June 8, 2020

Dear Fellow Investors,

Adestella lost 23% in the first quarter of 2020, with almost the entirety of the drawdown coming in March following the onset of the CV-19 pandemic. Modest profits from our small short book and US dollar strength were not nearly sufficient to stem widespread losses from our longs, for which the declines were evenly spread between domestic and international positions.

That said, as of the end of May we are up in excess of 50% for Q2, which means we have recovered all losses incurred during February and March and have now gained nearly 20% for the year. This result was achieved by aggressively adding exposure and buying stocks while everyone else was selling, which caused pain in the short term but added value in the slightly less-short term. Outsized performance from a handful of stocks – seven holdings have more than doubled from their Q1 purchase prices, and two have gained more than 7x since mid-March.

My previous letter, published right at the onset of the virus's global outbreak, included a table showing various pandemics and market performance over those periods. COVID-19 has certainly been more serious than what I or almost anyone else expected at the time. But so far, it has followed the same pattern as the rest – a temporary buying opportunity followed by a rapid market recovery. Indeed, just like the JFK quote, crisis usually comes with opportunity. And as I'll try to explain below, I believe the window of opportunity created here is far from closed.

Where We Are and How We Got Here

The pandemic has provided a fascinating case study of the survivalist reactions individuals adapt when fearful, from hoarding common household items to "sneeze shaming" those with seasonal allergies. Behavior in the markets followed a parallel pattern, as fundamentals become irrelevant and sentiment dominated trading action. As the near-term outlook rapidly declined in early March, so too did security prices, wiping away years of gradual index gains in a matter of a week or two.

In the political sphere, the policies created to combat the outbreak reflected, like all other decisions, the personal incentives of those in charge. The President tried to maintain his base's confidence during an election year. Virologists tried to provide worst-case estimates to make the public take the risks seriously. Governors tried to position themselves to look like good stewards of their residents' health. Once the severity of the situation became clear, a race to be most cautious immediately broke out among the states. This too was not surprising, as most leaders agreed the risks to being too careful were less than the risks of not being careful enough.

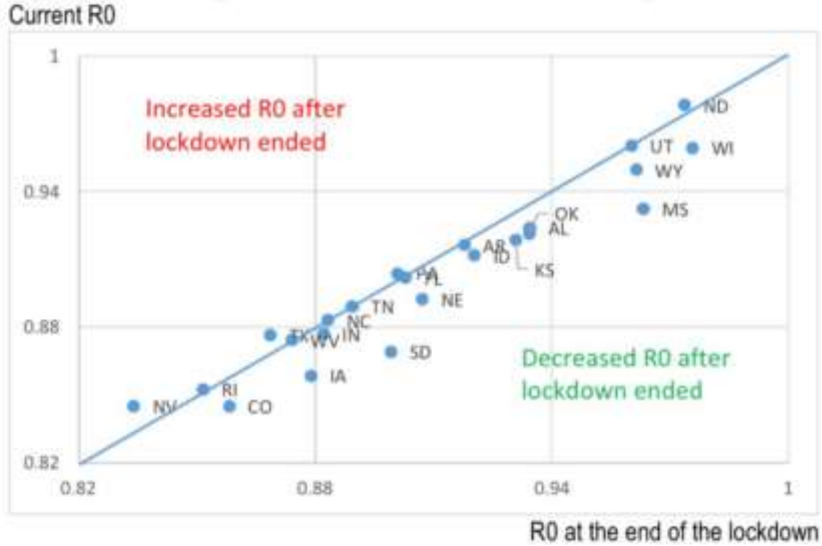
Investors took such dire warnings at face value. The novelty of the situation, or at least perception thereof, compounded the issue. It's well known that markets hate uncertainty, and without historical parallels of voluntary nationwide shutdowns to provide guidance, the uncertainty was further heightened. Spooked by (wildly over-pessimistic) death projections, investors abandoned all perspective and extrapolated trends into worst case scenarios, with frightful daily moves that made the 2007-2008 financial crisis look mellow by comparison.

However, from the start, we had a variant view that gave us the confidence to buy the dip: that the uncalibrated response of shutting down everything, everywhere – indefinitely – was completely untenable, and thus unlikely to last long. It was abundantly clear very early who is at real risk (the median age of death is almost 80 and the vast majority already had underlying health conditions),[1] and it seemed probable that once the public started feeling the mental and financial squeeze of being at home all day, they would quickly push back.

It made much more sense, in our view, to aim our collective societal focus on making sure this subset of the population was aware of the importance of staying completely quarantined, and to provide the goods and services needed for them to do so, instead of trying to keep 20 and 30-somethings from getting their hair cut or going out to eat.[2] This would have had a negligible impact on curve flattening and would've prevented an economic blowup from forcing the 95%+ of people at minimal risk[3] to stay home indefinitely, which was the plan at the time.

This idea has gained traction now that we're well past the worst of the impact from the disease. Some are still apprehensive of the potential impact of a second-wave, but many more are beginning to view it as a risk we must live with for the time being. Fortunately, with most states and countries well underway in their re-openings, we now have the ability to run A-B tests to compare the effectiveness of different responses. And the data so far is very encouraging:

Figure 1: R_0 during lockdown vs. after lockdown end by US state



Source: J.P. Morgan Quantitative and Derivatives Strategy

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1 Moreover, a large portion of the impact was being felt in only one metro area (NYC) with unique characteristics, which suggested that a blanket approach was not the logical solution.
2 For people under 35, the risk of dying from CV-19 approximates that of being struck by lightning.
3 High-risk population defined as people 65 or older with underlying medical conditions.

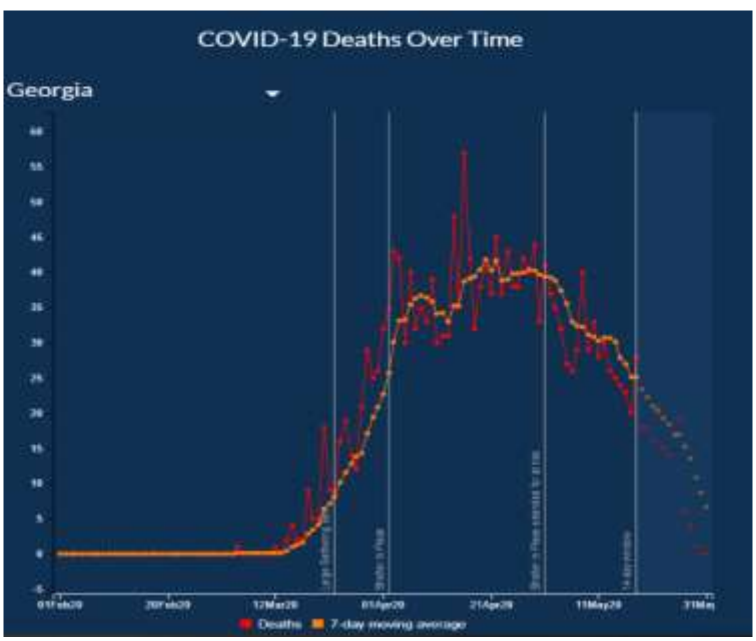
As depicted above, the great majority of states have seen the rate of CV-19 spread slow even after lifting lockdown measures. This suggests that with a bit of common sense and preparation, a second surge of cases is unlikely to materialize. Charts like the above are currently receiving approximately zero media attention, but will eventually become known to the public by lived experience.

Understand Backwards, Live (and Invest) Forwards

Recounting what's happened in recent months, while important, doesn't really help us with determining our course now– what really matters is where we'll go from here. My view is that now that CV-19 is no longer an "unknown unknown",[4] markets will be willing to look past the near-term issues (with some help from the Federal Reserve) and thus won't retest the March lows, as many market participants still seem to expect. Indeed, investors focusing on how bad the data points are ("look at those unemployment numbers!") should instead be focused on the second derivative effects ("look how much jobless claims have already started to fall!").

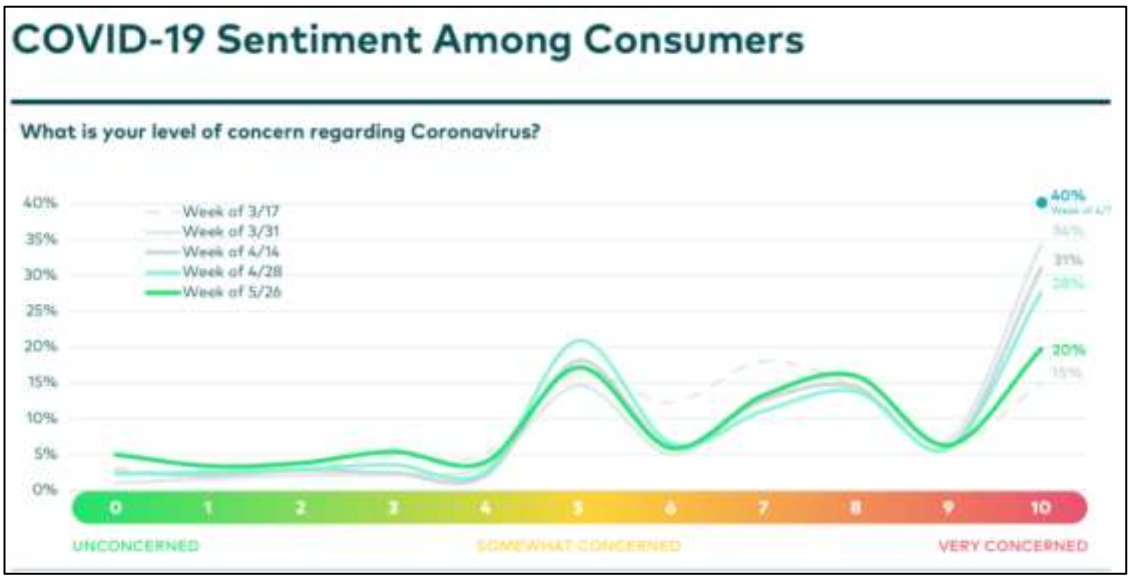
So how does this play out in practice? The outline of my working hypothesis is as follows:

1. Further data continues to show the same pattern we've seen to date: cases and fatalities continuing to progress down the right side of the bell curve. Consider the following data from Georgia, the first state to reopen, reflecting a few weeks of lifted lockdown (left table). Other states, such as Texas, that have followed suit are seeing the same pattern on a few weeks' delay (right table).



[4] For an excellent discussion of this dynamic, see this blog post.

2. Widespread re-openings without an attendant spike in deaths (consistent with what we've observed so far, albeit with much less breathless media attention) creates greater confidence that we've passed the apex of the disease's impact. Indeed, as quickly as closures cascaded in March, openings may snap back just as quickly. States currently pursuing [slower plans](#) will be forced to succumb to their citizens' wishes[5] and accelerate their processes as the evidence piles up against them. People are already wary the narrative shifting from "flatten the curve" to "wait 'til there's a cure", and they (understandably) [don't seem to appreciate](#) having the goalposts moved on them. Once again, all that matters are the incentives. No longer worried about being viewed as reckless or careless (see graph below), governors instead bow to public pressure and take credit for their pragmatism and business-friendliness.



3. A resumption of most activities combined with the reassurance from the Federal Reserve of highly accommodative monetary policy for the foreseeable future (driving down interest rates and creating the perception of [TINA](#)), leads to sustained equity buying. The indices as a whole may not move significantly higher, since the resilience of mega-cap stocks has allowed them to already regain more than 90% of their value lost. However, smaller companies operating in shutdown-sensitive industries (casinos, restaurants, etc.), many of which are still 40% or more below their highs, will see sharp rallies as fears of a shutdown-induced liquidity crunch subside. I believe increased investor confidence will lead to money flowing from the larger, ostensibly safer stalwarts towards the less famous stocks that were first on the list to sell when people wanted to cut their market exposure.

[5] Put another way, last month [48% of people thought](#) that restrictions in their area were about right, with the other 52% split about evenly between preferring "more" or "fewer". My bet is that those in the middle will continue to shift into the "fewer" camp as time goes on.

And if I'm wrong? Given the speed of developments and complexity of the problem, it's certainly possible. But at the end of the day, a company is worth the present value of all of its future free cash flows. For public companies in most industries with reasonable value propositions and competitive positioning, these flows tend to be spread out over quite a long period of time. Hence, the impact of any one year's contribution to the total value is relatively inconsequential.[6] Just how inconsequential, you ask? Were a no-growth company to lose all cash flows for a whole year, the intrinsic value falls by less than 4%. If you assume those cash flows will grow over time, the impact is even smaller. Thus, *so long as* the company has the resources to ride out short-term adversity, the long-term value is largely unimpaired. Given that we define risk as permanent loss of capital and have a long-term horizon, this means our reward will be a matter of when, not if.

The mathematical truths above, along with their conditional caveat, form the basis of my three-pronged criteria for Adestella's CV positions, outlined below:

1.) Unfairly beaten down. We are looking for "babies out with the bathwater" situations. Additionally, new positions should be not obvious beneficiaries of the pandemic, unlike many eCommerce-type stocks that are already at all-time highs.
2.) Balance sheet strength. As mentioned above, long-term value can be preserved *so long as* the company can reach the long term. Path dependency matters; a 10,000% return on $0 is still $0.
3.) Significant remaining upside. Of course, all else equal, the more upside the better, but this is especially true given the size and distribution of price dislocations the pandemic has created. There are quite a few companies out there currently trading at prices that I think would make us a satisfactory return as conditions normalize, but when presented with these exceptionally rare opportunities, "satisfactory" is not sufficient. To paraphrase Warren Buffett, we want to catch this rain with a bucket, not a thimble.

Discussion on Selected Positions

The great majority of our action in recent months has been related to adding to existing positions. However, we also added several new holdings that met the three conditions described above; the thesis for two of them are explained below. The summaries are shorter than usual because 1.) the wide range of economic outcomes at present makes attempting precise financial projections a fool's errand, and 2.) I believe that behavior is the most important factor in making money right now, which is why the CV criteria above isn't particularly complicated – it doesn't need to be.

HostelWorld Group (LON - HSW): headquartered in Dublin and traded in London, HostelWorld is an online booking platform for hostel accommodations. With nearly 18,000 properties across 179 countries, HSW has built up powerful network effects that create a compelling value proposition from both sides – hostels want to be on a platform that generates 87 million visits a year, and travelers want all the accommodation options (and the 13 million reviews) in one place. I believe the industry niche itself is also attractive. On the demand side, it's important to remember that hostels tend to be frequented by younger travelers on a tight

[6] See a great summary of this concept here

budget. The combination of the cheaper price (unlike hotels) and social element (unlike Airbnbs) they provide has created consistent demand in the niche, with revenues increasing a few percentage points a year. However, the hostel industry is still dwarfed by annual hotel demand (~$6 B for hostels vs. $550 B for hotels), and the industry is much less concentrated (most operators are independent vs. only 40% of hotels). This combination of small size and fragmentation has kept it from becoming a strategic priority for the likes of Priceline or Google, and in turn allowed HSW to maintain stable take rates over time.

Like all other travel-related stocks, 2020 will probably end up being lost year for HostelWorld. However, at current prices, HSW is trading at about 4x 2019 free cash flow. Even if it takes several years for travel demand to fully recover to that level, applying a still-low but more reasonable 9x multiple and then discounting back to the present value at 9% suggests over 50% upside. Given the company has around €20 M in cash on hand, no debt, and an asset-light business model, there is more than enough liquidity to ride out the storm. Furthermore, given that CV-19 disproportionally affects older people, the relatively low-risk youth demographic HSW targets should be among the first market segments to return to normal travel patterns.

Before the outbreak, the company had targeted over €100 M in total revenues and 200 bps EBITDA margin expansion by 2022. While the timing on those milestones will likely have to be pushed back, the margin of safety on the existing operations here is sufficient enough that I'm happy to accept those initiatives as just a free option on further upside.

XPO Logistics (XPO): one of the largest logistics companies in the US, XPO operates both its own ground transportation fleet (15k tractors and 40k trailers) and an expansive non-asset transportation network (over 1 M trucks brokered). The company occupies a top-three industry position in virtually all major service lines and is run by a CEO who has already built and sold multiple billion-dollar businesses (not to mention growing revenues 94x since starting at XPO).

Despite its success to date, XPO still only has a 2% market share in the highly fragmented transportation industry. This number will likely get a solid bump from the wave of recent industry bankruptcies, and as the company continues to expand its scale and technological advantages over the surviving players, I expect further share gains for many years to come. XPO also stands to benefit as a backdoor eCommerce play from the acceleration of shopping moving online that the pandemic has caused.

XPO pulled guidance for 2020, and Jacobs has already stated that earnings will almost certainly be down, but XPO's long-term viability is not in question. They have about $2.8 B in liquidity with no debt maturities until mid-2022 and a cost base that is 77% variable. Shares remain down around 20% (much more at our purchase prices) from February despite increased demand for outsourced supply chain solutions. I value the company on a sum-of-the-parts basis, awarding a higher multiple to its asset-light business lines that comprise 69% of revenues. Using this methodology, I believe the stock is worth somewhere between $105-125 per share, which at the midpoint implies further upside of around 45% from here.

As an added bonus, if the market doesn't recognize the value, the company itself will – XPO has been an active acquirer of its own shares in past periods of adversity. Given that the incentives here are fully aligned (as the CEO owns 18% of the company), I'd expect them to strongly consider doing so again once the operating environment has normalized. The potential resumption of a strategic alternatives process (called off due to market turmoil in March) provides another lever for future value creation, but in the meantime I am content to wait as the company continues to execute.

Conclusion

Though our society is facing unprecedented challenges today, from the market's point of view, there's nothing new under the sun. Take this century alone. In 2001, a horrific terrorist attack led some to speculate that globalism and international travel demand would be halted in their tracks. Instead, air traffic and international trade were back to record highs within two years. Seven years later, many feared that the global financial system, and even capitalism itself, was on its knees. But US and world GDP were back to all-time highs by the end of 2010. Extending the analysis back further, the Great Depression and 1918 Spanish flu could also be classified as events that, at the time, likely seemed insurmountable but were eventually overcome. The market is resilient because the world is resilient, and I feel quite certain that we will get through this setback as well.

Great track records are built during periods of great adversity. Given that we weren't around during the Financial Crisis, I'd say this is the first such period Adestella has experienced. In many ways, the large drawdown we experienced in 2018 proved useful to navigating this one, as the lessons learned were instrumental to positioning ourselves for a sharp rebound in portfolio value. However, the bifurcation of individual stocks means that opportunities still abound. While the indices are only down single digits YTD now, there remain large swathes of companies trading 40-50% off their recent highs, and most of them did not have their intrinsic values impaired nearly that much.

Heightened emotions and wide ranges of outcomes mean this is a time when careful analysis is needed more than ever. Most stories pertaining to the pandemic today remain gloom and doom, but I feel optimistic for both our world and our portfolio and think each will emerge stronger than ever on the other side. I look forward to providing another update on developments in a few months; in the meantime, I hope you and your families stay safe and healthy.

"Damn the torpedoes! Full speed ahead."

- Admiral David Farragut

Per Ardua Ad Stella,

Andrew Jakubowski

Performance Summary:

	1Q 2020	YTD 2020	Since Inception
S&P 500	-19.4%	-4.9%	74.9%
Vanguard Total World Stock ETF	-22.2%	-9.6%	34.0%
Russell 2000	-30.7%	-15.8%	27.0%
HFRI Equity-Hedge (Total) Index	-14.5%	-5.0%	19.6%
Adestella Investment Management	**-23.1%**	18.8%	**104.9%**