Adestella
Investment Management

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Dear Fellow Investors,

Adestella ended the second quarter about where it began, with a loss of less than half a percent. This flat performance masked a good deal of intra-quarter volatility: a strong start to the period, a nearly 10% peak-to-trough decline in May, and then a rally back to complete the round trip in June. In the end, though, there was little net variation on either side of the portfolio; longs, shorts, and currency all finished with a less than one percent change. The only notable disparities came on the basis of geography, as domestic stocks lost 4.1% while international ones gained 3.8%. At quarter's end, the Fund had gross exposure of 169% and net exposure of 91%, with the great majority of the short book in the form of index ETFs.

An updated performance summary is below. I have continued to include this chart, even though it is no longer nearly as flattering as it was 15 months ago, because I believe it would be disingenuous to remove it in the middle of a run of underperformance. At the same time, placing it front and center each quarter signals a much greater focus on shorter-term fluctuations than we actually have. Hence, starting next year and regardless of how the rest of 2019 plays out, I am likely to make some letter formatting changes. In the future, expect to find the table at the end of the document or displayed annually/semi-annually instead. Of course, investors will still receive their statements containing all pertinent data on a quarterly basis.

Let me also take this opportunity to remind everyone that the indices are only relevant in terms of the opportunity cost of a Fund investment. Less than 20% of our current investments are actually included in any of the below benchmarks, and those that are represented tend to be weighted much differently. Accordingly, it should be expected that our performance will occasionally diverge materially, as it did at the end of last year.

	2Q 2019	YTD	Since Inception
S&P 500	4.23%	18.33%	65.75%
Vanguard Total World Stock ETF	3.49%	16.13%	35.74%
Russell 2000	1.93%	16.86%	40.63%
HFRI Equity-Hedge (Total) Index	1.56%	9.25%	20.94%
Adestella Investment Management	**-0.39%**	**13.45%**	**41.35%**

**all index returns include reinvestment of dividends*

Focusing on Higher Quality Stocks: A Lower Quality Decision?

In my last few letters, I have alluded to an increased focus on business quality when analyzing potential investment opportunities, a decision spurred by having experienced burns from “cigar butt” stocks and hangovers from the dangerous cocktail of cyclicality+leverage too many times. That said, I am cognizant of the fact that the quality dimension of value investing has enjoyed a massive boost in attention and mindshare ever since the 1989 Berkshire Hathaway letter in which Warren Buffett describes his company’s shift to preferring a “wonderful company at a fair price.” Given that this strategy has been in vogue for a long time now, and that its popularity has even perhaps accelerated in recent years, it is fair to ask whether pursuing it now is too late. Has the increased attention removed these mispricings and competed away returns? A financial writer whose work I very much respect recently made an argument to that effect, stating that funds espousing a strategy based on the Berkshire trinity of understandable companies/sustainable competitive advantage/shareholder-friendly management are engaged in mindless imitation and lack the differentiated, second-order thinking needed to outperform markets over the long term.

The question is an important one. Much like a value investor attempts to avoid individual equities for which all good news is already priced in, he should also try to avoid a strategy with an opportunity set that has already been closely pored over. Or, to paraphrase Charlie Munger, he needs to make sure he doesn’t follow the bunch of cod anglers that keep fishing in the same waters long after the cod’s been overfished, instead moving to where the fish are now. Accordingly, I want to discuss why I believe there are still plenty of catches to be had in Adestella’s current pond.

First, I believe that the financial screening metrics used by most investors to isolate quality companies are far too narrow and accounting-focused, and that the actual universe of these quality companies is far larger than can be uncovered in this manner. The subset of firms boasting a 20% ROE and a twenty-year streak of uninterrupted sales growth are now very fully valued, leaving prospective investors left to either lament that they “can’t find anything to buy” or to try to play the relative performance game. This has often brought predictably disappointing results, particularly in the face of the steadily rising market levels of the past decade. As a result, quite a few funds have closed shop and cited a lack of attractive opportunities as a contributing factor.

For those who subscribe to this strict definition of quality – companies in steady industries with long track records of sustained performance and high historical levels of profitability (in the mold of Coca-Coca a few decades ago) – then I fully agree that bites on the fishing rod today will be few and far between. However, for those willing to consider opportunities in a more idiosyncratic manner, on a case-by-case basis, and with a focus on economic value creation instead of GAAP ratios, I think plenty of quality investment candidates remain. Some of these are hidden because they are currently unprofitable while they plow their earnings into long-term growth opportunities. Others are concealed by virtue of having several business lines whose values should be calculated in different ways. Still more will operate in industries and/or business models that are still relatively new to the world. Such firms will not show up together via a stock screen, because they can’t – there is no one statistical attribute that unites them all. As such, the risk that this subset might become structurally unprofitable is almost zero – to fish in our pond, competitors would first need to be able to find it.

Furthermore, even if such attributes could be distilled into a single screen, I believe the conclusions drawn by investors who ran it would be very different. Qualitative analysis by definition requires the use of personal judgment, which is unique to each person by virtue of both their nature and their experiences. Differing opinions on key aspects of an investment thesis are a common occurrence – is a loss-making company spending on projects that increase its net present value, or simply lighting money on fire? Reasonable people can disagree on such matters, sometimes drastically so; it's for this reason that several of our holdings have double-digit percentages of short interest (meaning many people are betting that the stock will decline in value). Accordingly, not only are there multiple facets to stock analysis, but also multiple facets to company quality research that further reduce overlap in market participants' perceptions of the firm. And with a greater variance of perceptions comes greater upside potential, as other investors gradually come around to your view and start buying for themselves.

Juggernauts: The Unstoppable Forces and Immovable Objects of the Market

The definition of a juggernaut, according to Merriam Webster, is "a massive inexorable force, campaign, movement, or object that crushes whatever is in its path." The term apparently originates from the Anglicization of the name of the Hindu god Jagannath and was used by Britons in colonial India to describe the imposing spectacle of wooden carvings of the god being pulled through the streets on towering carts. The contemporary stock market has juggernauts of its own, though they may not be as visually striking as those chariots were to 19th century Englishmen. In this context, the juggernauts are the companies that manage to grow their businesses no matter what competitors or economic climate they face off against.

One thing that the market teaches again and again is that there is no defense for unknown unknowns – and it's a lesson that every investor will likely have the misfortune to experience at some point(s) or another. No checklist can cover every possible event path, which is problematic because many of these unpredictable turns of events can have negative implications for equity holders. For example, last year the succession plans of our then-largest position, Fiat Chrysler, went from orderly to chaotic very quickly when its star CEO was permanently unable to return to work following complications from a surgical procedure. Needless to say, it's very hard to accurately discount the risk of a medical procedure leading to the death of a key executive, and it is impossible when the procedure's occurrence isn't revealed until after the fact. But the effect has been easy to see – Fiat's stock has been unable to win investor confidence ever since, badly lagging both peers and the market.

So what is an investor to do in the face of such uncertainty? Beyond his standard due diligence, he can focus his research efforts on companies that demonstrate one or more elements of a juggernaut

– or that have the pieces in place to become one someday. In my opinion, the common threads between companies meeting the definition are as follows:[1]

1. Operate in secularly growing industries that provide a natural tailwind augmenting preexisting business momentum.
2. Pursue business models in which advantages are increased by scale, allowing them to become ever more formidable as they grow.
3. Tend to focus more on long-term value creation than quarterly EPS numbers and prioritize the customer experience, realizing the importance of building a base of loyal, satisfied clients or supporters.
4. Have often proven their competence in more than one business line or model, reflecting ambitious company cultures that encourage prudent risk-taking and a willingness to pivot if the situation warrants it.

Of course, this list is not exhaustive, and there are always exceptions to the rules. But it seems to me that the companies meeting the above criteria demonstrate the most resilience against the external shocks they face, including those unforeseen. They are able to find ways over, around, or through such issues and come out the other end still growing. They are often "anti-fragile" and always nonfragile. And, perhaps most importantly to a public market investor, they have a funny habit of outperforming the market over the long run.

There are 11 companies currently in the S&P 500 that managed both to grow their profits during the Great Financial Crisis (in the midst of perhaps the toughest economic environment in decades) and to post positive growth in every calendar year since then. From the start of 2007 to today (roughly a full market cycle), they have produced an average total return of 629% to date, vs. 157% for the S&P 500. And, with a median value of 677%, their performance cannot be attributed merely to a few outliers. Even the worst performer of the group had a total return of 224%, still well ahead the index. Moreover, these companies were each from different FactSet industries and represented nearly all GICS sectors, implying the effect was not isolated to a specific well-performing niche of the market.

Alternatively, if you believe that such an exercise is guilty of hindsight bias and that one couldn't have predicted in advance which would firms continue to grow, you could have simply bought the 125 S&P constituents that grew sales every calendar year from 2007-2009 in March 2010, by which time their 2009 numbers would've been released. With no prognostication or additional research required, the basket has generated an average return of 420% up to today. Positive outliers played a bigger role here, but the median was a still-impressive 317%, more than double the 196% total return of the S&P, and more than two-thirds of the group outperformed the market average. With a hit rate like that, it seems the pond isn't saturated yet – one could certainly find worse places to fish.

[1] I think it's worth highlighting that current market value is NOT one of the criteria here; small-cap companies can be juggernauts too. The fact that many common examples are large caps is an effect of their meeting the above definition rather than a cause.

Discussion on Selected Positions

This quarter, I want to discuss two of the top five largest positions in the fund currently: Gan plc and Sea Ltd.

Gan plc (LON-GAN): Gan is a UK-based firm that provides software that allows casinos, mostly located in the US, to offer online betting to their customers via desktop, mobile, and app. Historically, Gan derived a large portion of its revenues from simulated gaming sites, in which participants wager purchased credits (much like those found in online games like Candy Crush) to play casino games. The business experienced solid growth during that period as online gaming and "freemium" business models became more popular, but concerns about the ultimate value proposition and sustainability of these simulations led me to pass on the stock.

But things changed dramatically in May of last year, when the Supreme Court struck down the 1992 federal ban on sports betting and allowed states to set their own laws on the issue. Soon afterward, several states legalized sports betting, with New Jersey being the first to complete the process. As it happens, one of Gan's largest clients there is PaddyPower Betfair, which in the same month purchased the well-known site FanDuel. Historically a daily fantasy sports site (anyone who watches sports will recall having seen countless ads of theirs), the law created an opportunity to direct FanDuel's significant brand awareness and traffic toward the much larger and more lucrative market of real-money live sports betting. Realizing the massive opportunity associated with this development, Gan pivoted its focus to the sports betting offerings introduced by its casino customers. By last August, the company had completed the process of integrating sports offerings into its platform, including powering the real-money sportsbook offering from FanDuel.

The decision proved to be a good one, as the amounts wagered came in ahead of already optimistic estimates, thus generating a significant amount of tax revenue for the state of New Jersey. Wanting a piece of the pie for themselves, several other states rushed to make legalizations of their own, and today 12 states have active legal sports betting, 6 (plus the District of Columbia) have recently passed laws allowing for sports betting and are awaiting launch, and 24 are in the process of considering bills related to it. Gan's software is now being used for the online gambling offerings of the largest casino in Pennsylvania, and they've also added new clients in New Jersey while expanding their relationship with PaddyPower Betfair into new verticals (such as FanDuel's new online casino offering) and geographies (such as its launch in recently-legalized West Virginia). All of the above has combined to create blistering revenue growth; Gan operators have grown sales by over 103% YoY and active players by over 50% YoY in each of the last three quarters.

While sports betting has already been a boon to Gan, I believe we are still in the very early innings of its development (no pun intended), and I am extremely bullish on the long-term prospects for the industry. Gan should do over £20 M in net revenues this year from its clients in New Jersey and Pennsylvania alone before considering the incremental opportunity from states that just launched (Iowa and Arkansas just in the last few weeks) or are set to do so in the months ahead. The company has also indicated that the cross-sell uptake from sports bettors to internet casino gaming has been stronger than expected, providing an even further boost. Gan already has a foot in the door of many casinos from the simulated gaming it supports for them, as well as a very strong industry reputation thanks to the success of FanDuel's sportsbook (which has positive app reviews and the #1 market share position). I believe these advantages will allow the company to take more than its fair share of clients as casinos in these states look to create their real-money sports betting products.

Despite having what I view as a massive opportunity and a long runway to execute upon it, Gan has flown almost completely under the radar. Shares currently trade at 2.5x EV/2019 sales, which is almost unheard of for a SaaS company growing at 100%+. But perhaps even more impressively, the company is already profitable; I estimate 2019 EBITDA of around of around £7 M with positive free cash flow. That means we're paying 9x EV/EBITDA for a high-margin, fast growing business that is a major player in an industry that remains in its infancy.

To further highlight the extent of the valuation discrepancy, let's compare Gan to Zoom Video Communications (ZM), a recent IPO that was heralded for its combination of rapid sales growth and profitability. Many software investors use a rule of thumb called the Rule of 40, which states that the sum of a software company's sales growth rate and free cash flow margin should ideally be above 40%. Zoom's 112% percent LTM sales growth and FCF margin of 6% create a Rule of 40 score of 118%, which is undeniably impressive and the highest of any SaaS company today. Accordingly, investors have awarded the stock an EV/S multiple of 64x (34x on an NTM basis). Gan, meanwhile, should grow revenue by just under 100% this year (I'm at 97%) with an estimated FCF margin of 13% (a number that will expand greatly with scale) – meaning it earns a 110% score, very close to Zoom, yet trades at only 3.3x/2.3x on an LTM/NTM basis. Lest you think I cherry-picked an egregiously overvalued company, I ran a multivariable regression on a universe of 76 SaaS equities focused on growth and margin profiles; plugging Gan's metrics into the equation suggests a fair EV/S multiple of 19x. While I doubt it will ever reach anywhere close to level, and while it's possible the software space is currently overvalued as a whole, I believe the size of the multiple discrepancy remains an order of magnitude too large.

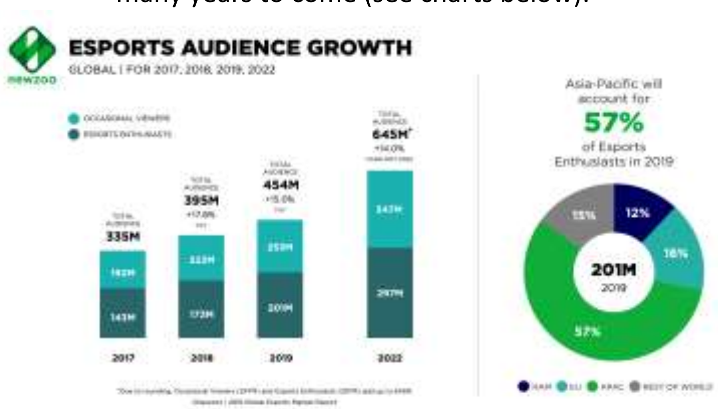
So why does the opportunity exist? I believe the main reason is that the company is a bit of an orphan stock, being listed in the UK while most of its clients, revenues, and focus are in the US. Furthermore, the small market cap (around $71 M USD) and relative lack of liquidity likely makes it too small for many funds to bother with. However, these issues should be ameliorated in the upcoming months when the company completes its planned US listing, which will increase both visibility and access to the stock among the investor group most familiar with the company's value proposition. Some may also believe Gan relies too heavily on its PaddyPower Betfair relationship, which may be true. However, the parties currently operate under a multi-year agreement that was extended last year, and in January they announced another long-term deal extending their partnership into Pennsylvania and West Virginia. Further highlighting the mutual value the parties receive, the contract was again amended in June to add FanDuel's online casino offering. But irrespective of the apparent strength of their relationship, over the life of the contract Gan's share of revenues from FanDuel is likely to significantly decrease as it onboards new casino clients in newlylegalized states (such as its aforementioned launch with Pennsylvania's largest casino). As a result, I'm comfortable with this risk, which is I believe is compensated for many times over in the current price.

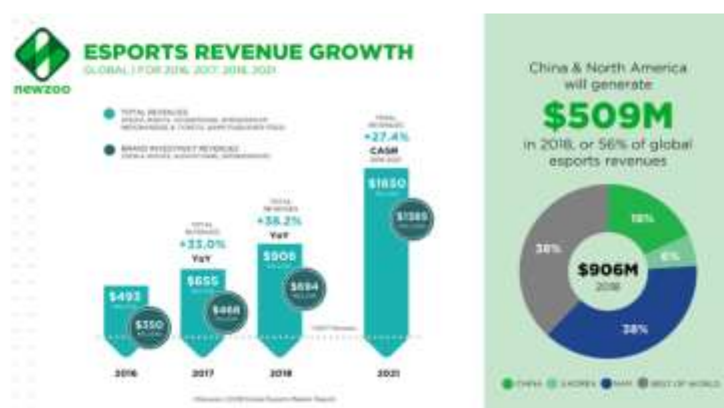
In summary, the combination of further growth in the 47 states where Gan does not yet have a sports-betting presence, plus multiple expansion (for which its upcoming NASDAQ listing should be a catalyst) and a shrinking EV (via cash generation), leads me to believe there are many ways we can win here – and potentially win big. And given insiders own 28% of the equity, I'm confident they're just as eager to find one of those ways as I am.

Sea Ltd (SE): Sea is a southeast Asian, US-listed internet company. Originally added to the portfolio as a mid-sized position, the stock has become one of our largest holdings by virtue of its nearly 200% gain year-to-date. However, the combination of management's excellent execution and my increased confidence in its ability to continue it has led me to avoid taking gains here, and I believe the remaining upside is still substantial.

SE is comprised mainly of two business lines. The first, the historical driver of the company's profitability, is a mobile and PC gaming business. This segment, known as Garena, has exclusive rights throughout southeast Asia to many of the most popular games in world. These include League of Legends (a multi-player online battle arena game that has been among the most popular in the world for over a decade), FIFA Online 3 (a version of the most popular sports video game franchise), and Arena of Valor (the international version of another battle arena title that is the #1 game in the world's largest gaming market, China). The company has also had success creating its own titles; one such offering, Free Fire, was the 2nd most downloaded mobile game globally across the App and Android stores combined in the first quarter of this year.

The digital entertainment business has very favorable economic characteristics, with high margins and very little tangible invested capital, allowing it to throw off large amounts of free cash flow to SE. Not only that, but the industry continues to grow at a double-digit annual rate. Garena is particularly well-positioned because of its operation of titles that are very popular for eSports, which have exploded in popularity in recent years and will remain among the fastest growing industry niches for many years to come (see charts below):





While the digital entertainment segment is attractive, it is the potential of the company's eCommerce marketplace, Shopee, that makes me excited about the opportunity here. The southeast Asian region is home to several of the fastest growing economies in the world, and the twin forces of rising average disposable income and increasing eCommerce penetration as a percent of retail sales combine to create a very powerful tailwind for companies like Sea. Not only is the region early in the process, the ultimate size of the opportunity is very large. I believe many Americans would be surprised to know that the Indonesia and Thailand combined have a larger population than the United States despite having only a quarter as much land; adding other members Singapore, Malaysia, Taiwan, Vietnam, and the Philippines creates a nearly 600 M population base from which millions more reach income thresholds to enter SE's target market each year.

Sea only started monetizing the platform in earnest toward the end of 2017, but the results to date have been terrific. From a near standing start (the segment had $17 M in sales in 2016), the business is now on pace for around $800 M in revenues this year. Losses are also growing, but given the size and early-stage nature of the opportunity they're targeting (active buyers more than doubled last year), I believe the decision to press their advantage by investing in customer acquisition and customer experience is the right one. Meanwhile, the cost leverage already displayed (EX) and the rapid ramp to profitability in smaller, more developed markets with fewer investment opportunities (the Taiwan operations will be profitable this year) give me confidence in Sea's long-term profitability profile and status as an emerging juggernaut.

Given the different lifecycle stages and divergent financial profiles of the two segments, I believe a sum of the parts approach is the most appropriate valuation method here. For the Digital Entertainment segment, I apply a 12x EBITDA multiple, which is five turns below the average for much slower-growing, lower-margin global gaming peers. I then apply a 0.8x multiple to Shoppee's gross merchandise value (GMV), which is well below the global eCommerce marketplace median of 1.2x. While I generally prefer not to use alternative metrics like GMV for valuation, I view it as reasonable here, since the company is still just beginning to monetize its traffic – the segment's take rate will be just over 4% this year, while most e-Commerce comps in are in the 20-35% range). With segment valuations complete (I assume no value to the company's very small financial service/payments business), I then deduct the PV of unallocated corporate costs using a basic DCF. Adding back the net debt, dividing by the fully diluted share count, and applying a further 20% conglomerate discount yields a $51 price target. This would be a 40% IRR to 2020 YE under what I believe are reasonable if not conservative assumptions, with intrinsic value continuing to increase rapidly for many more years after that.

Conclusion

Fears of tariffs and yield curve inversions, combined with reduced summer liquidity and slowing economic growth, have united to create a volatile investment environment in recent months. However, public market investors are not the only ones dealing with the consequences of these developments. Indeed, thousands of businesses throughout the country must navigate the difficult supply chain and capital allocation adjustments that are becoming required as a result, all while hoping not to be swept up in another Tweet-storm in the meantime. Such conditions are likely to provide a robust litmus test that again separates the juggernauts from the rest – both in terms of business and stock performance. Only time will tell if that is truly the case, but if the past is any indication, it seems likely. In the interim, we will focus on tracking the success of each of our holdings in meeting these challenges, and I look forward to providing another update on it in a few months' time.

"History doesn't repeat itself, but it often rhymes."

- Mark Twain

Per Ardua Ad Stella,

Andrew Jakubowski

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