Adestella
Investment Management

March 8, 2021

Dear Fellow Investors,

Adestella gained 25% in the fourth quarter to finish the year with a 93% net gain. Long positions were once again responsible for the entirety of the profits, as small short book losses and currency gains more or less offset each other. Currently, our portfolio is nearly equally split between domestic and international stocks, and over the period, the returns from the two groups were evenly split as well. We are pleased with the result, which represented easily our best year since inception, but caution that such gains are unlikely to be replicated in the years ahead.

Given the magnitude of the annual return, it is only natural to ask whether it was dependent on either outsized risk or luck. I don't believe either to be the case – our net exposure fluctuated within a few percentage points of 100% throughout the last nine months of the year, and we had virtually no exposure to options contracts or other shorter-term derivatives. Furthermore, we had 14 different positions make at least a 2% contribution (average weight x total return) to the annual result, and among positions that made at least a 1% absolute contribution, 84% of them were positive. While there are no points awarded for having quite a few winners and a high hit rate as opposed to one or two very large holdings outperforming, it is encouraging insofar as it indicates our process is working and producing fruitful ideas on a regular basis.

"Slowly, then All at Once"

One of the main reasons for taking a multi-year horizon when analyzing investments is that markets do not move linearly. One cannot simply extrapolate a short-term trend into a longer-term result; there is just too much noise. While many would prefer the mental comfort that comes from such predictable changes, the nature of highly complex and adaptive systems such as securities markets precludes it. Accordingly, the only way to obtain the true signal is to take more trials, which in the stock market's case is synonymous with "more time", given that there's never more than one trading session per day. Equities have historically been the best performing asset class in the long-term, and you are virtually certain to make money over a 20-year period. However, the chance of the market rising on a given day is only a little above 50%, meaning it takes quite a while for all that noise to filter out.

I mention this because the same applies to analyzing managers. In a year, much less a quarter, there is a lot of largely random variance in our results. We cannot expect to routinely have near triple-digit years, nor should we overreact when we have one with 20% losses. This is particularly true because our portfolio tends to be relatively concentrated, which means a handful of positions can (and did) make an outsized impact on the final result. Four flat years and one like our 2020 is superior to five years of 14% annual gains, but it can take time, and require patience and conviction, in order to achieve. Thus, it's only by putting together a few of these periods, spanning a variety of positions and investment climates, that we can normalize for investment strategy and style. Only then can one begin to get a clearer picture of the underlying signal and get an idea of whether performance was due to skill or just good fortune. While the more the better, a common rule of thumb in the investment management industry is a five years minimum sample size to be reasonably confident that superfluous movements will have evened themselves out.

Adestella crossed that minimum threshold near the end of 2020.[1] Over that period, the median absolute change in NAV was 38%, and we deviated from the S&P 500 by at least 10% in all but one year. In short, there was a lot of noise along the way. Overall, the result has been favorable, with an annualized net return roughly double that of the S&P, but there were multiple points at which an extrapolation of recent results would have been unflattering. Only by broadening the time horizon could one "mute" the constant din and hear the song playing in the background, which is why it's so important to be listening for the long term.

The same dynamic should be expected to show itself the next five years as well, so we hope current and potential investors alike will continue to resist the temptation to extrapolate short term fluctuations. In return, we will try to build on our success to date by staying the course while pursuing an ongoing cycle of analysis and improvement, regardless of the inevitable ups and downs that materialize along the way. We thank all those that have joined us so far, and we look forward to extending our track record and further silencing the noise in our performance in the years ahead.

Sizing and Selling

There is a myriad of resources and advice available when it comes to the best strategy for selecting stocks to own in your portfolio. Many hundreds of books, papers, and blog posts have been written advocating all sorts of approaches for discretionary investors. But in my experience, a closely related topic, and one of near equal importance, tends to receive far less attention and consideration. As a follow up to the investment checklist I shared in the last letter, I wanted to provide a few thoughts on the topics skipped then – position sizing and sell discipline – which I think are worthy of their own discussion.

While there may not be as many books on the subject, there are nonetheless a wide range of approaches to position weighting, crossing the full spectrum from art to science. Many investors seem to simply go by their gut feeling, using their prior experiences and pattern recognition to settle the issue. On the other extreme, some rely on mathematical formulae with full proofs to calculate an optimal value. Others more or less avoid the issue altogether by simply giving each holding an equal weight. Everyone seems to have their own method, and over time, we've settled into one that works for us as well.

Like most actively managed investment funds that strive to outperform the market, the explicit goal of Adestella is to maximize the expected IRR of our portfolio – the returns generated normalized for the length of time needed to achieve them. Accordingly, it's common sense that the greater the expected

[1] Based on our initial external clients; the Fund operated as an incubator for about a year prior to that.

IRR, the larger the position should be. While target prices can create the illusion of false precision, they are still useful as long as they are 1.) arrived at under conservative assumptions; 2.) treated as a rough estimate rather than a precise calculation; and 3.) updated frequently as new information becomes available. Accordingly, we set one for each stock we own, along with the contemplated timeframe for hitting that target, in order to generate an IRR projection.[2]

That said, it is important to understand that not all IRRs are created equal. The next step is to assess our level of conviction that our projected return, or something close to it, will be met. The key aspects we evaluate are as follows:

1.) Growth Certainty – comprising factors such as the degree to which the underlying industry is cyclical, and the company's track record, competitive advantages, market opportunity, and organic growth potential.
2.) Asymmetry/Downside Protection – determined by the current valuation and how it compares to the company's growth and trading history, along with peer comparables. Contemplated downside protection is shaped by examining ROIC, the historical cyclicality/results variance in the business, and any hidden/unappreciated assets it may have.
3.) Fundamental Momentum – recent developments in growth, margins, profitability, leverage, and the industry environment; importantly, it is completely unrelated to recent trends in the stock price.
4.) Edge/Why the Opportunity Exists – degree to which the business is understandable and not overly specialized or technical in an unfamiliar area (thus reducing likelihood of judgment error or oversight), the amount of analyst, media, and retail investor attention, and why the mispricing exists.
5.) Micro Supply/Demand – reviewing the nature of share ownership (such as the amount owned by insiders, retail investors, hedge funds, venture capital firms), the company's history of share buybacks or capital raises, company size and trading liquidity, and the percent of the float held short.
6.) Range of Outcomes – the most important; draws on the results from each of the first five list items with special consideration to potential Black Swan risks, the degree of conservatism in our valuation, and the presence of secular headwinds/tailwinds that may impact the company's operating environment.

To illustrate with an extreme example, a merger arbitrage situation with a 1% spread that should close in two weeks and a stock with 70% upside over two years have roughly the same IRR but vastly different investment profiles. In our experience, the hardest variable to get right is the timing, which is especially impactful in short-term situations where minor adjustments can have a large impact on IRR – in the merger-arb example above, if the deal closes in three weeks instead of two, the IRR falls by more than a third. We would view such a situation to have a much wider range of outcomes (as well as far less

[2] Even for event-driven situations with potential short-term catalysts, we never underwrite less than a one-year holding period so as to be conservative with our expected return.

attractive asymmetry) in terms of realized returns, and as such would view its risk-adjusted or confidence-adjusted IRR to be far lower than the longer-term investment. Such a framework helps us to focus our time and capital on situations that not only offer the best expected returns, but also are able to deliver them under a larger number of potential future states of the world.

Any economists reading this would be glad to know that our sell discipline is done on the basis of opportunity cost. We are predisposed to inaction unless the conservatively measured cost of that inaction (i.e. the opportunity available elsewhere) is clearly greater even after giving effect to potential slippage or tax consequences. Because opportunity cost essentially connects scarcity with choice, this hurdle can vary greatly depending on the market environment. If we are sitting with a sizable cash balance, the opportunity cost to holding a position is quite low, and we are unlikely to sell until the stock surpasses our fair value estimate. Conversely, during periods when we are fully invested yet still finding attractive prospects, the opportunity cost of continuing to hold a stock with a lower or less confident IRR is much higher. At times like that, it can make sense to exit a position even while we still think it could have further upside.

For the most part, the latter of the two scenarios has been the case in recent months. It's for this reason that our turnover in recent months has been higher than normal – given that we aren't going to move to a leveraged long net position, the only way to take advantage of opportunities that arise now is to sell something else. There will undoubtedly turn out to be (more) situations where we sold too early, but we accept this because the goal is to reduce the opportunity cost, not eliminate it. Looking at each opportunity through the lens of our best alternative gives us the best chance to maximize the risk-adjusted IRR of our portfolio at any given time, and to date we think this approach has added value to our investors.

Discussion on Selected Positions

CY20 Idea Review: Just as I did last year for 2019, I'd like to provide a brief update on the stocks discussed in letters published in 2020.[3]

Vonage (VG) – the VG thesis has largely played out as expected. The market has gradually shifted its focus from the declining consumer operations to the growing business ones, highlighted by the API unit. As its legacy home phone VOIP solutions continue to become a smaller and smaller portion of the overall pie, we think this trend will continue. If the API unit can continue to grow at 25-30%, that segment alone covers most of the enterprise value at just a ~6x sales multiple before giving any credit to the sizable UCaaS operations. The API unit's closest comparable, Twilio (TWLO), currently trades at 31x sales, so it's not unreasonable to think there's upside to our estimate here. Shares have returned around 80% since our writeup (and slightly higher from our cost as we added in the weeks that followed), but we've maintained most of our position as the key growth drivers remain intact.

[3] Though Genomma Lab was briefly mentioned in 2020, our piece was not published until 2021, so I will save the review of LABB for next year's Q4 letter.

Hostelworld (LSE:HSW) – HSW proved to be a disappointment. While the company cannot be blamed for the very difficult travel environment, and while the stock is still very cheap on normalized numbers, pre-existing common shareholders now stand to benefit much less than we originally did. In June, HSW undertook a massive capital raise that was supposed to give the company ample liquidity even in a pessimistic scenario. But just over six months later, the company changed course and took out a loan that has both dilutive warrants and a very high interest rate attached. This suggests either very poor capital allocation or that business conditions have been far worse than management has let on; either is a clear negative. The extended timeframe for recovery coupled with these issuances has greatly reduced the potential upside in a post-COVID world. Insiders also seem hesitant to take advantage of what we hoped would've been seen as a buying opportunity, and the company may have trouble competing if its direct traffic suffers as a result of the prolonged hiatus. We exited the stock at a loss to harvest the tax offset and pursue more favorable setups in other names.

XPO Logistics (XPO) – the XPO thesis was very simple, but it proved very successful. As the stock irrationally sold off in the spring and made only a tepid recovery in the following months, we were able to buy into a well-operated business with plenty of growth drivers at a compelling price. Sentiment surrounding the company improved thanks to a strong earnings, the resumption of asset sale plans that had been shelved in the spring, and the announcement of a spinoff to unlock the SOTP value. As the stock approached our estimate of a $115 fair value, we exited with more than a clean double from our cost basis.

LiveChat Software (WSE:LVC) – LVC has continued to execute well. While the stock has not been a high-flyer to the extent of many other SaaS names, both the business and share price have continued to grind higher, and the valuation remains undemanding. A long runway lies ahead as businesses increasingly adopt live chat and chatbots as their preferred customer service channel. LVC has appreciated by just under 50% since our purchases last summer, but we continue to hold our shares and remain optimistic that the company can further compound value in the years ahead.

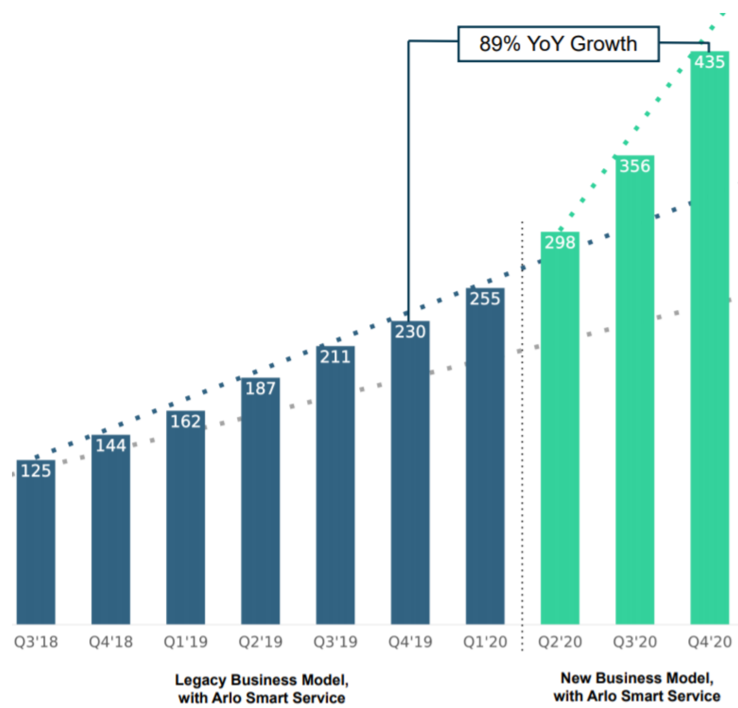
Arlo Technologies (ARLO): Longtime readers will know that some of our favorite investment situations are ones where a highly valuable segment or a business model shift is obscured in the consolidated financials by the impact of growth investments or the presence of a another less appealing segment. Such situations are often fertile ground for mispricings, as few investors do the work required to analyze the pieces separately and get to an accurate estimate of fair value. We think Arlo Technologies, a new addition to the portfolio, is one such opportunity.

Arlo makes high-end home security cameras and video doorbells. Standard features include high resolution video, motion detection, smart speaker integration, and AI capable of differentiating people, animals, and vehicles; all of this comes in a wireless device that works from negative temperatures to over 100° F. With people tending to spend much more time indoors during the last year, consumer demand has increased significantly as people invest in their homes. Arlo's range of cameras have received almost universally positive reviews from both testers and consumers who are willing to pay up for superior quality.

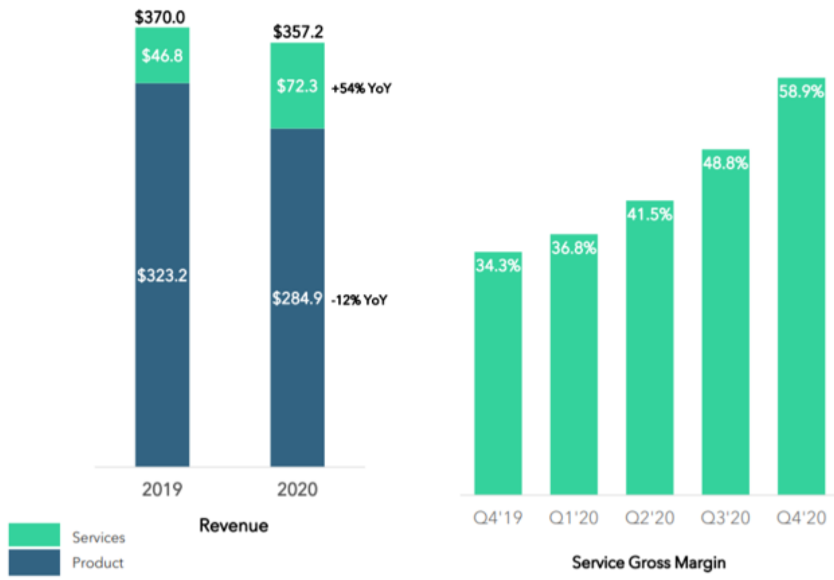
What makes ARLO interesting as an investment is that the company is in the midst of a successful shift away from one-off product sales to recurring service-based revenue. Up until the first quarter of 2020, ARLO offered free 7-day cloud storage of "triggered events" (for example, someone coming to the front door) along with a 30-day trial of Arlo Smart, its cloud-based suite of monitoring and detection notification tools. Unfortunately, this model was only leading to a 5% conversion rate to an Arlo Smart subscription upon trial expiry, as most customers were content to simply review anything captured within the following week. This left the company reliant on continued device sales for further growth.

In Q2, ARLO pivoted its busines model and Smart Service offering. The company extended the length of the free trial from one month to three but removed the free 7-day triggered event storage; instead, customers who choose not to subscribe would only get live view after the trial expired with no access to the collated collection of triggered events. In essence, while both models are razor and blades, ARLO decided to lean into the latter.

While such a sizable change was certainly a risk, early results of this shift have been excellent. In the three quarters since the change, conversion rates have gone from 5% to 50%, and paid account growth has accelerated in each of the periods (see chart below):



This success is not immediately apparent from a quick glance at the financials, as total revenue fell in 2020 (due to lower device sales) and consolidated margins are not impressive. This, however, masks the rapid development of the service segment, which grew revenues at a 70%+ clip in the latest quarter while expanding gross margins by over 20% YoY (see charts below).



While service revenues are still a relatively small piece of the total, with growth rates like these, it won't take long for the impact of the business model shift to start to be appreciated by the market. Furthermore, the company seems to have significant room for future price hikes (and thus further margin expansion), given that it currently offers plans for as low as $2.99 a month.

At the current ~$7 stock price, we think it's easy to pencil out at least 40% upside for ARLO even under modest assumptions. At the current run-rate, the company generates about $86 M in service sales. Assuming service sales grow 50-60% in the next twelve months (recall they accelerated above 70% in the latest quarter) and the company can maintain its ~58% segment gross margins (which we think will actually continue to expand), we triangulate a fair multiple of at least 7-8x sales based on SaaS comps with similar growth and profitability profiles. At a 7x multiple, the unit is worth over $600 M, well above the current EV. We value the hardware sales at 1x LTM revenue, which is below consumer tech hardware peers like GRMN and GPRO, as well below the Fitbit takeout price. Adding the company's net cash position and applying a 15% SOTP discount gets us to a ~$10 price target.

While the above already represents an attractive-risk reward, further upside is possible if the company's paid account growth remains robust, service margins continue to expand, multiples converge toward peers, or if ARLO manages to break into commercial verticals or related markets such as baby monitors. While insiders own less of the equity than we'd like, much of their compensation is in the form of options with an ~$11.50 WA strike, meaning they're incentivized to see a much higher stock price as well.

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Earlier this year, we published a piece on Mexican-based consumer products company Genomma Lab (MX:LABB); rather than include the entire writeup as an appendix, we will simply include the link here for interested readers. In recent weeks, we have also added sizable positions in two businesses based in Commonwealth countries. I would expect each to be discussed in detail in upcoming letters.

Outlook and Conclusion

As the world normalizes, our portfolio returns likely will as well. Bargains are harder to find now, and the B-word is thrown around in financial media on a regular basis. The recent attention and huge price movements in so-called "meme stocks" lends credence to the idea that speculative financial behavior has reached a fever-pitch, and that it could signify a market top.

That may be true, but regardless of broader index levels or the emergence of a few volatile stocks favored by retail investors, there are still a wide range of prospects available if one is willing and able to go off the beaten path to find them. Indeed, we are still finding plenty of situations that offer very favorable risk-rewards based on modest valuation assumptions – particularly in international markets, which in most cases have not recovered from last spring to the same extent as US-based ones. Fortunately, our mandate allows us to do this, so we will continue to take advantage of it by pursuing interesting investment situations whenever and wherever they may appear.

All the best for 2021, and I look forward to writing you again in a few months' time.

"I am a slow walker, but I never walk backwards."

— Abraham Lincoln

Per Ardua Ad Stella,

Andrew Jakubowski

Performance Summary:

	4Q 2020	2020	Since Inception
S&P 500	12.1%	18.4%	117.6%
Vanguard Total World Stock ETF	15.5%	16.6%	72.8%
Russell 2000	31.3%	20.0%	81.1%
HFRI Equity-Hedge (Total) Index	14.7%	17.7%	48.1%
Adestella Investment Management	**24.8%**	**93.3%**	**233.4%**