March 28, 2023

Dear Fellow Investors,

Adestella gained 11% to end the year with a net loss of 14.7%. Long positions benefited from a modest market rebound during the quarter to post a 9% gain, while the short book was approximately breakeven, finishing with a loss of 20 bps. Domestic stocks led, producing about 70% of the net gain versus only 30% from international positions, though the contributions were approximately equal after adjusting for their respective net exposure levels. Given its sizeable foreign currency balances, the Fund was also helped by the significant weakening of the dollar index, which fell 7-8% over the period.

As 2022 unfolded, the market environment underwent what some described as a sea change, with many of the best performing types of stocks in recent years finishing the period sharply lower. With its heavily-weighted technology and communication service companies performing poorly, the S&P 500 ended up posting its worst annual performance since 2008.

Still Here

The longer I am in this business, the easier it is to see why multi-decade track records of outperformance are so rare. The unfavorable reality of the math behind recovering from a sizable drawdown (i.e., needing to gain 100% to recover from a 50% loss) makes it annoyingly quick and easy to impair years of strong returns, particularly during tumultuous periods.[1] Such radical changes in direction, and the inability to predict their timings, can be fatal to a performance record if one fails to think in bets and appreciate that the potential ranges of outcomes are almost always wider than hoped.

We got a taste of this firsthand in 2018 following a painful drawdown, and since then I have tried to improve our review and monitoring processes to avoid a repeat. I think one of the areas that we have especially progressed in is our willingness to change our mind quickly and to admit when we made mistakes, thus preventing them from snowballing. For example, I am much more selective on averaging down on our losing positions than I was a few years ago. Averaging down felt good in the short-term ("I took advantage of this opportunity"), but too often elements of loss aversion and anchoring were also at play, and we ended up compounding problems and creating additional headaches. This increased selectivity served us well in limiting damage to the portfolio in a challenging environment, when many investors that went all-in on certain high-flying stocks or themes saw a dramatic reversal in fortune.

[1] As one crude measure of turbulence, the annual return volatility of the S&P 500 has been roughly twice as high in the last four years than it was in the first four years of the Fund (22% vs. 11%)

World events in recent years have also reinforced the fact that there are always things that cannot be predicted, and past a certain point, spending more time on research doesn't make you more likely to be right — but it does make you feel more certain that you are. This can be very dangerous, as many investors feel as though doing tons of extra work on the minutiae of an idea entitles them to a superior outcome. They feel as though they earned it, that they are entitled to a sizable profit from going the extra mile — which is natural, as in most other fields there is a direct connection between effort expended and quality of results. But in the stock market, this mindset can instead lead to one making a position far too large and/or being completely unwilling to change his mind on it regardless of what new data points materialize. And while owning 25-30 stocks across various industries and investment types may hinder our chances of posting a triple-digit return year, it also makes it significantly harder for an unfavorable run to blow an unfixable hole in our capital. This has been especially critical in recent years given the magnitude of the black-swan events that have materialized, and it's helped us weather the storm without permanent capital impairments.

Finally, it's worth mentioning that from an asset-gathering standpoint, our more conservative approach was almost certainly suboptimal. Multiple firms that started after Adestella grew AUM much faster than us, largely due to one or two years of incredible performance from highly aggressive bets on specific stocks or themes, rather than the smaller and more varied ones we made. When times were good, the results and subsequent attention from performance-chasing investors and allocators undoubtedly led to huge investor inflows. Yet after last year, many of them are now behind broad, easily-accessible benchmarks such as the S&P 500 since their inceptions despite those home-run years. Meanwhile, we are still here, still ahead of benchmarks, and still well-positioned for the years ahead.

Portfolio Updates

The top of the portfolio remains similar from a position-sizing standpoint. Our portfolio hasn't changed much because my view has not changed much – I still think we are entering into a multi-year period where capital will be more expensive than expected, where higher interest rates crimp long-duration, terminal-value-heavy investments, and where stocks with real earnings and cash flows are likely to outperform.[2] The positions discussed this quarter all fit this framework; while the timeline for it may be slightly altered in light of the recent banking turmoil, I believe the ultimate path remains the same.

Franklin Covey (FC): A recurring theme in our portfolio is businesses undergoing a structural shift in either their business models or division prominence. Such opportunities generally require "looking under the hood" and are not as easily exploited by quantitative methods. The most recent example

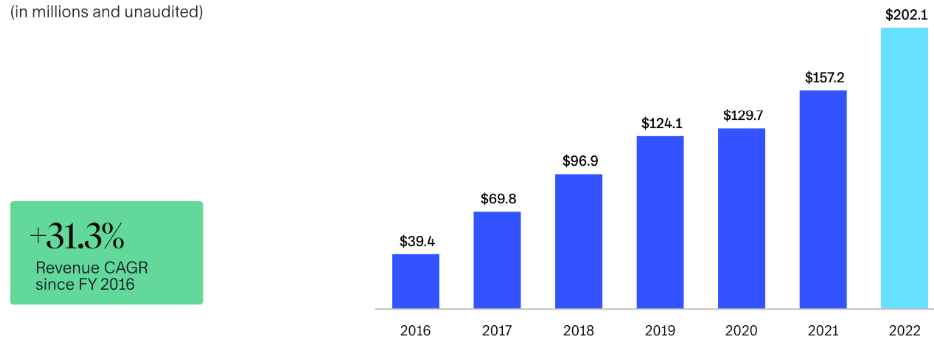
[2] This is not quite a growth vs. value call as classically defined; it's been shown empirically that the link between value and interest rates is "ambiguous and complicated." That said, the value of any company is the present value of all its future free cash flows, and changes in discount rates disproportionally affect those whose cash flows are expected to arrive farther into the future, which tend to be companies currently classified as growth ones.

of this dynamic for us is Franklin Covey, which provides products and services designed to drive organizational performance improvement. FC operates two divisions; the larger of the two (77% of sales) is Enterprise, which offers solutions for businesses in areas such as sales performance, customer success, leadership development, and company culture framework. The other segment is Education, which helps schools increase student performance and parent/teacher engagement.

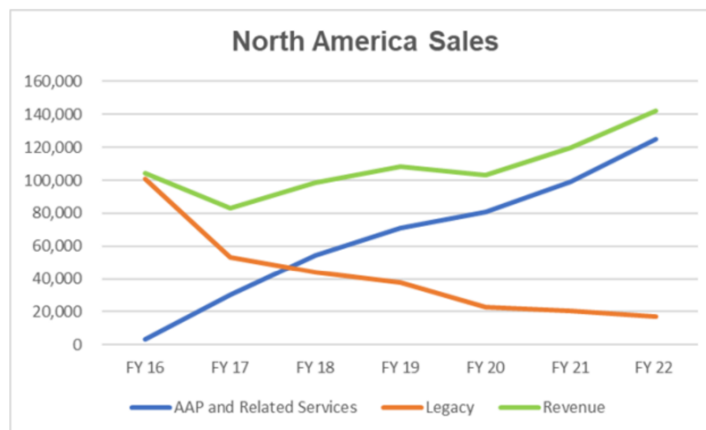
A few years ago, FC moved from an a la carte model to all-inclusive subscription offerings, the All-Access Pass (AAP) for Enterprise and *Leader in Me* for Education. The transition has been highly successful thus far, with subscription revenue growing at a 31% CAGR at 85%+ gross margins.

Subscription Revenue Model

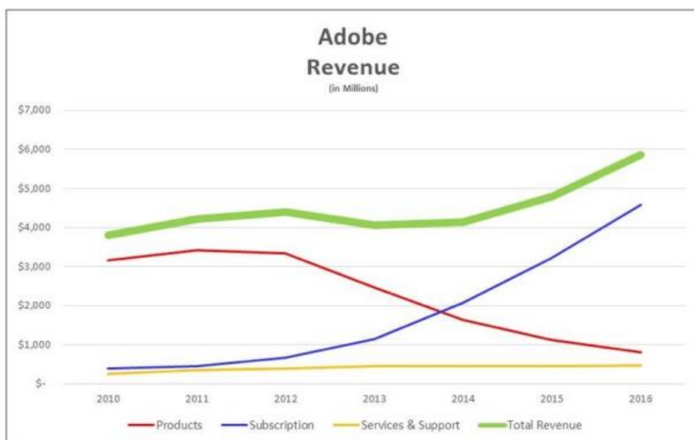
Total Company Revenue from
Subscription & Subscription Services
(in millions and unaudited)



For the first four years or so, much of the subscription businesses' growth was obfuscated by the corresponding decline in the legacy operations. Only in the last two fiscal years, once subscriptions reached 60% percent of total revenue, has FC's strong underlying performance started to materialize in its consolidated financials.



In its latest investor presentation, FC makes an interesting comparison with Adobe (see chart below), which undertook a similar business model shift starting in around 2010. From 2014 (the first year the transition was "unmasked" on a consolidated basis) to YE 2022, Adobe stock compounded at 24% per year (38% if we take out 2022's 41% decline), as investors awarded the business a higher multiple as revenues went from one-time to recurring. Another well-done report points out another analogous situation, TechTarget (TTGT), which managed to sharply increase its EBITDA margins while greatly reducing revenue volatility by shifting to annual subscriptions in 2016. Investors were rewarded with a 13x return over the next 5 years, and even following last year's sharp pullback, the stock has returned more than 3x the S&P since 2016. FC is not a pure SaaS business like these two, but with 90% retention rates in its key Enterprise segment, it has proven quite sticky all the same. Accordingly, I think it's likely that there is upside to the current 2.3x EV/S multiple that we see today.[3]



	ADBE	TTGT	FC	
Starting Year of "Unmasking"	2014	2017	2020	
Starting % Sub. Rev.	50%	22%	65%	
5 years later % Sub. Rev.	89%	43%	85-90%	
Avg. EBITDA margin in 3 years prior to transition	23.5%	13.2%	4%	
Avg. EBITDA margin in 5 years prior to transition	32.5%	19.2%	~16%	
Avg. EV/S in 3 year prior to transition	4.0	2.4	1.9	
Avg. EV/S in following 5 years	10.0	6.6	2.3	<-- FC current
Imp. Mult. Expansion	151.3%	171.6%	23.0%	

As mentioned above, FC's transition has been underway for a while – so why invest now? FC has hit a small air pocket of adjusted EBITDA growth, with 14% guidance vs. the 51% delivered in the last fiscal year. That growth falls into the single digits when removing stock-based compensation (SBC) and a few miscellaneous numbers to get a true EBITDA figure, as a hiring ramp to support 40+ new client partners means SBC will increase disproportionately in upcoming quarters. Furthermore, the stock has gone nowhere in the last 15 months despite strong underlying performance, with sales growth of 17% and operating income nearly tripling. And of course, a flat numerator with a much larger denominator means shares are now materially cheaper than in the recent past.

Looking beyond this investment-heavy year, the prospects are bright. FC has already guided to $57 M and $67 M in adjusted EBITDA for the next two fiscal years, which suggests many of the investments being made this year in personnel and content will quickly be leveraged. Assuming continued moderate revenue growth and proportional SBC, this should produce about a 16% EBITDA margin in less than two years. In the cases of ADBE and TTGT, tandem EBITDA margin and recurring revenue

[3] While I try to use EV/S multiples selectively, I believe it makes sense in this context as a proxy of the ascribed value of a dollar of revenue, which increases with the predictability and durability of that revenue.

increases led to significant multiple expansion; applying a 3x multiple (which implies less than half the expansion comps experienced) to my estimate of FC's FY25 sales and adjusting for interim cash buildup produces a $79 target price, representing a 34% IRR from here.[4] On current guidance, this works out to 19x EV/EBITDA. While this is certainly more of a GARP multiple than a value, it seems reasonable given the expected 28% true EBITDA CAGR, peer multiples, and FC's own historical trading ranges (during which the business had a less attractive model). Additionally, there is reason to believe there may be upside to these numbers. Management have historically been conservative with their forecasts – last year, they initially guided for 25% EBITDA growth before delivering more than twice that by year end.

Short Positions: To date, I have generally only written about our long holdings — we are a long-biased fund, and accordingly that portion of the portfolio comprises the great majority of our exposure and the key drivers of our performance. The negative dynamics of shorting means it requires much more of a trading mentality, with much shorter average holding periods and much smaller position sizes. That said, some discussion on our short book is occasionally warranted as well, and the timing now makes sense given our slightly lower net exposure levels compared to years prior. Most of our positions fall into one of the below categories, and quite a few check multiple boxes. The most obvious similarities among them are that almost all are loss-making, utilize adjusted metrics liberally, and try to have investors focus on sales growth and industry potential while ignoring mounting losses. As discussed above, I am of the view that profitability will be increasingly important to investor psychology in years ahead, and such a scenario is likely to be highly detrimental to their shares' performance.

- Competition – companies operating in industries with multiple players, and where most of the surplus goes to consumers on account of the lack of differentiating features and low switching costs. DoorDash (DASH) and DraftKings (DKNG) are two such examples. Customers simply want the fastest/cheapest delivery and the best odds, and they can switch to a peer with a few swipes of a finger. Unsurprisingly, both industries are rife with promotional offers. DASH and DKNG are now trying to wean customers off these specials, but I believe this will prove impossible without mostly destroying the value proposition. In the meantime, they continue to burn cash and heavily dilute shareholders.
- Poor Unit Economics – generally companies where benefits of scale (or the eventual scale itself) will not be sufficient to generate a true economic profit. Beyond Meat (BYND) is currently selling its products for less than they cost to make, not even including all the other costs associated with running a business. Sales growth at Oatly (OTLY) has only brought worse margins and larger losses. Adding in the fact that initial TAM estimates for both these alt-food products were highly overoptimistic, there is no reason to believe either will ever generate meaningful free cash flow.

[4] FC is scheduled to report earnings within a week of the release of this letter – this is not relevant to the thesis itself, but I am flagging it so that readers are aware the numbers above may shift somewhat in the near future.

- Valuation/Hype Far in Excess of Reality – Snowflake (SNOW) may be a great company, but it is very hard to make the math work for buying any company at 19x sales, much less one going head-to-head with established industry titans. Artificial Intelligence will be a huge trend, but C3.ai's basic machine learning models aren't going to lead it, irrespective of their ticker symbol or how many CNBC ads they buy. As the hype cycle winds its course, fair value in these names is likely to prove lower than many hope.

Of course, the market can remain irrational longer than we can stay solvent, so our position sizing and risk management limit the potential profit from any one member of our short book. In aggregate though, we think these stocks are very likely to underperform the market; at the very least, betting against them allows us to invest a bit more into our favorite long ideas.

Outlook & Conclusion

2023's market has been a bit odd thus far. Following a fairly strong January effect, the information technology sector has once again been the top performer on a YTD basis, and many beaten-down, highly shorted companies have rallied sharply. In the last few weeks, drama in the banking sector has created some strange distortions in asset prices, with Treasuries rallying by the most since "Black Monday" despite another 6% inflation print. However, such distortions can create opportunities for stock pickers, and we will continue to try to capitalize on them while remaining mindful that there can always be another shoe to drop. This balanced approach gives us the best chance of being able to say that we're "still here" for years to come. I hope 2023 is off to a great start for everyone and look forward to writing you again this summer.

"Fruit-laden trees bow, but dry sticks break because they do not bend."

-Chanakya

Per Ardua Ad Stella,

Andrew Jakubowski

Performance Summary:

	4Q 2022	2022	Since Inception
S&P 500	7.6%	-18.2%	129.3%
Vanguard Total World Stock ETF	10.1%	-18.0%	67.6%
Russell 2000	6.3%	-20.4%	62.4%
HFRI Equity-Hedge (Total) Index	4.0%	-10.4%	48.5%
Adestella Investment Management	**11.4%**	**-14.7%**	**209.2%**

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