Adestella
Investment Management

May 24, 2019

Dear Fellow Investors,

Adestella gained 13.9% in the first quarter of 2019. Long positions returned 18.4%, offset by 4.9% in short book losses. Both domestic and international holdings made a positive contribution, adding 3.1% and 10.5%, respectively, while currency provided a 30 basis point tailwind. At quarter-end, Adestella had gross exposure of 171% and net exposure of 86%.

Markets rebounded sharply over the period, finishing with the largest first-quarter increase since 1998 and erasing most of the losses from the final three months of 2018. We managed to match the indices despite our lesser domestic and net exposures, as well as the underperformance of Fiat Chrysler and BlueLinx, two of our largest positions.

An updated performance summary is below:

	1Q 2019	Since Inception
S&P 500	13.52%	59.02%
Vanguard Total World Stock ETF	12.21%	31.16%
Russell 2000	14.64%	37.97%
HFRI Equity-Hedge (Total) Index	7.63%	19.15%
Adestella Investment Management	**13.90%**	**41.90%**

**all index returns include reinvestment of dividends*

Investors' Least-Favorite Relative

With the recent conclusion of tax season, I thought the timing might be apt for a discussion of this oft-ignored element of investing. It's easy to see why capital gains taxes are usually overlooked: they are probably the most unglamorous aspect of any investment lifecycle. Nevertheless, this is an area that I have been paying much more attention to in recent years, as their longer-term effects on actual realized returns can be substantial.

In my previous letter, I wrote about my plan to allocate a larger portion of the portfolio to higher-quality, compounding type businesses that can be held for long periods of time. This is certainly not a novel idea, yet one of its primary benefits is almost never discussed. Aside from reducing the number of tough decisions related to sale-timing, longer holding periods allow us to defer paying taxes on that position.

Given that many investors pay a combined rate (federal, state, and local) approaching 50% for short-term capital gains and 30% for long-term gains, the drag from these payments to Uncle Sam is significant. Over a five-year investment horizon, and assuming the above rates, a hypothetical investor able to generate 15% from a buy-and-hold strategy would need to generate nearly a 22% CAGR if the assets were held at least a year and then sold in order to generate the same after-tax return (this jumps to more than double that 15% if they're sold within a year). Even for a very skilled investor, this is a high hurdle to overcome. While 7% per year might not sound like much, it's the difference between nearly doubling your money over ten years or having it stay flat (a formula the overall stock market has followed over the past century to generate trillions of dollars of wealth – all from 7% annual growth). And this is just for the more favorable rate of the two; if any portion of the gains are short-term, the math becomes all the more difficult.

The comparisons above indicate that there is real value in being able to defer these government payments. But just as importantly, the magnitude of that value increases every year. Take two portfolios, each generating a 15% pre-tax return per year. The first (Portfolio #1) switches out its assets every year, thus creating annual long-term gains tax obligations, while the other (Portfolio #2) is able to defer all taxes until the end of the holding period. If liquidated after five years, Portfolio #2 will generate a 1.4x better return (93% vs. 64%); after ten years, it will have outperformed by 1.7x (289% vs. 171%). In this manner, the discrepancy becomes ever larger as more time passes. This is why, for example, Warren Buffett owns several stocks that no longer offer much in the way of upside potential (Coca-Cola being the most prominent case in point). He has made it clear that nevertheless, these positions will likely never be sold because the longer the holding period, the more valuable the ability to continue deferring the capital gains taxes attached to them. And after 20-30 years of ownership, this option becomes very valuable indeed. Accordingly, because the embedded tax benefit of holding is far too compelling to relinquish within Berkshire's C corporation structure, he is content to keep them on the books.

Of course, one must also be careful to avoid allowing the tail to wag the dog – i.e. making investment decisions on the basis of tax impact as opposed to business performance. However, in my experience, this risk is much more acute for cyclical companies for which sale timing is important, since if you get it wrong, you may no longer have any gains to be taxed. Meanwhile, if you can identify long-term compounders whose intrinsic value grows every year, there is less of an issue. Time is undefeated, so we want it on our side.

Casting the Nets

Competitive advantages can come in many forms. Some companies manage to build strong brand loyalty; others find a way to produce their goods at a lower price than anyone else. But one particularly powerful type of advantage, and one that has become much more prevalent in recent decades thanks to the ubiquity of the internet, is a network effect.

The power of network effects stems from their decentralized nature – the importance of any individual user is very small. This makes it slower and more difficult to build up the critical mass required for the effect to occur, but it also makes the advantage more difficult to erode once in place. Subsequent efforts to encroach on this competitive moat often fail because of ineffective coordination, the power of inertia, and the effect of social proof. Furthermore, like the compounders mentioned above, these networks have time on their side. Many other forms of advantage require steady to growing spend to maintain; brands must continue to make marketing outlays to convey intended perceptions, and low-cost producers must further lower costs to stave off ever-improving competition. On the other hand, a powerful network's value increases exponentially while its costs increase linearly, allowing the system to naturally reinforce itself over time.

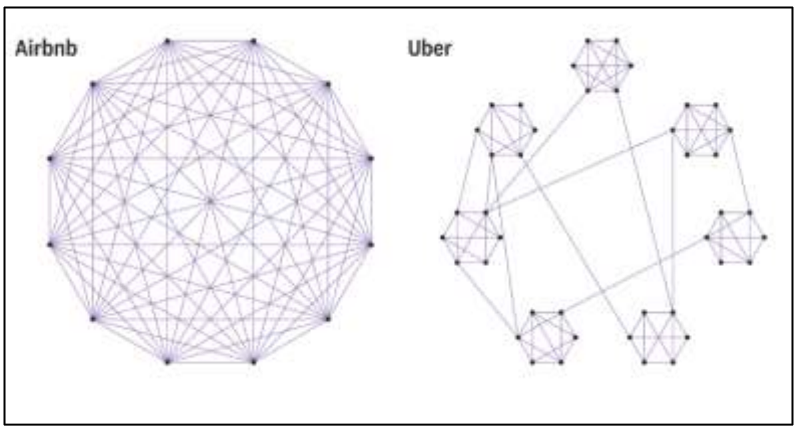
Not all networks are created equal, though, and many firms that claim to benefit from network effects are confusing them with economies of scale. The key differentiators between the two are the nature of the underlying supply and demand for the service.

Demand: I recently read an excellent article arguing that the fragmentation and clustering of networks has a massive impact on their ultimate viability. The authors' comparison between two venture capital "unicorns," Airbnb and Uber, is instructive here (and perhaps timely given Uber's recent IPO). The value of the Airbnb platform stems from the fact that it offers accommodation options throughout the world, wherever you are going, all in one place. Anyone that wanted to compete with them would need to build out a global network; no one wants to have to use a separate website for each location in which they need accommodation, and if only a handful of cities are available on a competing website, few people would go through the friction of making a separate account when they could already see those same cities on their existing default platform. Facebook is another good example of this – most people don't want to maintain separate social network accounts for different groups of people from all different places, and no one is motivated to join if the new network's members are simply a subset of the existing one. It is for this reason that Google, despite its massive reach and resources, was unable to ever get its Google Plus social platform off the ground and dislodge Facebook's position.

On the other hand, networks like Uber's are much more localized, with limited interconnectivity. In my hometown, I really only care about the availability of cars nearby; meanwhile, people in San Francisco are only concerned with availability in the Bay Area, and so on. While there is of course some overlap from out of town visitors and the like, this is an exception as opposed to the main use case. So instead of having large one global network, Uber really just has a large collection of small networks. This means that anyone that wants to compete with them can start simply competing in one city, attacking only that local network and then gradually expanding from there; in fact, this is exactly what Lyft did and why it's managed to grab 30% of the US ridesharing market despite Uber's more than three-year head start. A similar dynamic exists with food delivery networks like Grubhub –

users only care about the options in their area. With fewer resources required (as compared to a global rollout) and the ability to focus on the individual market peculiarities more closely, an upstart food delivery company would have a much easier time developing a foothold in one or a few locations and then expanding from there. It is for this reason that I believe the profitability of these ride sharing and delivery services will ultimately disappoint investors, even at scale.

Note the focus in the preceding paragraphs about what people want – i.e. their demand. It is the nature of this demand that determines the differences in the structure of the network. These differences can be quantified with Metcalfe's Law, but the graphic below from the aforementioned article provides an excellent visual summary of the salient point: having vibrant clusters is great, but what really gives a network its strength is the demand for interconnectivity between those clusters.



Supply: On the other side of the equation, network structures are influenced by the nature of the platform's goods and/or services for sale. Differentiated inventory allows networks to continue to strengthen with each new piece added. To continue the above example, people have different priorities with their Airbnb lodging choices – some require a private bathroom or self-check-in, while others just want a place near the train station. The endless number of possible configurations of these amenities means that each new listing added tends to add something novel and broaden the consumer's choice, thus increasing aggregate satisfaction and strengthening the network.

Conversely, commoditized supply has little marginal value once sufficient economies of scale have been attained. Once Uber has enough cars in a metro area to ensure readily available pickups, users don't gain much from an additional car on the road – they may have a mild preference for the make and model they ride in, but it is primarily the utility of moving from Point A to Point B that concerns them. It is this general indifference to the specific piece of inventory they are assigned that makes it commoditized, and prevents the company from deriving much benefit from an incremental driver beyond a certain point. As a result, the benefits to further growth decelerate materially once critical mass is reached.

As I evaluate different opportunities whose value depends in some part on their networks, I am now spending more time thinking about how the underlying supply and demand dynamics impact the robustness of each system. Given the packed slate of technology IPOs this year, this exercise will become all the more important for investors attempting to separate the wheat (long-term profitability) from the chaff (rapid but uneconomic sales growth) within this crop. In the end, I expect these market participants will come to the same conclusion that I have: it is rare to find companies with a true web of demand for differentiated supply, but that makes them all the more valuable when they do arise.

Discussion on Selected Positions

Continuing with the format introduced last quarter, I would like to provide a relatively brief overview of two of the Fund's newer positions in this section.

Wayfair (W): Wayfair is an online home furnishing store and the 13th largest e-Commerce player in the US (the largest among those specializing in home goods). The company is not a conventional value investment, but I think it's attractive for investors with a multi-year time horizon. Everyone knows that e-Commerce taking share from brick and mortar retail, but far fewer are aware of why home goods are an especially attractive industry niche.

The home furnishings market is characterized by large, heavy inventory that turns slowly. These items tend to carry both large retail markups (200-400%) and large sales commissions owed (7-20%) upon purchase. Furthermore, shoppers often have a difficult time articulating exactly what they're looking for, as this is largely an unbranded category – making it difficult to attack via traditional search engines. All of these factors combine to create an industry with quite a bit of fat to cut. Thus, it's perhaps not surprising that housewares/furnishings is easily the fastest growing category for e-Commerce in the US. Wayfair estimates it's getting over a third of these incremental sales, implying that it is taking significant share from legacy competitors.

Given that short interest is currently over 20% of the float, the opposite investment viewpoint must be explored. The main points to the bearish thesis are as follows:

Short Point #1: The company has not and cannot make a profit.

Counterpoints:

- This ignores that W was self-funded with no VC money from 2002-2011 while going from $450k to $500 M in sales. The company's lack of profitability in recent years has been due to their decision to accelerate growth during land-grab phase of market opportunity.

- Even after making a large G&A allocation to produce a conservative new customer acquisition cost estimate, I estimate W is receiving a less than one-year payback from customers' initial purchases, with all repeat orders after that generating over 4x contribution dollars relative to the ad spend required to stimulate these repeat purchases. Hence, increasing ad spend now to grow the customer base is an NPV positive move even if it masks profitability in the short term.

Short Point #2: There's been no scaling with growth.

Counterpoints:

- Looking at the company on a segment level basis, the US business is already profitable, but the money is being plowed into a European expansion that will effectively double their TAM; incremental ROICs have on these investments have been excellent to date.

- Going line-by-line through the company's long-term financial targets, I believe they are very feasible
    - Gross margins should expand as a higher proportion of sales come from in-house brands, current warehouse footprint buildout will ultimately reduce logistics cost, and larger economies of scale will allow greater leveraging of G&A spend over sales, etc.

Short Point #3: There is the risk Amazon enters the space in earnest and begins throwing its significant resources and expertise toward taking over the category for itself.

Counterpoint:

- There is plenty of space for both. 90% of the category still belongs to neither company, and the online segment of the market continues to expand each year.

In terms of valuation, Wayfair trades at 1.5x 2019 sales, which I believe is fair (if not somewhat cheap) for the following reasons:

- If the company were to stop spending on customer acquisition after next year and were content to simply grow at the market rate (thus allowing the business to generate about an 8% EBITDA margin), I estimate the company would be trading at the same unlevered FCF multiple as main comps Restoration Hardware and Williams Sonoma while having a much more attractive sales mix (as RH and WSM only generate about half their sales online). However, given we are still in the early innings of home furnishing purchases moving online (still less than 10%) and the opportunity remains massive, I don't expect them to pursue this route.
- Pure-play e-Commerce M&A deals (such as Walmart/Jet, Chewy's/PetSmart, Yoox Net-a-Porter/Richemont, QVC/Zulily) have been done at a median of about 3.7x EV/S.

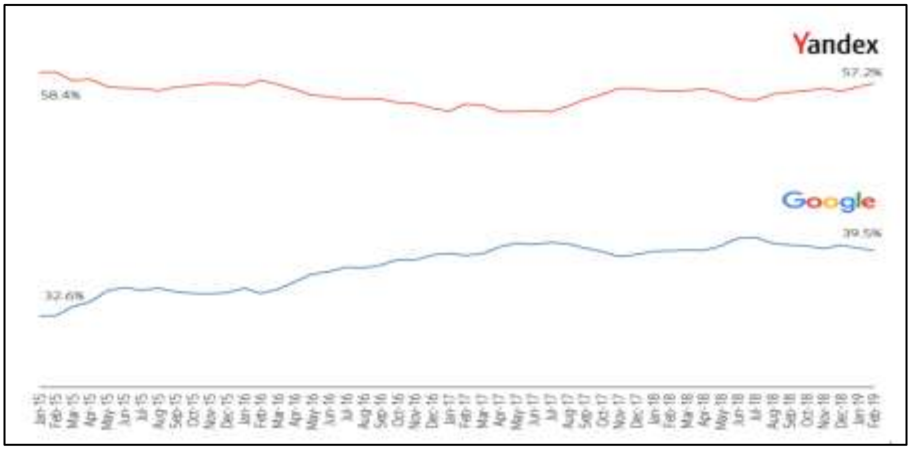
- The specific multiple received in these deals was a combination of the growth rate, scale within targeted industry, and the ultimate TAM; I believe Wayfair's metrics in these categories are equal if not superior to the average of the above.
- Though I don't expect it, it's not absurd to think of the company as a buyout candidate – Wayfair is roughly the same size that Whole Foods was at time Amazon bought them

There are also several qualitative factors that made me more comfortable with the investment opportunity here. Anecdotally, I believe the quality of the layout, discovery features, and range of styles on Wayfair are far ahead of anyone else's. The company's strategy of working closely with suppliers by providing ancillary services and increasing their volumes while providing excellent customer service to consumers (evidenced by the firm's high net promoter scores) is a textbook example of building a flywheel. Finally, and most importantly, I believe management here is excellent. The co-founders started the business selling stereo racks from a spare bedroom and have built that into an enterprise that is likely to do over $9 B in sales this year. They still own 30% of the shares and only take an $80k annual salary. Moreover, it's clear they think like owners – I would encourage investors to read their shareholder letters, published internal company emails, etc., to get a better sense of this.

As my base-case price target, a 1.5x sales multiple (equal to about 5x GP), which is below Wayfair's own history as well as peer/M&A comps, can pretty easily get you to a $200 PT next year, with intrinsic value continuing to grow at 20%+ for quite a few more years after that. Thus, I believe the long-term risk-reward remains favorable, and as a result I still haven't sold any shares despite the stock's run-up this year.

Yandex (YNDX): Alphabet (Google's parent company), which I discussed last quarter, is perhaps the highest quality business that we own. Accordingly, a company's ability to effectively compete with it is a robust litmus test for its own quality (recall the Facebook example in the prior section). I believe one such firm in Yandex, the Russian internet giant.

In most areas of the world, Google's search engine dominates all other competitors. However, it appears as though there are viable niches available to other firms in regions in which the local language does not utilize the Latin alphabet. One such example is Baidu in China, and another is Yandex in Russia. As the chart below shows, they have not only maintained a large market share vs. Google, but they have actually expanded it in recent years.



This search engine, accounting for the largest portion of Yandex's value, has a significant monetization opportunity as Russian ad rates converge toward developed peer country rates. The next largest piece is the company's ride-sharing operations, which they purchased from Uber early last year. It may seem inconsistent to be optimistic about this segment after just expressing doubts about the strength of Uber's, but they key difference is that Yandex is primarily focused on just two cities, Moscow and St. Petersburg, as opposed to more than 600 for Uber. This means Yandex is able to focus its time, attention, and financial resources to a much greater degree, allowing it to maintain a competitive advantage despite the localized nature of the network. To date, this has been borne out in the company's financials – Yandex's ridesharing operations are already solidly profitable.

Beyond that, Yandex owns a fast-growing classifieds business (think Craigslist with ads), a media services business that offers digital entertainment subscriptions, and an "Other Bets and Experiments" segment that includes such items as a public cloud platform and car-sharing service. Finally, the company owns a 50% stake in an e-Commerce JV (in partnership with Sberbank, by far the largest Russian bank) that is growing sales at a 40%+ clip in a market that remains very underpenetrated. Overall, I believe this is a very strong collection of assets, and my governance risk concerns are largely assuaged by the presence of an owner-operator founder that serves as the company's CEO and retains a 10% stake in the business. On a sum of the parts basis, I believe shares will be worth about $56 by next year, with a long runway of further growth after that.

Outlook & Conclusion

It seems to me as if the longer this macroeconomic expansion continues, the quicker investors are to react severely to any minor data point that they view unfavorably. They fear that the latest development could be the straw that finally breaks the camel's back and then rush to preserve their profits from the past decade. As a case in point, all it took was concerns surrounding an interest rate increase of 0.25% last December (despite this rate remaining well below historical averages) to create a 20% decline in equity prices at the end of last year. But once it becomes apparent that at least one more straw can be supported, fear of missing out replaces other concerns and creates a sharp rebound. Such was the case in the first quarter this year. The 20% fall and subsequent 25% rebound during a six-month period in which economic growth (and forward estimates of it) remained relatively steady is just the latest example of how markets are not always fully efficient, largely on account of the fear and greed that pervade investor thought processes. However, it is this inefficiency, generally catalyzed by scary-sounding news headlines, that provides chances to transact at favorable prices. The latest issue *de jour* is tariffs, which has created opportunities in recent weeks and may very well create more in the months ahead.

Of course, at some point this expansion will inevitably end, and there will be a few individuals who will have timed their exits well in hindsight. However, these lucky few will be dwarfed by the number of those who had wagered on another straw and lost, thus missing out on the interim gains. Given that neither we nor anyone else can predict with any degree of certainty when that may occur, I believe the best course is to simply stay the course. Accordingly, we remain focused on the performance of our underlying holdings and continue to evaluate the portfolio on a micro rather than macro basis. Doing this in the first quarter produced a good first step to recovering from a tough 2018, and I look forward to continuing on this path throughout the rest of the year.

"You must accept the truth from whatever source it comes."

- Maimonides

Per Ardua Ad Stella,

Andrew Jakubowski

Disclaimer:

This document, which is being provided on a confidential basis, shall not constitute an offer to sell or the solicitation of any offer to buy which may only be made at the time a qualified offeree receives a confidential private offering memorandum (“CPOM”) / confidential explanatory memorandum (“CEM”), which contains important information (including investment objective, policies, risk factors, fees, tax implications and relevant qualifications), and only in those jurisdictions where permitted by law. In the case of any inconsistency between the descriptions or terms in this document and the CPOM/CEM, the CPOM/CEM shall control. These securities shall not be offered or sold in any jurisdiction in which such offer, solicitation or sale would be unlawful until the requirements of the laws of such jurisdiction have been satisfied. This document is not intended for public use or distribution. While all the information prepared in this document is believed to be accurate, Adestella Investment Management, LLC makes no express warranty as to the completeness or accuracy, nor can it accept responsibility for errors appearing in the document.

An investment in the fund is speculative and involves a high degree of risk. Opportunities for withdrawal/redemption and transferability of interests are restricted, so investors may not have access to capital when it is needed. There is no secondary market for the interests and none is expected to develop. The portfolio is under the sole trading authority of the investment manager. A portion of the trades executed may take place on non-U.S. exchanges. Leverage may be employed in the portfolio, which can make investment performance volatile. The portfolio is concentrated, which leads to increased volatility. An investor should not make an investment, unless it is prepared to lose all or a substantial portion of its investment. The fees and expenses charged in connection with this investment may be higher than the fees and expenses of other investment alternatives and may offset profits.

There is no guarantee that the investment objective will be achieved. Moreover, the past performance of the investment team should not be construed as an indicator of future performance. Any projections, market outlooks or estimates in this document are forward-looking statements and are based upon certain assumptions. Other events which were not taken into account may occur and may significantly affect the returns or performance of the fund. Any projections, outlooks or assumptions should not be construed to be indicative of the actual events which will occur.

The enclosed material is confidential and not to be reproduced or redistributed in whole or in part without the prior written consent of Adestella Investment Management, LLC. The information in this material is only current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Any statements of opinion constitute only current opinions of Adestella Investment Management, LLC, which are subject to change and which Adestella Investment Management, LLC does not undertake to update. Due to, among other things, the volatile nature of the markets, an investment in the fund may only be suitable for certain investors. Parties should independently investigate any investment strategy or manager, and should consult with qualified investment, legal and tax professionals before making any investment.

The fund is not registered under the investment company act of 1940, as amended, in reliance on an exemption there under. Interests in the fund have not been registered under the securities act of 1933, as amended, or the securities laws of any state and are being offered and sold in reliance on exemptions from the registration requirements of said act and laws.

The S&P 500 and Russell 2000 are indices of US equities. They are included for informational purposes only and may not be representative of the type of investments made by the fund.