reality, several practical difficulties prevent this scenario from transpiring. Some key challenges are the following:

1. **Borrow costs** – in order to borrow the shares necessary to initiate a short position, you pay a fee that can be thought of as the annual interest rate on your loan. It is not uncommon to see this rate in the teens, and for some of the most popular shorts, it can reach extremely high levels (think 50%+). Accordingly, you're working against the clock whenever you short, and given the difficulty of timing the market or individual stock, this is a big drawback. You might nail the thesis on a company and see the stock fall 30% – but if it took a year to play out and there was a significant borrow cost in the interim, your net profit may be minimal (or even negative).
2. **Guaranteed short-term capital gains** – in the example above, let's say now that borrow costs were *de minimis*, and after all fees, you earned a 30% return. That's great, but even if you held the stock for over a year, you'd still be subjected to short-term capital gains because you technically borrowed the stock instead of owned it over that time period. As a result, shorting is structurally tax inefficient, and the difference in the net result can really add up over time, particularly for those in the highest tax brackets.
3. **Inherently unfavorable risk-reward** – another natural drawback to shorting is the unfavorable range of outcomes. With a long position, the most you can lose is 100% (if the stock goes to $0), and your upside is uncapped. On the other hand, the most you can ever make betting against a company is 100%, but your potential losses are unlimited and will continue growing if the stock continues climbing.
4. **Risk management difficulties** – mistakes are inevitable in investing, but they can be particularly costly with short positions. If you are incorrect in your assessment of a long holding and the stock declines, the position becomes a smaller part of your portfolio over time as its value falls. However, an unprofitable short grows as a percentage of your asset value over time (as your cost to buy it back increases with the price) and becomes a larger problem. The need to prioritize risk management can force an exit from the position at the worst possible time, thus making price volatility work against you rather than for you.
5. **Psychological difficulties** – the combination of #1, #3, and #4 above can make an investor skittish when a position starts moving against him, making it very tempting to exit with a known loss instead of waiting and continuing to remain exposed to unlimited risk in a stock the market is telling him he's wrong about. This again has the effect of making a potentially good idea unprofitable solely due to unfavorable timing.
6. **Swimming against the tide** – for centuries, the trend of economic growth has basically moved in one direction, and thus for the most part, the stock market has as well. Every day, dozens, hundreds, or thousands of people wake up and spend their day working to improve the position of the company you're betting against. None of this means a given equity won't decline in value over a given period of time, but it does mean that in the long run you tend to be swimming against the tide, making things all the more difficult.

On top of all the financial obstacles listed above, there are also significant concerns related to another scarce resource – time. In general, researching and monitoring short positions requires just as much time and effort as it does for long positions. However, because of the difficulties outlined above, these short holdings tend to be smaller in size than our longs. As a result, the "return on time" – the amount of fund exposure a given idea comprises relative to the time dedicated to it – is almost always lower for short positions. Without the resources of a large team behind me, building and monitoring a large short book would be an inefficient use of time and effort better allocated elsewhere.

So given the drawbacks delineated above, why bother short selling at all? Even when shorting isn't profitable by itself, it can allow for the fund portfolio as a whole to gain more. Let's say you run a 130-30 fund, which means you take long positions worth 130% of your net assets and short positions worth 30%, putting your net exposure in line with the market at 100%. At the end of the year, both your long portfolio and the market have gained 10%, while your short positions lost 5%. Here is what the gross returns would be in our 130-30 structure, versus the long-only 100% net structure of a market index.[1]

Structure	Long Portfolio Return	Long Exposure	Returns to Longs	Short Portfolio Return	Short Exposure	Returns to Shorts	Total Portfolio Return
130-30 Portfolio	10%	130%	13.0%	-5%	30%	-1.5%	11.5%
100-0 Market Index	10%	100%	10.0%	0%	0%	0.0%	10.0%

As you can see, even though the long positions didn't outperform and the short positions lost money, the return to the 130-30 portfolio is 1.5% higher! Alternatively, if your shorts were in line with the market (10% loss) while your longs outperformed by one percentage point, you'd end up with an 11.3% return. In both cases, the short positions made losses – but these were more than offset by the fact that they provided the counterbalance necessary to increase exposure to the longs. Of course, the returns could be even higher without any shorts at all, but taking on leverage just to accentuate returns adds a significant element of additional risk and is, in my view, almost always imprudent.

In light of all the above, Adestella's short positions are heavily weighted toward indices, which have several advantages. They tend to be cheap to borrow (often less than 1%), require less effort to maintain, and greatly reduce the risk-reward, risk management, and psychological concerns mentioned above thanks to the stability provided by the law of large numbers. Of course, the flipside is that they won't underperform very much either. But if we are confident in our long holdings, the extra exposure we can attain in this manner makes this tradeoff favorable, particularly considering the tax consequences. By tilting our short index exposure toward factors that we think are more likely to underperform relative to the broadest indices (for example – shorting a large cap domestic growth index instead of the S&P 500), we can further enhance the attractiveness of this structure in an attempt to maximize our returns.

[1] The long and short portfolio returns are simply the result of multiplying that portion's return by its exposure level.

Outlook

As temperatures have risen for the summer, so have tensions related to international trade disputes. Threats, accusations, and retaliations have become seemingly daily news headlines and threaten to end a trend of declining costs of commerce that has persisted since the end of World War II. However, I continue to believe that what I wrote last July holds true: our performance will ultimately be determined by the underlying business performance of our holdings and not by the frequency of rate hikes, missile launches, or (to add to that list) tariff implementations. Thus we will stay the course, occasionally taking some hits on our way, in order to pursue the potential rewards in the longer term.

Conclusion

Losing money is a very unpleasant thing. As Charlie Munger once said, “Everybody wants… to have a yearly outcome path that never diverges very much except on the upside. Well, that is a very artificial, crazy construct.” I would very much like to achieve the outcome path he describes, but unfortunately, I believe he is correct. If we want to beat the market over a multi-year period, we have no choice but to also accept occasional interim periods of underperformance – it is the inevitable side effect of a concentrated portfolio. When deciding what they desire most from their investments, market participants are forced to choose between the comfort of a smooth outcome path or the potential longer-term reward of superior returns. We have chosen the latter, and I look forward to continuing to work toward that goal in the second half of the year.

> *“Complaining is not a strategy. You have to work with the world as you find it, not as you would have it be.”*
>
> \- Jeff Bezos

Per Ardua Ad Stella,

Andrew Jakubowski

Appendix A: Grupo Supervielle (SUPV) Investment Thesis

Introduction

A year ago, Argentina was a market darling as investors became excited about the potential for the Argentinian economy under the pro-business administration of President Maurico Macri. The country's flagship Merval Index rose 77%, the highest of any in the world. That optimism has come to a screeching halt in the last six months, as country-specific and emerging market (EM) fears produced a selloff that drove the index down by 28% at its lows. Today, EM equities are still viewed as untouchable by many investors, who often cite concerns related to trade wars and dollar strength as prudent reasons to take a "wait and see" approach. And of these EMs, Argentina is viewed as perhaps the least desirable, thanks to the heightened currency and political risk it layers on top of all the typical concerns.

With all that said, I believe amidst the carnage there are several high-quality Argentinian businesses that were indiscriminately sold this summer as investors attempted to reduce their exposure to both the country and the emerging market arena. These businesses are well-positioned to grow in the upcoming years, regardless of who becomes the next president or whether inflation remains stubbornly high. One of these companies that fits this description is US-listed Grupo Supervielle (SUPV), Argentina's fastest growing private bank.

Company & Situation Background

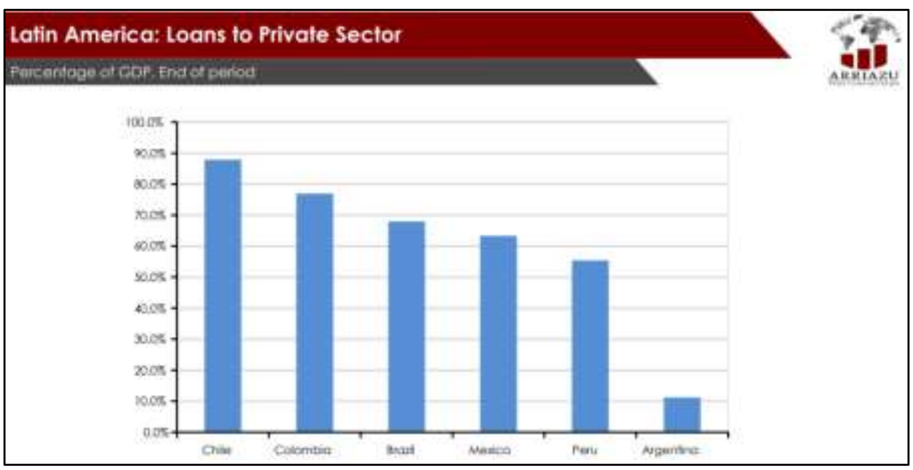
Grupo Supervielle traces its roots all the way back to 1887, when French emigrants started a business in Buenos Aires offering time and demand deposits, savings accounts, currency sales, and letters of credit payable in European financial centers. However, it did not become a broader regional player until the 1960s, when a series of transactions extended its reach to 60 branches and facilitated an entry into the corporate market. Over the next decades, a series of bolt-on M&A deals continually expanded the company's presence, during which time the company also acquired its present name. Having now reached sufficient scale, Grupo Supervielle sought to accelerate its growth by going public in the spring of 2016. The company managed to raise $322 M USD to facilitate loan book growth in an offering that was four times oversubscribed. Today, the company is one of the leading banks in Argentina, with an integrated financial services platform focused on retail banking, corporate banking, and consumer finance while also maintaining product lines in insurance, asset management, and online trading.

Following its 2016 IPO, SUPV nearly tripled in 18 months as investors became excited about the prospect of sustained economic growth in Argentina. This came on the back of a large number of structural reforms, many of which were designed to rid the country from the disastrous policies implemented over the twelve years of rule of socialist presidents Nestor Kirchner and Cristina Fernandez de Kirchner. But these gains were completely erased in just a few months earlier this year, as a violent swing in sentiment about Argentina's outlook combined with profit-taking, US dollar strengthening, and rotation from emerging markets caused the stock to lose two-thirds of its value in the second quarter.

Key Investment Points

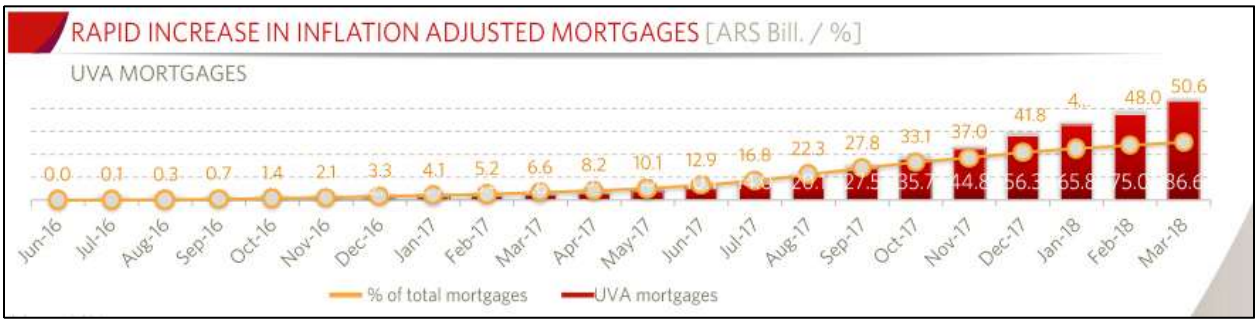
While Argentinian sentiment may have gotten ahead of itself last year, I believe that the pendulum has now swung too far in the other direction. Longer term, I believe the outlook remains quite positive, creating opportunities in high quality businesses for investors with a multi-year horizon. Here are the key points of my thesis:

Argentinian market remains significantly underbanked. Despite being the third largest economy in Latin America, Argentina has one of the smallest financial industries – private sector loans as a percentage of GDP are less than one-fifth of regional peers. Any sort of reversion to the mean, even a modest one, would imply significant industry growth.



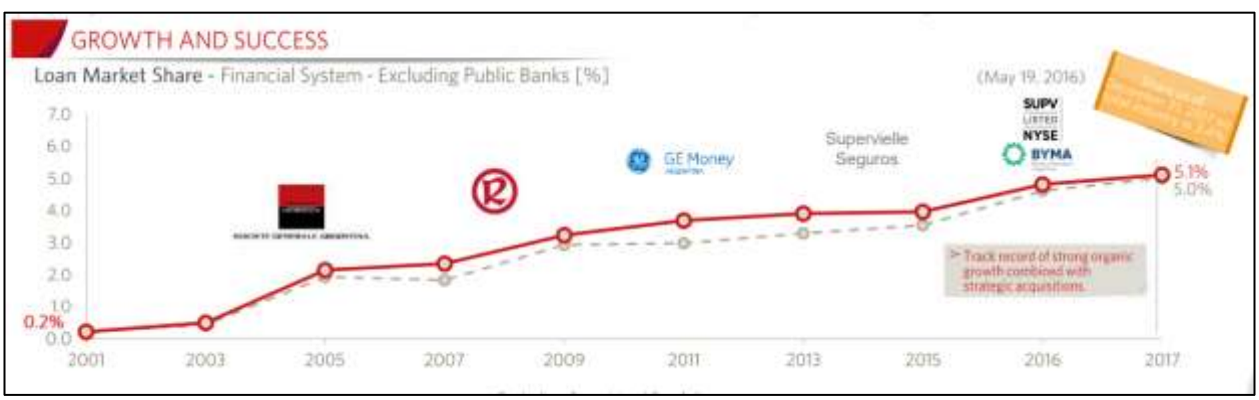
There is ample room for further leverage across all sectors. Household debt service ratios as a percent of disposable income are 12%, while South American peers are all above 17%. Meanwhile, corporate leverage ratios are easily the lowest as well (see chart below):

There is strong evidence that these large discrepancies are already in the process of being narrowed. Loans and deposits have been growing rapidly for some time, but they have accelerated in the last twelve months and are now expanding their [fastest in over a decade on a real basis](). Households in particular have been taking on additional debt – mortgage penetration, which was less than a fourth of peers until recently, has grown very rapidly:

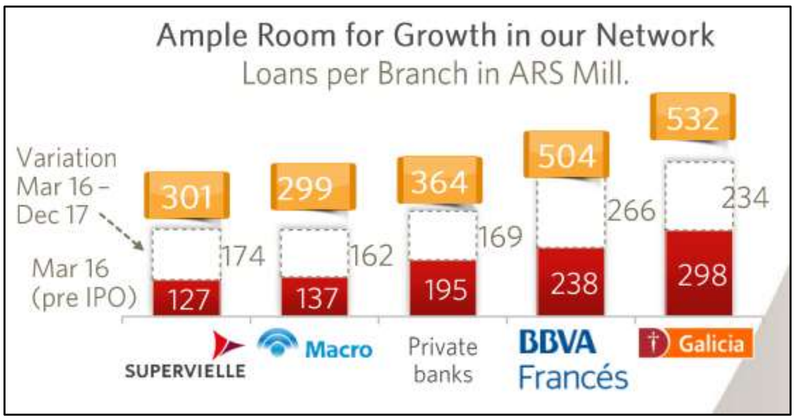


Taken together, the Argentinian financial system should double in size over the next 5-7 years, to the great benefit of banks like SUPV.

High quality bank with long track record of growth. While a positive industry outlook is no doubt of great importance, company-specific considerations are equally key, particularly with an emerging market firm in a macro-sensitive sector. To that end, I believe SUPV's excellent track record is a key differentiator. Growing in the context of an expanding industry is good, but what separates SUPV is its performance relative to peers with the same tailwinds. As you can see below, SUPV has managed to increase its market share every single year for nearly two decades:



What's more, there is a very good chance that this pattern can continue for the foreseeable future. Before its IPO, SUPV had one of the lowest loans per branch average because of a lack of capital to grow its book. Now that that is no longer an issue, much of that gap has been erased, and I expect the company to trend toward the peer median (see graphic below). These efficiency gains layered with new branch openings should continue to help the company expand at above-market rates in the years ahead. Furthermore, Argentina's banking system is one the least concentrated in Latin America; given the well-known link between industry concentration and competition, this implies that small and mid-size firms like SUPV are not at a disadvantage relative to the largest players and can continue to increase share if they offer a superior value proposition.

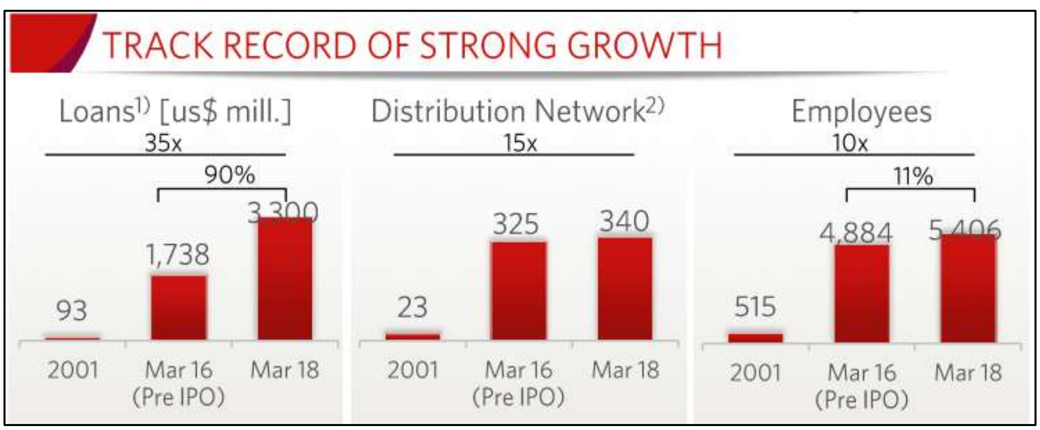


So what is it about SUPV that allows them to provide a superior value proposition and thus continue to take share? I believe there are two main reasons. First, the company has developed core competencies in a variety of niche product lines, such as social security payments and factoring, in which there tends to be less competition. Second, SUPV has some of the lowest funding costs in the industry thanks to their account mix (which skews toward no-cost checking accounts), allowing them to offer the best loan rates while maintaining profitability levels (see breakdown with SUPV and its two closest competitors below).

Table 5: Argentine banks – average funding breakdown and costs (4Q17)

	Macro	Galicia	Supervielle
Mix			
Checking	1%	2%	32%
Savings	30%	41%	26%
Time	57%	39%	24%
Total deposits	**88%**	**82%**	**83%**
Corporate bonds	10%	12%	17%
BCRA	2%	6%	0%
Total funding	**100%**	**100%**	**100%**
Avg balance			
Checking	1,214	3,205	19,237
Savings	34,134	65,494	15,562
Time	65,209	61,674	14,245
Total deposits	**100,557**	**130,373**	**49,044**
Corporate bonds	11,735	19,674	10,348
BCRA and other interest bearing liabs	1,725	9,564	-
Total interest bearing liabs	**114,017**	**159,611**	**59,392**
Yield			
Checking	*0%*	*0%*	*5%*
Saving	*0%*	*0%*	*0%*
Time	*16%*	*20%*	*17%*
Total Deposits	***10%***	***10%***	***7%***
Corporate bonds	*17%*	*23%*	*16%*
BCAR and other instruments	*11%*	*15%*	*0%*
Total interest bearing liabilities	***11%***	***11%***	***9%***

Experienced management team that has navigated these situations before. Julio Patricio Supervielle is the chairman and CEO of SUPV. The descendant of the 19th century founders of the firm, Julio retains control of the company with a 36% economic interest and a 64% voting interest. His title has varied over the years due to the company's convoluted group structure, but he has led the group since 2002 and officially been CEO of the holding company since 2008. Under his tenure, the company's operational performance has been excellent, and its footprint has greatly expanded (see graphic below).



In late June of this year, SUPV [announced that it would split the roles of chairman and CEO] starting in September. Julio Supervielle will remain the chairman of the board, focusing on longer-term strategic initiatives, while longtime lieutenant Jorge Ramirez will become the next CEO. While personally I would probably prefer if Julio simply retained his current role given his performance to date, his significant equity stake and continued full-time commitment to the company give me confidence that SUPV will be able to continue to execute well and pursue its growth strategy under its new structure without skipping a beat.

Valuation

Following its 54% decline year to date, SUPV has gone from trading at a premium to the Latin American banking universe to a discount, despite its superior growth and profitability (note the comp set below only includes banks with a market value above $1 B USD and ROE above 10%).

Symbol	Name	MV (USD)	LTM P/E	NTM P/E	Price / Book Value	ROE	LTM EPS Growth
201813	Banco Bilbao Vizcaya Argentari...	2,768.2	16.8	-	1.97	12.2%	31.8%
B00FM5	Banco Bradesco SA Pfd	55,718.1	13.6	9.8	1.86	13.9%	-2.8%
B4KC97	Banco Davivienda SA Pfd	5,693.8	11.7	9.7	1.25	12.3%	-25.8%
207503	Banco de Bogota SA	8,055.4	11.4	-	1.30	12.2%	-52.1%
210084	Banco de Chile	15,516.2	17.4	15.5	3.16	19.2%	7.1%
206785	Banco de Credito del Peru SA	16,498.3	17.4	-	3.12	21.0%	2.7%
206935	Banco de Credito e Inversiones	8,377.7	15.8	13.4	1.96	14.2%	6.5%
232859	Banco do Brasil S.A.	24,679.8	8.1	6.6	0.99	12.7%	51.6%
B23F8S	Banco do Estado do Rio Grand...	1,795.4	5.7	6.3	0.87	15.6%	59.9%
202676	Banco Internacional del Peru S...	4,522.1	14.9	-	2.82	20.2%	18.5%
208050	Banco Macro SA Class B	4,776.3	11.7	8.0	3.35	28.8%	25.8%
B23D3B	Banco Patagonia SA Class B	1,110.0	8.4	-	3.80	34.9%	8.8%
Average		**12,982.5**	**13.5**	**10.2**	**2.17**	**17.5%**	**9.5%**
Median		**6,421.0**	**13.7**	**10.3**	**1.97**	**15.7%**	**6.8%**
	SUPV (ADR)	*1,215.3*	*8.1*	*7.3*	*2.05*	*25.3%*	*28.4%*

Below is a summary of the key financial assumptions I use in creating my model:

Metric	Projection & Explanation Summary
Net Interest Margin	Boost in 2018 from higher interest rates; gradual decline in 2019 & 2020 as funding costs slowly increase
Loan Growth	50% loan growth in 2018 (implying large deceleration in second half); slower nominal but higher real growth in 2019 & 2020 as inflation slows and economy returns to growth
Fee & Insurance Income	Grows at 5% above inflation, in line with recent trend
Efficiency Ratio	At higher end of company's guidance range for 2018 due to impact of projected slower loan growth, partially offset by tightened expense controls. Steady decline thanks to economies of scale in 2019 & 2020
Inflation	Assumes latest central bank targets of 30% for each year

Using these assumptions, I arrive at the following net income and EPS projections (with the domestic listing at the top and the US ADR underneath):

	2015	2016	2017	2018	2019	2020			
Total PBT	909	1,863	3,210	5,031	7,540	10,621			
- Taxes	247	501	867	1,358	2,036	2,868		27%	effective tax rate
NI	662	1,363	2,437	3,673	5,504	7,753			
/ Shares Out.	249.0	363.8	456.7	456.7	456.7	456.7		0%	annual dilution
EPS (local)	2.66	3.75	5.34	8.04	12.05	16.98			
EPADR	1.02	1.18	1.60	1.48	1.89	2.36		16.6%	CAGR

In most geographies, bank P/B multiples correlate to returns on equity. This relationship holds in Latin America as well, particularly in Argentina (0.81 R^2). Running a regression based on this data, a fair P/B for an Argentinian bank generating a 27% ROE comes out to 3.6x. However, 3.6x may seem high to investors used to the sub-1x multiples often found for US bank stocks, and I am not interested in wading into an emerging market idea solely on the basis of large expected multiple expansion, so I apply a 15% discount to the fair yield. These calculations produce a price target of about $22 (note that all targets are for the ADR listing instead of the domestic one and are denominated in USD). My price target triangulates to a P/E multiple of 11.5x, which is again below peers and SUPV's history. This implies a PEG ratio of only 0.7x, less than half the comp set average.

	2015	2016	2017	2018	2019	2020			
EPADR	1.02	1.18	1.60	1.48	1.89	2.36		16.6%	CAGR
x Multiple	11.5	11.5	11.5	11.5	11.5	11.5		11.5	P/E
Value	11.75	13.56	18.42	16.98	21.75	27.12			
Upside	*-12.7%*	*0.8%*	*36.8%*	*26.2%*	*61.6%*	*101.5%*			
IRR	*-12.7%*	*0.8%*	*36.8%*	*42.3%*	*33.5%*	*30.1%*			
ROAE	*32.2%*	*29.3%*	*25.9%*	*26.7%*	*28.3%*	*28.6%*			
YE ROE	*32.2%*	*26.3%*	*25.4%*	*28.0%*	*28.6%*	*28.5%*			
Avg. Book Value	2,056	4,658	9,428	13,747	19,440	27,156		61.0%	2016-2019 CAGR
x Multiple	3.69	3.32	2.90	3.00	3.20	3.23		<-- see regression calculation below	
MC	7,583	15,465	27,299	41,294	62,264	87,655		15%	fair P/B multiple discount
BV per ADR	3.17	4.03	6.19	5.53	6.68	8.26			
Value per ADR	11.70	13.39	17.94	16.61	21.40	26.66			
Upside	*-13.0%*	*-0.6%*	*33.3%*	*23.4%*	*59.0%*	*98.1%*			
IRR	*-13.0%*	*-0.6%*	*33.3%*	*37.5%*	*32.2%*	*29.3%*			

Because there are a relatively wide range of variables in play here, it may be instructive to also consider an upside and downside valuation case for SUPV. Let's start with the downside. Here, we will assume Argentina only manages to increase loan penetration to pre-crisis levels over the next five years, and that SUPV ceases to gain market share and merely manages to match industry growth (implying about 15% real loan growth). We also reduce expectations for the company's efficiency ratio and net interest margin. Further, we will apply the same 8.3x earnings multiple that the stock currently has. In this scenario, I project SUPV to earn $1.72 per ADR share in 2020, which produces a $14.25 price target, just above the current trading price.

Alternatively, what might happen if Argentina makes it through this difficult current period and then continues on the path it began in 2016? I believe there are strong parallels between Argentina today and Brazil in 2003. Following years of anemic economic performance for Argentina's larger neighbor, Brazil experienced a credit boom that drove 25%+ real loan growth. During that time period, Brazilian banks traded at multiples above 3.5x book and 15x earnings, and the combination of rapid EPS growth and multiple expansion drove 9-10x returns over four years for investors in bank stocks like Bradesco and Itau. Argentina is perhaps in even better position than Brazil was, given that its loan penetration levels are nearly ten percentage points below those of Brazil before its boom. If SUPV were to manage that, I believe the company could earn nearly $3 per ADR share and be worth $43 in 2020, which would be more than a triple from here.

There are plenty of assumptions here, so feel free to use whatever growth and multiple projections you think are reasonable, but based on a range of reasonable values, I think that the risk-reward proposition to SUPV is very positive near current levels.

Why Does the Opportunity Exist?

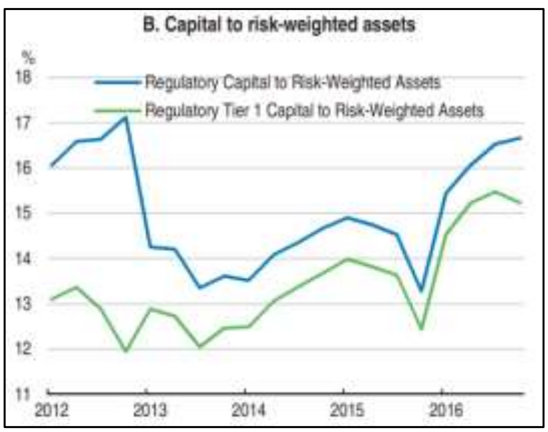
My introduction section went over the sequence of events that got us to this point, but here I'd like to explore several of those points in more detail:

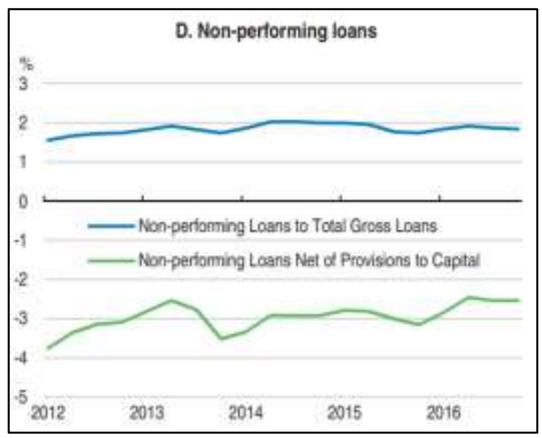
- "**Unownable"** – investment professionals at large firms may decide that the volatility and economic uncertainty isn't worth jumping into or prefer not to take the risk of incorrectly recommending an emerging market stock that has already dropped nearly 60% year to date.
- **Panic from inflation and potential brief recession** – investors often maintain short-term time horizons, which probably led many to sell in an effort to exit their Argentine holdings before the potential recession hits.
- **Emerging market rotation** – emerging markets as a whole, not just Argentina, fared poorly in the second quarter. Indiscriminate selling from investors looking to reduce their EM allocation likely exacerbated the pressure on Argentine equities.
- **Under investors' radar** – as a relatively recent IPO, SUPV is not particularly well known to investors. The company's sell-side coverage is mostly LatAm-focused investment banks with limited US exposure. From a retail investor perspective, SUPV only has about 700 followers on Seeking Alpha, far below the average for a company of its size.

Why Is This Time (Somewhat) Different?

One positive of the Argentine great depression was that it catalyzed a variety of reforms that should be beneficial to the banking system in the current period of turmoil as well as in the future.

- **Asset/liability match** – perhaps the main cause of the 2001 crisis for the banking system was that it lent dollars while taking deposits in Argentine pesos, creating an asset/liability mismatch the eventually led to a run on the banks. Now, all USD deposits are matched with loans or investment securities in USD, and only companies that generate revenue in dollars are allowed to take out USD loans. This insulates bank balance sheets from FX volatility and ensures that a situation like 2001 cannot reoccur.
- **Strong capitalization in banking system** – Argentinian banks are well-capitalized, with a capital to risk-weighted asset ratio more than 3% above the upper bound of the Basel III standard. Moreover, non-performing loans as a percent of total gross loans in Argentina are nearly half the world average.





The Macri administration has further strengthened Argentina's financial reputation by reaching agreements with holdout creditors following the country's 2001 default and eliminating foreign exchange controls. These were key factors in MSCI's decision to upgrade the country to an emerging market (which should help attract foreign investment – more below), as well as in the IMF's agreement to offer the largest credit line in its history to help the country fend off potential current attacks and comfortably meet all financing needs. Some view Argentina's decision to accept IMF assistance as a political mistake, as many citizens still blame the IMF for their causing their 1998-2002 great depression through its austerity measures. However, both sides are keenly aware of the mistakes made in that deal (and subsequent reputational damage), and this time they actually agree about the policies being implemented. This should allow things to run much more smoothly – particularly since there are no austerity measures this time around.

Risks & Their Mitigants

- **Continued inflation** – Argentinians have long struggled with currency depreciation. It remains perhaps the biggest concern both for citizens tired of seeing their purchasing power erode and for foreign-currency denominated investors who have lately watched Argentinian ADRs perform much worse than the (already poor) performance of domestic listings. However, I continue to believe that Argentina took the right steps in the recent months to stem the peso's decline, and that the country's market-based reforms will eventually manage to reduce inflation to a sustainable level, if on a slightly longer timeframe than originally hoped.
- **New administration** – Argentina will have its next presidential election in October 2019. Many investors are already looking ahead and fearing that the current turmoil increases the odds that the pro-business Macri administration will be replaced by a less market-friendly party. However, his approval rating remains high, indicating citizens have not lost their faith in his platform. Additionally, SUPV managed to grow and take market share every year under two of the most business-unfriendly administrations in the country's history earlier this century, so I feel confident that the company is equipped to deal with any type of political eventuality.
- **Recession** – the consensus economist expectation is now that real GDP in Argentina will contract in the second and third quarters of this year, largely thanks to the impact of the drought experienced earlier this year. That said, the full year expectation is still positive, and my thesis was never based on a few quarters' GDP numbers. Once we see a return to a positive trend as the effects of the drought wear away, I believe investor sentiment will brighten once again.
- **Guidance cut** – SUPV has not yet released its earnings for the tumultuous second quarter period. In the first quarter earnings release, management indicated they saw no reason to cut their guidance but that they were keeping a close eye on economic fundamentals. Since those fundamentals have only become more challenging in the interim, it's possible that the company decides to moderate its expectations for the back half of the year. However, with 2018 consensus estimates and the stock price down 25% and 60% from their respective peaks, I would argue such a potential cut is more than priced in, thus creating the possibility of a relief rally if the quarter isn't as bad as feared. In any case, the long-term industry tailwinds that create the opportunity here remain intact.
- **Capital raise** – late last summer, following a sizable run-up in its stock price, SUPV completed a follow-on stock offering to further accelerate its growth. Given the success they had with deploying their IPO capital and the low credit penetration with their market, there was a reasonable argument to be made that raising money to grab loan origination market share made sense. However, I view that as highly unlikely to occur at current prices (which are 47% lower than the secondary price), as management's significant ownership stake (36%) ensures their interests are aligned with shareholders.

Potential Catalysts

- Argentina introduction to EM index – in June, MSCI announced that Argentina would be upgraded from frontier to emerging market status in their stock indices, marking a return to the status the country enjoyed until 2009. This is important because many index funds benchmark their holdings to MSCI's indices, and the amount of money indexed to emerging markets is more than 50 times the amount to frontier ones. Thus, flows should improve as index funds benchmarked to the MSCI start buying to reflect the new index composition; markets that have been upgraded to emerging have historically seen 12-34% returns in the six months following the announcement.
- Inflation normalizes – while all Argentinian equities were hit hard in the last six months, banks were especially punished thanks to their macro sensitivity and the outsized impact of interest rate changes on their business model. However, the central bank took decisive steps (including the aforementioned IMF loan) to stem the decline, and it appears based on the last month's trading action that they've succeeded in returning the currency to stability.
- Economy returns to growth – as the Argentinian economy shows positive growth again at the end of this year and the prospect of this poor harvest rolling off year-over-year comparisons becomes clearer, investor optimism could push the Argentinian markets higher as a whole. If the rising tide lifts all boats, SUPV could stand to benefit as well.

Conclusion

Pattern recognition is an important part of investing. With practice, one can learn to identify certain reoccurring series of events and then use that knowledge to gauge the likely outcome that that specific series will produce. One relatively common pattern is as follows: investors become concerned with the growth outlook of an emerging market, often coinciding with a swift decline in the value of its currency. Selling pressure begets selling pressure as everyone rushes for the exits, with economically sensitive stocks (like banks) being the first to go. Individuals see the massive decline in value and decide they'd rather wait for the knife to hit the ground than to try to catch it. But then at some point, finally, the news isn't quite as bad – not even good, just not as bad. Now, comfortable that the worst is over, bargain hunters dive in, pushing up prices. Seeing that people are now making money in emerging markets, investor optimism returns, increasing prices still further, and soon enough the stock has recovered its losses.

In the late 1990s, around the time of the Asian financial crisis, Colombia experienced a recession. The country's largest bank, Bancolombia, lost over 95% of its value by 2001. But then at some point, investors figured out that the country's issues wouldn't last forever, and the stock returned 22x in less than five years – not only recovering current losses, but nearly doubling from the previous highs. From late 2013 to late 2014, Sberbank – the largest bank in one of the largest countries in the world – lost about 50% of its value as market participants fretted about the impact of low oil prices and economic sanctions on Russia. But then eventually, investors realized that maybe a nation that traces its history back to the Middle Ages would survive this particular commodity cycle too, and just over three years later the stock was up 600%, nearly 200% above its pre-crisis high.

I don't think the returns to SUPV will be anywhere close to the ones in those cases, but I do believe that we're seeing another example of this pattern occurring here. Eventually, Mr. Market will reevaluate Argentina and realize that maybe things aren't quite as bad as they seem now. At that point, he will look at SUPV's fundamentals, see a fast-growing stock in an industry with long-term tailwinds, and decide that shares should be worth more than they are now. I don't know what will catalyze his decision, or what price he will eventually decide it to be worth. What I do know, though, is that the range of likely outcomes seems quite favorable and could easily produce a 30 % IRR out to 2020. For that reason, I own SUPV stock today and expect to continue holding it in the years ahead.

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