Adestella
Investment Management

March 8, 2020

Dear Fellow Investors,

Adestella gained 23% in the fourth quarter to finish 2019 with a 38% gain. The last few months of the year saw the US market complete its rebound by posting its best year since 2013 and recouping all of its losses from the end of 2018. However, nearly the entirety of the Fund's profits for the quarter (and the year as a whole, for that matter) were driven by our international long positions (21.2% net returns). Domestic longs added another 3.1%, partially offset by our short positions (-1.7%). Currency fluctuations had a positive impact of 34 basis points.

2019 proved to be a great example of the importance of maintaining a longer-term time horizon when analyzing investments. While we ended the year with a satisfactory return and favorable result relative to the market, we trailed benchmarks in each of the first three quarters. Were I to have written only an annual letter, I would have had good news to share 100% of the time, but with a quarterly cadence, it was only 25% of the time. The net result was the same, but framing bias makes the former seem much more attractive than the latter.

An updated performance chart is below:

	4Q 2019	2019	Since Inception
S&P 500	8.99%	31.23%	83.82%
Vanguard Total World Stock ETF	9.07%	26.82%	48.23%
Russell 2000	9.87%	25.40%	50.92%
HFRI Equity-Hedge (Total) Index	5.59%	13.60%	25.75%
Adestella Investment Management	**22.97%**	**38.44%**	**72.49%**

**all index returns include reinvestment of dividends*

Decision Revisions

As you may remember, the challenges of 2018 prompted me to spend a lot of time thinking about how our process could be improved. This led me to shift more of my attention to companies that were, on average, higher quality – not because such companies have been strong performers in recent years, but because this approach put the effects of time horizon, tax, and the 8th wonder of

the world on our side. A year later, those benefits remain intact and have been joined by a new and equally important advantage that I had not previously given much thought to.

I am an avid poker player, so when an investor of mine hosted an event in which a former professional named Annie Duke would be giving a talk, my interest was piqued. Though a scheduling conflict prevented me from attending, I was nevertheless spurred to read a few of her books to try to pick up some of the ideas that would likely be discussed. Her latest book, *Thinking in Bets*, is probably the most broadly applicable for decision makers, but it was another title, a poker-specific one called *Decide to Play Great Poker*, that offered me an especially resonant lesson.

One of Duke's key insights is that the secret to playing good poker lies not in making great reads of opponents or having the nerve to pull off huge bluffs. Rather, it's a matter of making your decisions less difficult. By playing only in situations where the odds are stacked in your favor, one can become a profitable player even without the use of the slick maneuvers that draw much more attention.

It seems to me the same lesson applies equally well to investing. Here, we can view our opponent as the market and its indices as a whole. Much like how there are multiple different decision points in each hand of poker, multiple decision points emerge in each equity investment as new data is revealed (following an earnings release, SEC filing, etc.). And while the impact of any one decision on the portfolio may be minimal, over time, the ability to make to make slightly better choices than our opponent can compound into a sizable advantage. And the best way to do this is to make a larger portion of our decisions easy ones.

For example, I've seen many writeups by smart analysts which provided convincing evidence as to why a certain stock had huge upside because of an imminent change in price of a key commodity or an upcoming FDA approval. But profiting off of bets like these requires accurately making a series of tough decisions. For the commodity input example, even if you get the underlying economic drivers right, you might still get the commodity price wrong. And even if you get the price right, the benefits might not show up in the company's financial performance. And even if they do materialize, the market may not reward the outcome if it perceives the benefit to be only temporary (multiple contraction). And even if the market does reward the outcome, how do you know whether there's further upside to come or if you should sell and move on? (This question is a painful reminder of our BlueLinx Holdings round-trip last year).

To be sure, these ideas have occasionally turned out just as predicted and led to lucrative returns. However, at least for me, the gains from these periodic winners were more than offset by losses in which something in the chain fails to come to fruition as anticipated. Such situations are the equity market equivalent to low suited connectors – sometimes you'll make your flush and win a big pot, but after considering all the times you miss or end up paying off a better flush, you actually end up losing chips in aggregate on those hands.

Instead, it makes sense to focus your time, effort, and money on opportunities that require a shorter chain of links in order to be profitable. Every dicey decision you need to navigate through multiplies

your likelihood of a permanent loss of capital, so you want to make the math as easy as possible. Sometimes, in both investing and poker, knowing what to play is just as important as knowing how to play.

SOTP Stories

Attracted by the idea of profiting in any market environment and captivated by the mystique of incredible performance of secretive funds, interest in and assets managed by quantitative funds have grown steadily in recent years. By the beginning of last year, it was estimated that 90% of trading volume and 30% of assets are now managed algorithmically. Given that these funds now control such a large swathe of equities while following very different methodologies than stock pickers, it seems only likely there have been lasting changes to the market structure as well. And I've spent a good deal of time in recent months pondering what the implications of such a shift may be.

In my view, one result is that it becomes much more difficult for a fundamental investor to outperform while following a rules-based strategy, at least in hypercompetitive markets like US or UK equities. Take the value factor, for example. Leaving aside the question of whether some of its metrics (especially price to book) are truly accurate reflections of economic value, it remains one of the oldest and best known efficient market hypothesis (EMH) anomalies in academic finance. And it makes intuitive sense – holding all else equal, low multiple stocks will always outperform high multiple ones as a matter of first principles, because an investment at any given dollar value buys more earnings power at a low valuation than a high one. As such, the value factor is a common target for quantitative practitioners.

But therein lies the problem. When you find two companies at differing valuation levels today, they are less likely to be "all else equal" than ever before. The combined popularity of the factor and the quant strategy means those stocks are likely to have been run through dozens or hundreds of algorithms while other known anomalies are controlled for or hedged against. And given that those algorithms' decisions are being made by computers, they will always be able to update, run, and trade on these screens faster than you or I ever could.

Accordingly, rules like "we only buy stocks trading at less than 15x earnings" often become subject to an adverse selection problem where the anomaly an investor is trying to exploit (such as the value factor) has already been reflected in the stock's supply and demand by the time he arrives. Thus, much like net-net stocks disappeared over time as the average market participant became more sophisticated, I believe the opportunity to earn outsized returns simply by buying a basket of low multiple stocks has been greatly eroded by the ever-advancing combination of free, abundant information and powerful machines to process it instantly.

I want to be clear – I am not at all postulating that it's time to give up on value investing, I am not saying that opportunities in cheap stocks are extinct, and I am not claiming that pricing differences based on human emotions like fear and greed no longer exist. I am simply arguing that they are

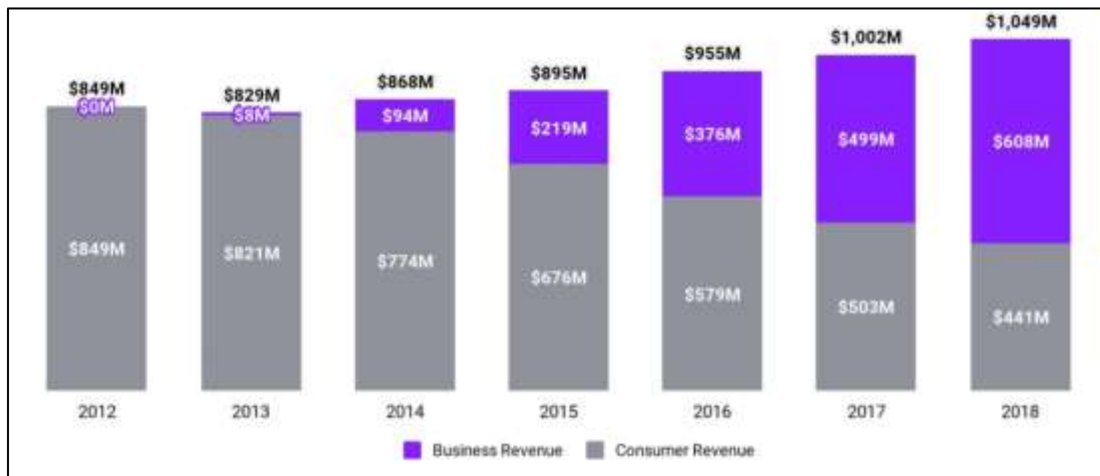
becoming much tougher to find, and as a result, it makes sense that exploring different methods of uncovering value may be useful in today's era.

If the above, what is the best strategy for a fundamental, discretionary manager like us to pursue? The answer is not to give up on trying to find value; rather, I believe it is focus on opportunities that are not exploitable by faster-moving market participants, ones where the value is hidden in such a way that it takes time and thoughtful judgment to uncover. This is why many of our positions now are in companies which are best analyzed with a sum of the parts methodology.

Sum of the parts valuations require an evaluation of the idiosyncrasies of a given company, and this is a domain where, unlike rules-based disciplines, cognitive capacity still reigns supreme. For example, Sea Ltd.'s Digital Entertainment and eCommerce divisions have very different economic characteristics. The former is already highly profitable but is further along in its growth trajectory, while the latter is still focusing on making investments for long-term market share. However, when you lump them together, you just see a company making heavy losses without getting the context of how or why they were created. Similarly, on a historical consolidated basis, Gan plc may not appear cheap by traditional metrics. However, if you value the fast-growing, high-potential real-money operations and much less exciting simulated gaming operations separately, I think you'll come to a very different conclusion.

Discussion on Selected Positions

Vonage (VG): One opportunity that fits this mold of the investments discussed above is Vonage (VG), whose value only becomes apparent when you consider each of its separate business lines individually. Many may already be familiar with Vonage thanks to their frequent TV commercials from 10-15 years ago (the ones with the catchy "Woo Hoo" song), advertising then-revolutionary internet phone service. What most people probably don't know, though, is that the company has totally remade itself in recent years and successfully pivoted from residential phone calling to unified, cloud-based communications solutions for the workplace (see graphic below).



The company's original business, which today comprises its consumer segment, allows customers to make and receive phone calls over the internet at cheaper rates than traditional landline service. This business is a melting ice cube with no prospects of turning around, but: 1.) it's melting slowly, churning only 1.8-2% of customers a year, and 2.) it generates a lot of free cash flow because of the now very limited reinvestment needs. This is important because the company is now able to fund its more promising lines of business without having to tap the capital markets.

While Vonage's consumer operation is the best known of its segments, it's the company's business division that generate most of its value today. This segment is split into two groups. The first, Applications, is made up of the company's Unified Communications as a Service (UCaaS) and Call Center as a Service (CCaaS) solutions. These offerings were mostly formed through a series of acquisitions that the company made upon seeing the writing on the wall for the long-term prospects of home phone centric services. Today, this is the larger of the two groups and continues to grow, though at a modest rate given the maturity and competitiveness of the market.

The company's other group within the segment, APIs, was essentially created through Vonage's purchase of Nexmo in 2016. Nexmo added the Communications Platform as a Service (CPaaS) vertical to the company's offering, and it has proven to be great investment, with proliferating use cases generating rapid market growth. Today, the API group is growing at 50%, and in my view, it's already the company's most valuable asset.

Vonage traded near multi-year highs as recently as August, but continued deceleration in the Application group's growth, coupled with a surprise loss in Q3 that caused the company to miss its full-year OIBDA guidance, led to a nearly 50% share price decline in the last few months of the year. Though there has been some recovery in 2020 to date, the stock is still well off its 52-week highs. Indeed, given the modest consolidated revenue growth and increased losses last year, a cursory glance shows little for anyone (or any machine) to be excited about.

However, VG is a classic sum of the parts (SOTP) investment, as each of the segments described above are in vastly different parts of their lifecycles. A quick version of the investment case is that the value of the company's API group operations is more than VG's current enterprise value, meaning we get the Applications group and Consumer segment for free. Below I'll dig into a bit more detail, but before beginning, I want to explain why I utilize an EV/sales multiple approach here. First, the company doesn't provide a breakdown of segment costs below the gross margin line, so it eliminates the guesswork of allocating expenses. Second, many of the company's business segment peers are not profitable, so an EV/sales valuation helps produce a more robust comp set that gets closer to how investors actually value these businesses today.

Let's first consider the consumer operations, which are the least valuable portion of the company. Assuming another 12.5% sales decline for 2020 and applying a 0.5x EV/S multiple leads to a value of $168 M for the division. This multiple is well below both what peer MagicJack VocalTec was acquired for in 2018 and roughly in line with the VG's historical average multiple before it branched into business services, so I'm comfortable with the estimate. Moreover, a quick DCF using Vonage's pre-2013 FCF margins yields a similar value at a 12% discount rate.

VG's Applications group competes with 8x8 (EGHT), RingCentral (RNG), Five9 (FIVN), and Jive Communications (now private). This group currently trades at an average multiple of 10.8x (including Jive's takeout valuation), but Vonage is currently growing at a slower pace than its rivals. Given that VG's growth rate for the segment is roughly a third of peers', applying a multiple that's a third of peers (3.6x) seems reasonable. This works out to $1.69 B.

So what's the crown jewel API group worth? CPaaS peers Twilio (TWLO) and Bandwidth (BAND) trade at an average EV/S of 8.7x, and VG's 47% growth rate (above the peer average) means it might be fair to apply that for our valuation. But double check the result, I ran a regression created based on the growth and margin metrics that have historically been predictive of SaaS business valuations[1], which suggested a fair multiple of 6.7x. Let's use this lower number and then apply a further 10% discount to it to remain conservative. This produces a value of $2.49 B for the segment, which is roughly equivalent to Vonage's EV at its current market capitalization and thus implies its other business lines are being ascribed zero value.

Putting the pieces together, we get a fair EV of $4.34 B. Backing out the net debt and dividing by the diluted share count, I get to a per share value of about $15; I then apply a further 20% SOTP discount to arrive at a target price of $12, which is over 40% upside at the current price. As an added bonus, there is a potential near-term catalyst – in its last earnings release, Vonage announced that it was undertaking a strategic review of its consumer operations, which would hopefully crystalize their value and collapse the sizable SOTP discount currently embedded in the stock. Accordingly, I believe

[1] I should note that it would also be possible to apply this methodology to the Applications group, but because 1.) its revenues are not purely recurring service-based ones, 2.) it has more listed peers to make comparisons with, and 3.) there are more moving parts given its M&A activity, I decided it was unnecessary for our purposes here.

the risk-reward here is very favorable, and am content to wait until other investors – or maybe even computers – catch on to the opportunity.

CY 2019 Idea Review: To date, I have generally not followed up on ideas shared in letters, but starting with the 2019 vintage, I'd like to annually revisit the companies discussed each year to provide an update on the theses and stock performances. Here are the nine companies that were discussed in letters published in the previous year; given the lag between quarter ends and letter publication, this comprises 4Q18 to 3Q19.

Alphabet (GOOG) – While far from an original idea, Alphabet has been a successful investment to date nonetheless. The company continues to chug along with its enormously wide-moat advertising business while making solid progress in its Cloud division, and I believe the eventual benefits to the company's AI and self-driving IP remain underappreciated. The stock no longer offers the same upside as it did following the selloff at the end of 2018 and so the position was trimmed upon long-term gains eligibility, but we continue to hold some shares. A market multiple on the core search business does not strike me as an unreasonable valuation for the gateway to the modern internet, and such a valuation would still produce double-digit upside from here.

Majestic Wine plc (LON:WINE) – It was a tumultuous year for Majestic Wine that ultimately brought disappointing stock performance (down 9% for the year). Following its decision to focus all attention on its direct-to-consumer wine subscription business (named Naked Wines), the company divested several smaller divisions and renamed itself to reflect the wine subscription's name. However, these changes were more or less expected; it was not until the company's CEO and founder stepped down abruptly that we became concerned. Following his departure, we decided that balancing the execution risk of trying to generate profitability in the highly competitive wine subscription industry with the change in leadership created too many difficult decisions, both for the company and ourselves. Hence, we exited our relatively small position with a modest loss.

Alibaba (BABA) – Another unoriginal but successful position, Alibaba gained over 50% in 2019 as concerns about Chinese tariffs eventually faded. In my initial writeup, I said that the company has perhaps the longest runway of 20% growth of any that I know of, and I continue to believe that to be the case. The size of the current Chinese market opportunity is hard to wrap one's head around, to say nothing of the very favorable secular tailwinds that it will continue to enjoy in the years ahead. So long as BABA retains its dominant position in the country, I believe we will retain our shares.

Wayfair (W) – Concerns about increasing cash burn and slowing sales growth have pushed down Wayfair stock in the last six months, and shares have now fallen in excess of 30% from our cost basis. I continue to believe that at scale the business model makes sense, that the current investments in its European expansion are reasonable, and that the 30% insider ownership ensures that management will not undertake a kamikaze mission to grow at any cost or with a dubious payback. That said, the market has recently had less patience for fast-growing money-losers, and in perhaps an acknowledgement of this shift, W recently announced job cuts and a higher ROI target on ad spend.

We continue to hold our shares, but I would like to see evidence of the promised cost leverage in upcoming quarters before adding any more at this lower price.

Yandex (YNDX) – YNDX posted a very solid year as both a business and an investment. The company consolidated its dominant position in Cyrillic alphabet search, increasing its search share lead over Google, and achieved full-year profitability in its Ride-hailing/FoodTech segment while nearly doubling segment revenues. After remaining sluggish for most of the year due to the overhang from a proposed law stipulating minimum ownership levels for Russian companies by Russian nationals, the shares appreciated significantly in November after the proposed rule was softened. The company continues to trade at a very reasonable valuation given its growth prospects, competitive positioning, and newly-simplified corporate governance structure, and we continue to remain shareholders.

Gan plc (LON:GAN) – The biggest contributor to our 2019 returns, Gan appreciated nearly 4x last year as investors gradually discovered this small company and huge opportunity its industry presents – legalized sports betting is a potentially massive market that remains in its infancy nationwide, yet even among professional investors I hear little discussion about it. Even after the appreciation to date, Gan remains one of the largest positions in our portfolio. Its performance to date has been essentially driven by excellent performance in a few of the states that already have online sports betting up and running (Pennsylvania and New Jersey being the main ones), which leaves a large amount of room for further gains as additional states launch (and there's no shortage of prospects in the pipeline). Furthermore, there is an imminent catalyst in the next few months, as the company is expected to begin trading on the NASDAQ exchange, which will hopefully bring an influx of investors (many were unable to access it the UK's smaller AIM exchange) that leads the stock to rerate closer to high-growth SaaS peers.

Sea Ltd. (SE) – The other big winner of the year, SE has gained some 70% since our letter after a consistent pattern of beating and raising its guidance. Much like with BABA, the southeast Asia eCommerce opportunity is enormous, but Sea is much earlier in its lifecycle and remains much less followed (it's only been public for less than 2.5 years). Coming off a year in which the company grew sales by 2.5x, they should grow another 40% in 2020, and on a SOTP basis I believe it's worth around $65 today, with many years of further intrinsic value growth ahead. Accordingly, there remains significant upside, and as a result it continues to be a sizable position for Adestella.

Farfetch (FTCH) – Our assessment that FTCH's selloff after Q2 earnings was overdone proved correct, as above-expectation gross merchandise value growth led to significant appreciation following Q3 and Q4 results. Farfetch retains a unique role in the global luxury ecosystem and continues to trade at a steep discount to e-Commerce peers with similar growth rates and margin profile, and for that reason we continue to hold our shares.

Zillow (Z) – Our thesis on Zillow came to fruition much more quickly than expected, as excitement surrounding the iBuying opportunity picked up in the last few months of 2019. We recently exited the position following Q4 earnings as the stock zoomed past our price target. The position was structured using call options that still had a significant amount of time value remaining, meaning that

the sooner we could exit the better, and without further intrinsic value upside, the decision became easy. I still believe the company has a path to capturing a reasonable share of real estate transactions and generating profitability at scale, but there is significant execution risk, and the long-term potential is now largely priced in.

Outlook

As I was drafting this letter, I originally had included a comment that we'd cut net exposure levels as the market continued to rise and risk-reward propositions became less favorable in aggregate. However, the rapid selloff stemming from fears of the coronavirus erased four months of gains within a week, showing how quickly things can change in markets and providing another useful example of the many black swans that lurk near us every day.

In my opinion, it is very unlikely that this virus will be the catalyst for the next recession. Yes, supply chains will be disrupted, and yes overall GDP growth may be temporarily slowed. But the common flu kills around 40,000 per year in the US with almost no fanfare (much less live updates), and we've seen pretty consistent economic growth nonetheless. I believe China will continue to act aggressively to curtail its impact, and we're already seeing signs of a gradual return to normalcy there. Ultimately, I expect this will be contained just like SARS and Ebola were before it, especially since the fatality and transmission rates are in similar ranges to past outbreaks. As a result, most of the net exposure cuts I had planned to mention have been redeployed into names that have sold off severely despite having little to no exposure to China or changes to their long-term prospects for growing intrinsic value. It may prove to be too early, but I'm betting time will eventually tell that the last few days were a buying opportunity. It's a wager that has history on its side:

MSCI World Index Returns

		Pre-declaration	Post-declaration			Total Period
	Year	3 Months	1 Month	3 Months	6 Months	9 Months
Pneumonic Plague	1994	4.61%	-2.65%	-4.27%	-3.47%	0.98%
SARS	2003	-6.02%	0.08%	11.57%	18.38%	11.25%
Avian Flu (H5N1)	2006	-1.86%	1.60%	6.14%	15.02%	12.88%
Dengue Fever	2006	4.47%	0.16%	8.37%	11.07%	16.04%
Swine Flu (H1N1) *	2009	5.62%	9.11%	17.30%	30.72%	38.06%
Cholera Outbreak	2010	12.27%	0.25%	6.37%	11.54%	25.23%
MERS	2013	8.78%	-1.28%	-0.56%	8.25%	17.75%
Polio *	2014	8.27%	0.07%	1.79%	1.52%	9.92%
West African Ebola *	2014	0.56%	0.35%	1.78%	2.91%	3.48%
Measles	2015	-1.18%	0.49%	7.18%	5.69%	4.44%
Zika *	2016	-8.09%	0.29%	7.67%	11.58%	2.55%
Measles/Rubeola	2019	-5.09%	1.27%	10.02%	1.27%	-3.88%
Congo Ebola *	2019	2.98%	0.34%	-2.11%	9.36%	12.61%
	Average	*1.95%*	*0.78%*	*5.48%*	*9.53%*	*11.64%*
Coronavirus (COVID-19) *	2020	10.39%	-0.02%	NA	NA	NA

* PHEIC declarations

Conclusion

2019 was an important year for Adestella, and I am glad to say that we managed to resume progress towards our long-term goals. We are much further along this path than we were last year at this time and are better positioned to avoid retracing our steps again. Not all quarters or years will go as well as Q4 2019 did, but I am optimistic for the way ahead even as virus concerns cloud the short-term outlook. In the meantime, we'll continue as we always have (and have written) – looking for pockets of value and preparing to capitalize on them when and if the price is right. Pursuing that seems like a pretty easy decision.

"You can shear a sheep a hundred times, but you can skin it only once. "

- Amarillo Slim Preston

Per Ardua Ad Stella,

Andrew Jakubowski

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