Adestella
Investment Management

November 23, 2019

Dear Fellow Investors,

Adestella lost less than 1% in the third quarter. A brief value factor recovery in mid-September proved to be yet another head fake, and for the second straight quarter the Fund treaded water (though fortunately it looks from Q4 to date that the trend will end in this period). The best performers in the quarter were our US holdings, which gained just under 3% but were more than offset by international losses. Our short book (80 bps gain) and currency exposure (37 bps) were net gainers while long positions lost just under 2%.

An updated performance chart is below:

| | 3Q 2019 | YTD | Since Inception |
|---|---|---|---|
| S&P 500 | 1.76% | 20.42% | 68.67% |
| Vanguard Total World Stock ETF | 0.13% | 16.28% | 35.92% |
| Russell 2000 | -2.33% | 14.13% | 37.36% |
| HFRI Equity-Hedge (Total) Index | -1.29% | 7.81% | 21.15% |
| **Adestella Investment Management** | **-0.77%** | **12.58%** | **40.27%** |

**all index returns include reinvestment of dividends*

## Mismatches: Not Just for Stocks

When it comes down to it, successful investing is all about finding mismatches – between price and value, expectations and reality, short-term shareholders and long-term investments – then betting on a return to an equilibrium state, and then simply waiting for that balance to occur. Most fund managers think about such mismatches every day. I would be willing to bet, however, that far fewer consider how these input-output discrepancies impact not just the public companies they study as outsiders, but also the investment pools they control themselves.

The manager's difficulty can be seen both in the context of evaluating an individual stock idea and in overseeing a broader portfolio. In most occupations, there is a relatively clear link between time spent working and rewards gained from that effort. A dentist that treats more patients or a lawyer that takes on more cases can usually see an immediate financial benefit from their incremental efforts. But things don't work that way with investing – there is frequently a mismatch between effort and result. You do all sorts of research on an opportunity – building financial models, reading earnings call transcripts, speaking to industry experts, etc. – without any guarantee that it will generate a profitable investment for you. In fact, there is always a chance that after such efforts, you'll be worse off than if you had done nothing at all, which can lead to losses of both capital and morale.

A final prominent mismatch is between the market's time horizon and our own. While it would be ideal if investors started reevaluating a company we deem an attractive opportunity right after we identify it, the unfortunate reality is that it can take quite some time until a critical mass come around to our view and begin to close the gap. But simply sitting and waiting in the interim feels wrong; even if are still confident in the ultimate outcome, it seems as though something should be done to accelerate the process.

I believe this cognitive dissonance leads to all sorts of suboptimal investor behaviors. The link between effort and reward that serves well elsewhere remains stuck, even just subconsciously, in managers' heads, and it leads us to overreact to minor data points ("now that I have the monthly KPIs, I need to do something with this information") while tempting us to reduce investment timeframes ("I should've gotten a return from this investment by now but haven't, I'm not wasting any more time holding this one").

When situations like these combine on the portfolio level, it can make the waiting all the more challenging during periods of underperformance because there are external benchmarks to compare yourself to each day. For competitive Type-A individuals, it is very difficult to sit and watch while your portfolio lags a market index and not feel the urge to do something, anything, to try to change that. It's something that I've experienced myself. Eighteen months is a drop in the bucket when it comes to stock market returns, which can take a decade or more to be seen over a full market cycle. But when you are managing a small fund and relying heavily on your relatively short track record to generate investor interest, I can assure you that eighteen months of poor results feels like a very long time indeed.

In my view, the best way to combat such a situation is to keep yourself occupied with work not directly related to your current portfolio holdings. Rather than trying to assign meaning to the latest wiggle on the chart or tweaking a model without material incremental information, an investor's time is much better spent increasing their knowledge of industries and mental models, or getting up to speed on potential future opportunities and building a watchlist so as to be ready to pounce when the price is right. Of course, news on existing positions still needs to be monitored carefully, provided that it is filtered so as to only include developments that affect intrinsic value. With investing, doing nothing is often the best course of action – but if you can't bring yourself to that, you can at least ensure you're directing your efforts in a way that can bring benefits down the road.

All Skewed Up

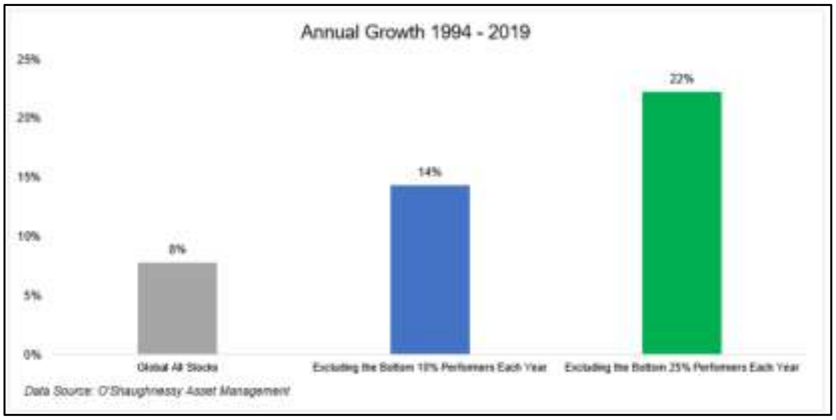
I recently read an interesting academic paper that broke down the long-term sources of stock market wealth creation. While the paper was full of useful data, the item that surprised me the most was just how narrow a subset of companies was responsible for driving the overall indices' multi-decade rise. According to the author's work, the best performing 4% of stocks were responsible for the entirety of the dollar wealth generated in the market from 1926 to 2018, and a fifth of that came from just 14 companies (out of the more than 25k that issued stock sometime in that period).[1] Meanwhile, the majority (about 60%) of issuers ended up posting a total return, including reinvested dividends, that was less than what could have been earned holding one-year Treasury bills for the duration of their public company life.

So, knowing the size of the positive skew, how can we tailor our investment strategy to best capitalize on it? Obviously, the best way would be to identify and buy the companies in that elite echelon at an early stage in their lives and then just hold them for a very long period of time. But this is a wholly unrealistic expectation; only with severe look-ahead bias could one convince themselves that they always knew who all the ultimate winners would be decades in advance. In the summer of 1996, with Apple stock at a split-adjusted price of 65 cents, how many people foresaw the chain of events in which Steve Jobs has his new venture acquired by the company, is reinstalled as Apple CEO, and then comes up with the most profitable product of all time eleven years later?

However, by applying some inversion, there does appear to be another option. Instead of finding the best of the best, we could simply try to avoid the (much larger) subset of firms that have characteristics correlated with negative stock performance – excess leverage, aggressive accounting, poor returns on capital, secularly declining end markets, and the like. We won't be able to ever fully evade them, as company values can fall for many more reasons than the aforementioned, but removing stocks with these qualities from our investable universe increases the odds that we can benefit from positive skew even without all of the top 1% of performers.

To illustrate, consider the graphic below (sourced here), which displays annualized market performance over two and a half decades versus what could've been obtained by removing the worse decile or quartile of performers each year:

[1] For those curious, the 14 firms are Exxon Mobil, Apple, Microsoft, General Electric, IBM, Altria, Johnson & Johnson, General Motors, Chevron, Wal-Mart, Alphabet, Berkshire Hathaway, and Proctor & Gamble.




As the chart shows, one can nearly double his annual return simply by eliminating the worst of the worst, the bottom 10%. The returns to eliminating the bottom 25% are of course even greater, but given the greater difficulty of eliminating a wider swath and lesser efficiency (the first 10% removed improved annual returns by 6%, but the next 6% improvement requires removing a larger amount), I think it makes sense to keep expectations modest and simply target the bottom decile.

This is a lesson that resonates all the more strongly given my own experience in the past year and a half – we've had several sizable positions that for various reasons have ended up squarely within that bottom decile and wiped out positive developments elsewhere throughout the portfolio, and the impact has been painfully clear. Hence, the above thought experiment on inversion seems to work on the portfolio level as well: the first step to making money is to avoid losing money.

Discussion on Selected Positions

**Farfetch (FTCH):** Farfetch is an online platform specializing in luxury goods. The investment is a product of the watchlist described above – assuming a fair purchase price, I believe eCommerce platforms with defensible niches and significant scale will ultimately prove to be successful investments as a group. Following a messy Q2 earnings release that combined a 3% reduction in gross merchandise value (GMV) guidance with the announcements of a forthcoming executive departure and a sizable acquisition, FTCH fell over 40%, and I began to look into the business in depth. And what I found was a company that is well-positioned for the future both from a macro and micro point of view.

In terms of broad secular trends, the luxury market is in the early stages of the same offline to online channel shift as other retail verticals. Currently representing just 10% of spend, eCommerce's share will more than double in the next six years (see graphic below).


Luxury is particularly well positioned for this ongoing channel shift because store footprints are 1the enhanced convenience, this shift also substantially increases the TAM by adding potential customers not living within close proximity to a store. Farfetch also stands to greatly benefit from the rapid economic growth in China, where Western luxury fashions are a coveted status symbol, even among the middle class. The resulting wealth creation has led to an explosion in the size of the luxury market in the country. Currently estimated at $115 B, Chinese luxury spend is expected to grow to $171 B by 2025, representing about two-thirds of incremental dollars and 40% of total global spend by the end of the period. Farfetch's status as the only global luxury brand marketplace along with its partnership with local eCommerce giant JD.com (which owns about 14% of FTCH, thereby aligning their interests) should allow it to capture more than its fair share of the opportunity here.

Making this dynamic even more interesting is the built-in competitive insulation from the exclusive nature of the goods. Luxury companies jealously guard their trademarks and brand perceptions and are far more concerned than most about distribution channel selections and the resale market. To maintain their image, such brands generally prefer not to be sold alongside mass-market ones, or in marketplaces not specifically focused on apparel. Therefore, the competitive risk from eCommerce behemoths Amazon and Alibaba is significantly less than for other industries, and this is the rare case in which their size and breadth work against them.

As I mentioned, one factor that contributed to the massive drop following second quarter earnings was the announced acquisition of New Guards Group (NGG), an Italian luxury fashion producer and distributor. I believe investors were concerned about the shift from a pure marketplace model to one where FTCH also sells some of its own products, as well as the perceived difficulty of integrating NGG at a time when the company had already made several other recent acquisitions. However, I believe concerns surrounding the deal are severely overblown. First, the purchase price was very reasonable – paying 7x pre-tax earnings for a profitable company (half of which was stock) growing at 60% does not scream "disaster" to me. There is execution risk in moving from a pure marketplace (3P) to a mixed (1P and 3P) model, but there is also significant opportunity in expanding the firm's value proposition upstream. Finally, in an industry where perception is reality, having rights to the current #1 brand, Off White, seems like a potentially valuable asset and source of differentiation. Time will tell which view is correct, but early results are encouraging – in FTCH's recent Q3 earnings call, management mentioned NGG had already become one of the top selling brand groups and driven increases in organic traffic and customer engagement to the site.

Putting these factors together, I believe Farfetch has a long runway to compound GMV at a 30% rate, with revenues perhaps growing even faster if take rates glide higher. Like many companies in the "land grab" phase of their lifecycle, Farfetch is not currently profitable. There has been considerable doubt expressed by many investors as to the company's ability to eventually achieve their longer-term EBITDA margin target of 25-30%, with some saying the company is just another example of tech unicorn excesses.

In the section above, I discussed using inversion to frame a discussion in a new way, and I think that can apply here too – instead of asking how Farfetch could reach those targets, it may be more useful to ask why they wouldn't be able to.  And as of now, I see no compelling reason why they couldn't. Robust two-sided platforms with similar gross margins have consistently shown an ability to generate the operating leverage required to reach that level, and there is no reason to believe FTCH's costs are structurally higher. If anything, there could even be upside to those figures given 1) their price-insensitive customer base that is not going to select one item over another on the basis of a brand passing along an incremental 2% take rate increase and 2) the NGG acquisition which has an even better margin and profitability profile.

Finally, I believe the bargaining position of individual brands (and thus their ability to squeeze FTCH's profits) is far overstated by bears. With 1,200 different brands now on the platform, the company's seller base is now sufficiently diversified to preclude concentration risk. And in the end, brands need to be where their customers are (subject to the image maintenance restrictions discussed above); given that 70% of multi-item sales on FTCH are multi-brand baskets, it's clear these customers see a value proposition in shopping a variety of brands at once. Luxury companies will of course continue to promote their products both in store and on their own websites, but it's also in their interest to be available to the massive purchasing power of FTCH's 1.9 M active customers. Given the 100% retention of top 100 partners over the past three years, it seems these companies have arrived at the same conclusion.

So what is all this worth? Public eCommerce company valuations can be largely explained by two variables – the rate of sales growth and the company's gross margin profile (which informs profitability levels at scale). FTCH's 51% platform service sales growth and 53% segment gross margin suggests a fair EV/S of over 6x just for the 3P business. Meanwhile, following the massive drop in

August, shares currently trade at 3.8x TEV/LTM platform sales, meaning all fulfillment revenue and the nascent 1P business (which is already profitable) are thrown in for free. Accordingly, even after the 30% pop subsequent to the company's Q3 earnings, there is still quite a ways to go to reach fair value. As Farfetch continues to win a larger share of the expanding luxury pie, I expect shares to appreciate substantially so long as margin improvement and acquisition integration progress smoothly. And given that insiders own around 15% of the equity, the right incentives are in place to drive that outcome.

**Zillow (Z)**: One of the more interesting books I read this past quarter was *Loonshots* by Safi Bahcall. The book describes the process by which big ideas, often appearing implausible at the time of suggestion, are either immediately shot down or explored further. Through a variety of examples and anecdotes, the author shows that given sufficient time, attention, and resources, these crazy ideas (like using radio waves to detect enemy planes or utilizing mold growing on rice to fight high cholesterol) are the ones that usually lead to breakthroughs and industry transformations.

Zillow is already well known by many as the dominant online portal for real estate listings in the US, with nearly 200 million unique visitors every month. What many may not yet know, however, is that the company is in the relatively early stages of pursuing a "loonshot" idea of its own. Historically, Zillow made money from having real estate agents pay to advertise their listings on the site. However, in April 2018 the company undertook a bold shift in its strategic focus: rather than simply selling ads, Zillow decided to become an investor in its own marketplace and transact on its own behalf. In short, the company was going to flip homes.

Reaction to the announcement has been roundly negative from both sell-side analysts and investors, and it's not hard to see why. Companies generally don't voluntarily pivot from a high-margin, asset-light business model like internet advertising to a low margin, capital intensive one like home flipping. Some question the value proposition to the average consumer; others, scarred by the financial crisis of 2008, picture what would happen if Zillow had too many lots on its books during the next downturn. On the day the company announced its intention to enter this segment, shares fell 9% and have fallen a further 20%+ since then while the broader market posted a double-digit gain. The stock is now 76% below its all-time high reached in the summer of 2014 and has seemingly fallen off the radar of many that used to follow it.

But amid the many clear challenges such a transition represents, I believe Zillow's initiative also has both of the ingredients required for a disruptive success. First, it addresses real pain points among a large group of consumers – home sellers. While real estate agents sell multiple houses and home buyers have multiple options, sellers have all their eggs in one basket. This relative lack of leverage puts the onus on them to deal with the stresses of showings and the risks of snares in the process. Second, it takes advantage of new technologies (accurate algorithmic pricing) and consumer attitudes (comfort with all types of online shopping) to make a market more efficient on a very broad scale.

It’s no secret that the digitization of the shopping process has become pervasive throughout society. Having started with everyday goods and services (think Amazon and Uber), the success of companies like Carvana shows how that the phenomenon has worked its way into big-ticket purchases like automobiles. Houses are the next logical frontier for “iBuying”, and the demand Zillow has seen to date (over 80,000 homeowners requested an offer last quarter) indicates consumers are open to the possibility. It’s not a completely new idea, either – other companies (most notably OpenDoor and Offerpad) have seen their valuations grow rapidly while pursuing a similar model, and Zillow itself ran a yearlong pilot before jumping into the market with both feet.

Though not the first to attempt this model, I believe Zillow is already easily the best positioned for long-term success. First and most importantly, unlike its competitors, Zillow owns the customer relationship. Its 200 M unique visitors each month give it a massive base of potential customers that are acquired nearly cost-free. Not needing to rely on paid advertising, which will likely become increasingly expensive as competition ramps, creates an immediate cost structure advantage over peers as the company can produce the same margin at a higher offer price. Second, Zillow has the most data and has been working with it the longest. The company introduced Zestimates in 2011, several years before its current competitors were even founded, and has now been tweaking and improving it for nearly a decade. Given the paramount importance of pricing homes accurately in order to make profitable offers, having the best algorithm is a small edge that will compound over time. The company’s scale creates volume that should help it draw more auxiliary personnel (inspectors, contractors, etc.) into its ecosystem, while the significant start-up costs can be largely defrayed by the profitable advertising business.

The truth remains, however, that even the best operator in the home flipping business will be making a low margin. This is why the incremental profitability provided by the add-on services that are part of nearly every real estate transaction – mortgage, title & escrow, warranty, moving/renovation services, etc. – will also be a key aspect of the company’s ultimate success. And I think their odds are good. All else equal, consumers will prefer to streamline their experience by working with fewer providers and points of contact rather than more; the same convenience and efficiency factors that drive them to use Zillow Offers in the first place will lead them to stick with Zillow for the add-on services as well. The potential for one-stop shopping, coupled with its listings dominance, makes Zillow the only player able to offer an end-to-end experience. And if other industries are any indication, this friction reduction could prove highly attractive to potential consumers.

All that said, the risks of shifting to radically different business model such as iBuying early in its lifecycle are obvious, and the range of potential outcomes is much wider than with most of Adestella’s positions. I would not have made the investment except for the fact that Zillow has a very liquid options market with long-term expiries available; I believe this situation is an ideal one to use such derivatives. If the business model gains traction and investors start believing the idea could actually make a dent in the $33 trillion real estate market, the sheer size of the opportunity, coupled with panicky short covering, could lead to significant upside in which we’d fully participate. On the other hand, if the company’s pricing is inaccurate or if another recession or housing downturn occurs and creates solvency or leverage concerns (which would likely significantly impair equity value), we have limited downside and much less money at risk than we would holding the common stock. Furthermore, these options became quite cheap following the company's Q2 earnings release and will expire profitable even if the stock only returns to levels seen as recently as August. This provides a reasonable margin of safety given my YE2020 fair value estimate of $64 on a sum-of-the-parts basis.

Given the unproven nature of iBuying and risk of total loss of investment, Zillow is and will remain a relatively small position. But I believe the mismatches here – between the market implied and actual odds of success, of the perceived value proposition to the actual demand seen – are too great to ignore and present a compelling risk-reward proposition.

## Outlook and Conclusion

On the last day of July, the Federal Reserve cut interest rates for the first time since 2008. In my opinion, with interest rates already at low levels and the economy still strong, it may have been preferable to save such an action until it was more urgently needed. Nevertheless, markets welcomed the development, and as I write this remain near all-time highs. However, index levels mask an increasing degree of bifurcation: while many stocks are at or near 52-week highs, there are also quite a few near their lows. In fact, among both NYSE and NASDAQ listed companies, there are nearly as many stocks making new lows as new highs.

Such a dynamic creates pockets of value even amid an opportunity set that many describe as unattractive. In the manner discussed above, we have been tracking several such situations and preparing to capitalize on them if and when the price is right. I look forward to updating you on this front early next year; in the meantime, hope everyone enjoys the upcoming holiday season.

*"I'm too busy. I have no time for worry."*

- Winston Churchill

Per Ardua Ad Stella,

Andrew Jakubowski

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