June 2023

Dear Fellow Investors,

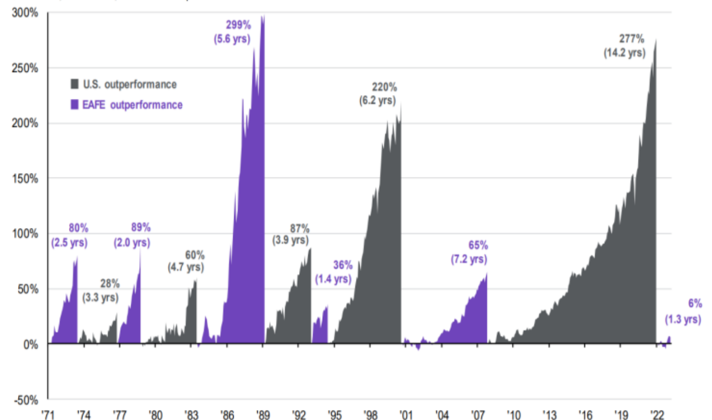
Adestella gained 5.6% in the first quarter of the year. Long holdings gained 7.9%, while our short positions lost 2.1%. For the first time in a long while, the international portion of our book outperformed, contributing 3.1% vs. 2.5% from the domestic side despite only making up about a third of our net exposure. Currency movements had a negligible negative impact in the period.

Markets and asset classes posted solid gains across the board in the initial months of the year. Growth stocks led the charge as many figured that a series of high-profile bank failures in the US might prompt the Federal Reserve to decelerate the pace of its interest rate hiking. While the financial system's resilience is a good thing for the broader economy and our companies in the long run, in the short term it was negative for our portfolio given our tilt away from longer-duration stocks. As a result, net gains of 10-11% in January were whittled in half by the end of the quarter.

## Globe-Trodden

Since my earliest letters I have believed that international stock markets, which are generally underfollowed by state-side investors, have the potential to improve a portfolio's aggregate risk-reward and provide some less-correlated sources of return. But to date, this exposure has been a net drag on the fund[1], as shown in the charts below and confirmed by VT/SPY return spreads and our own performance attribution reports. I imagine many other investors have experienced the same, and fatigue and disillusionment with the concept of international diversification is certainly understandable given the length and magnitude of this US outperformance cycle. An ongoing war that has upended a wide range of prices, as well as business and market sentiment, certainly hasn't helped either.

[1] While we occasionally have positions based in Asia-Pacific and Latin America, the majority are based in Europe, which is why the following discussion focuses on stocks and developments in this region.



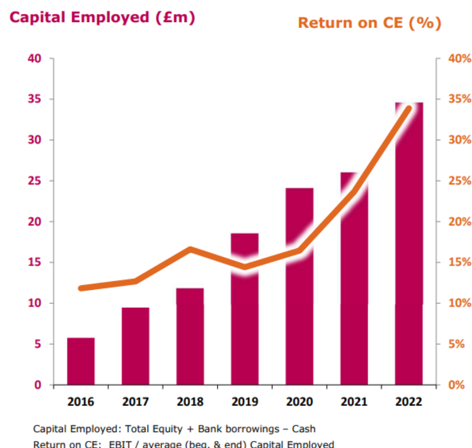

Nevertheless, I believe if we stay the course we will eventually be rewarded for our patience. The US economy has undoubtedly outpaced foreign peers recently, but does 30% GDP outperformance over two decades warrant 270% equity market outperformance and these record valuation gaps? The magnitude of the discrepancy is jarring, especially given the length of the dataset shown above. Is the US really so much better on a relative basis now than it was any time in the past 75 years? My guess is no. Now, could the spread widen even further? Sure – I thought it was already quite stretched in 2017 when it was approaching that of the Nifty Fifty era, and since then it's nearly doubled. But while we can't be sure when this gap might start to close, the balance of historical evidence strongly suggests it will eventually do so.

Thus, we remain active abroad, and have been finding comparatively more opportunities in these regions as of late. While I continue to think that average European energy prices will move higher (albeit with lots of volatility on the way), there are plenty of companies with limited exposure to such inputs – and some that even benefit from them – and that can do well regardless of how they shake out over the next few years. In line with the framework discussed in recent letters, we are continuing to prioritize cash-generative companies that can comfortably withstand an environment of higher interest rates and scarcer access to external capital.

## Catches from Across the Pond

**SDI Group (AIM-SDI)**: SDI is a British rollup of scientific instrument designers and manufacturers. Its Digital Imaging division, comprising about 40% of sales, is a group of subsidiaries that make highly sensitive cameras and precision viewing tools for life science and industrial applications. The Sensors & Control division, which makes up the other 60%, houses companies that produce a wide range of products ranging from flow meters to safety fume cupboards to anti-static machines.

SDI operates a buy-and-build strategy that generally sees them add anywhere from one to four operating businesses to the portfolio each year; since 2014 it's completed 17 acquisitions and grown its portfolio from 2 to 14 (net of mergers). It follows the Berkshire model in that all targets must already have management in place, and that once acquired the business is able to continue operating with a considerable degree of autonomy. The Group's markets are quite niche (there are only so many buyers of laminar flow cabinets) and generally single-digit growers. However, this often works to its advantage for M&A, as targets are often not large or fast-growing enough to move the needle for many would-be bidders. As a result, SDI is often able to buy at 5-7x earnings multiples from founders looking for financial security while remaining involved in their businesses. Improvements to the "build" side of the strategy – accelerating organic growth and driving margin improvement at newly-purchased subsidiaries – as well as SDI's track record of being an attractive purchaser and friendly integrator, has led to expanding ROCEs now approaching 30%.




**SDI Group's acquisition track record**

| Financial year | Month | Year | Company | Segment | Fair value net consideration | EBIT multiple |
|---|---|---|---|---|---|---|
| FY14 | February | 2014 | Opus Instruments | Digital Imaging | £1.0m | N/A |
| FY16 | October | 2015 | Sentek | Sensors and Control | £2.3m | 4.6x |
| FY17 | January | 2017 | Astles Control Systems | Sensors and Control | £4.8m | 4.1x |
| FY18 | August | 2017 | Applied Thermal Control | Sensors and Control | £1.1m | 5.1x |
| | February | 2018 | Quantum Scientific Imaging | Digital Imaging | US$0.3m | N/A |
| FY19 | September | 2018 | Fistreem | Digital Imaging | £0.7m | 3.4x |
| | February | 2019 | Thermal Exchange | Sensors and Control | £0.9m | 4.5x |
| | February | 2019 | Graticules Optics | Digital Imaging | £3.4m | 5.2x |
| | April | 2019 | MPB Industries | Sensors and Control | £1.5m | 4.9x |
| FY20 | November | 2019 | Chell Instruments | Sensors and Control | £5.2m | 6.6x |
| FY21 | December | 2020 | Monmouth Scientific | Sensors and Control | £5.8m | 5.8x |
| | February | 2021 | Uniform Engineering | Sensors and Control | £0.35m | 3.5x |
| FY22 | January | 2022 | Scientific Vacuum Systems | Sensors and Control | £4.9m | 5.0x* |
| | March | 2022 | Safelab Systems | Sensors and Controls | £7.7m | 7.2x** |
| FY23 | July | 2022 | LTE | Sensors and Controls | £4.2m | 6.4x** |
| | October | 2022 | Fraser Anti-Static | Sensors and Controls | £13.0m | 7.0x** |

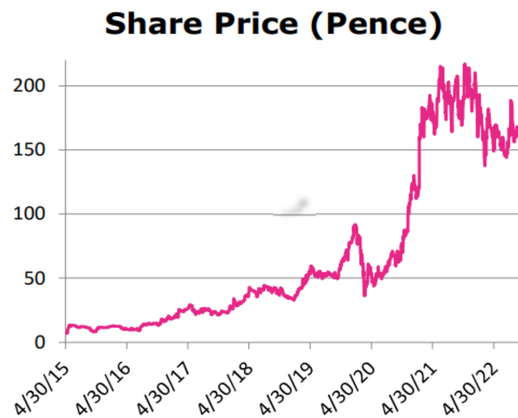
The success of SDI's strategy to date can be clearly seen in the company's consolidated results. Revenues and operating profits have improved steadily and at an impressive CAGR. Importantly, cash generation has remained strong[2] and allowed the company to maintain conservative leverage ratios (currently about 1x net debt/EBIT) while funding most acquisitions internally – particularly important in a higher interest rate environment. And at its current $170 M USD market capitalization, there remains a substantial runway to execute further M&A before the Group is forced to begin fishing for acquisitions in larger and more competitive ponds.

Unsurprisingly, business success has created stock success over time – SDI equity has compounded at 22% over the last decade. However, the market may have gotten ahead of itself in early 2021, and following a significant run-up near the end of 2020, SDI has mostly tread water despite strong

[2] Cash generated from operations has historically closed tracked operating profit, but was pulled forward in FY 20 & 21 due to advance payments from COVID-19 related orders at subsidiary Atik Cameras. SDI is also currently building up inventories to mitigate impact of certain component shortages. The combined effects means that operating cash flow will lag EBIT this year, but it should normalize in the year ahead.

underlying business performance, causing its earnings multiple to contract from a peak of 41x to less than 20x today.

| Metric | 2016-2022 CAGR | H1 FY23 – H1 FY22 growth |
|---|---|---|
| Revenues | 34% | 28% |
| Adjusted Op. Profit | 57% | 19% |
| Op. Profit | 63% | 8% |
| Cash gen. from Ops. | 50% | (57)% |
| Adjusted diluted EPS | 32% | 28% |




Last month, the Group put out a trading update in which they announced that operations were tracking as planned for the year, but that an OEM customer who purchased £8.5 M worth of PCR cameras in FY23 was unlikely to make any further orders. Despite being a relatively short-term issue that was already communicated to the investing community, the stock finished the day down 14%. We viewed this as a myopic reaction and increased our position significantly. Management seems to agree, as they were buying shares in the open market the same day.

Given a robust pipeline of opportunities and its resources to take advantage of them, we think SDI is well-positioned for the years ahead. I expect FY24 profitability levels to be hindered by additional investment into the four CY22 acquisitions, but recover[3] by FY25. Modeling financial projections from a company that relies on inorganic growth is difficult, but if SDI can deploy a similar amount of capital at similar purchase multiples it should be generating around £18 M in operating profit by the end of FY25. Assuming modest increases in interest costs and share count, this works out to about 13 pence in EPS.

Roll-ups in different industries with a wide range of financing strategies trade at a wide range of multiples, but SDI's 10-year average of 25x trailing earnings seems reasonable considering its track record and defensible market niches. Applying this multiple works out to an IRR of about 30% in just under three years; keeping it at its current level would still produce annual returns above 20%. European scientific instrument peers currently have a median P/E north of 30x (closer to 35x for those with a life sciences bend), so if the company is ever ascribed platform value or valued in line with comps, there is upside to this number. But given what should be double-digit intrinsic value growth for the foreseeable future, as long as we're buying at a solid price – which I'm confident we

[3] Note that normalized margins going forward will be slightly lower due to the business mix change following the 2022 acquisitions.

are today – such expansion is simply an added bonus, and not required to generated a satisfactory return.

**Verallia (ENXTPA-VLRA):** Verallia is the world's third largest producer of glass packaging for food and beverages. The company was originally a part of the French conglomerate Saint-Gobain (SG), and took its current form following an SG division reorganization in 2007. In 2014, Saint-Gobain sold Verallia's North American operations to the Ardagh Group of Ireland, and then the remaining European and LatAm businesses to PE firm Apollo Global in an LBO the following year. Apollo took VRLA public in 2019, and had fully exited its stake two years later.

While certainly unglamorous, glass bottle manufacturing tends to be a good industry. Demand grows slowly but steadily thanks to glass's properties of infinite recyclability, chemical inertia (preserving taste), and enhanced quality perception relative to alternatives like plastic. A high weight-to-size ratio makes long-distance transportation expensive, and many products are subject to appellation requirements in order to be considered authentic. As a result, supply options for consumers are generally limited to producers in close geographic proximity.

Furthermore, the European glass bottle industry has consolidated significantly in recent decades, and the top 5 players now control 70% of the market (see graphic below). The concentration is even greater in the more relevant Western European sub-segment, in which the top 4 comprise 85%. This reduction of competitive rivalry has allowed VRLA to increase gross margins and returns on capital (which are now approaching 15%) each year since 2016.

Nearly half of VRLA's sales are still and sparkling wine bottles, mainly to small producers with limited nearby alternatives, which makes VRLA much more of a price maker than a price taker in its negotiations. Glass packaging, especially for wine and spirits, also benefits from being a relatively small COGS item for the beverage producer, yet of outsized importance in terms of conveying

product exclusivity and quality – a critical concern for small vineyards and premium liquor manufacturers looking to differentiate themselves in the marketplace (see graphic below).

When it first went public in 2019, Verallia was around 2.5x levered and trading at a premium multiple of 40x earnings. Since then, the company has managed to remove a turn of net debt while still paying a sizable dividend and purchasing one of the largest premium glass players in the UK. Thanks to 40% cumulative sales growth and 7% operating margin expansion, EPS has nearly tripled over three years. However, the formerly premium multiple turned into a discounted one, and as a result shares are only about 20% above their initial IPO price.

In its Q1 release, VRLA reported 35% organic revenue growth, driven almost entirely by price and mix. Meanwhile EBITDA margins expanded nearly 5% despite significant cost inflation. Far from being a one-off blip, management guided to at least 20% sales and 17% EBITDA growth for the 2023. While

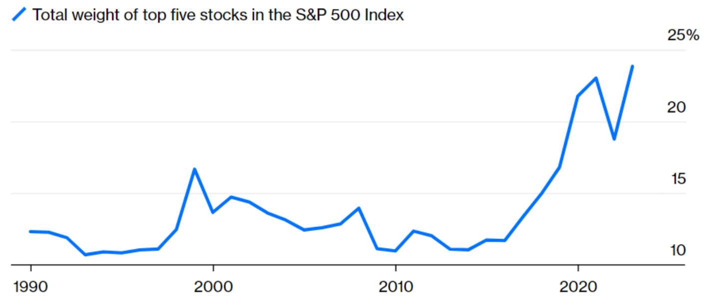
such growth rates are clearly unsustainable for a glass packaging company, it does demonstrate VRLA's ability to take price when needed. Energy costs will remain an area of concern, but VRLA's exposures are roughly 85% hedged, and its margin expansion in midst of the widespread input cost inflation of the last 15 months proves it's a manageable issue for the Group.

Going forward, we think VRLA can maintain a double-digit earnings growth rate from ~5% organic sales growth (below its 7% CAGR from 2016-2020) and 2% annual cash production cost reductions combined with modest operating leverage and share repurchases. The company's closest peer is probably Spain-based Vidrala (VID), which has similar profitability levels, capitalization ratios, and geographic scope as Verallia (not to mention a similar name). VID currently trades at 17x earnings, near its 10-year average of 18.5x. With a few turns of multiple expansion from its current 11.5x, and adding in its 4% annual dividend, a 20%+ total return IRR should be possible for VRLA over the next few years. While we wait, management is taking advantage of the opportunity to retire shares at discounted prices.

Verallia's four-year year run as a public company has been a great success thus far. The company has already surpassed mid-term targets given at the time of its IPO, managed to remove the overhangs of elevated leverage and a PE exit, and further expanded operations with its UK acquisition. 6x EBITDA, a significant discount to closest peer Vidrala at 11x, is too cheap for market leader that is well-positioned in a solid, defensible industry. So, while investment pitches for F&B packaging companies generally make investors glassy-eyed, the attractive risk-reward here will hopefully be enough to get some of them to take another look.

## Outlook and Conclusion

The recent AI craze has created a new member of the trillion-dollar club and once again unleashed investors' animal spirits. Market participants seem to have been struck with the same FOMO that permeated during the stimulus check era, and have rushed back into any stock that could be considered even tangentially related to artificial intelligence. With tech (broadly defined) comprising 7 of the 8 largest S&P components, this has propped up indices despite a zero net contribution from the rank-and-file constituents (see graphic below). Unsurprisingly, things like pressure calibration instruments and glass bottles, particularly in the AI-lagging region that is Europe, have not enjoyed the same rapid influx of buyers.




However, buying winners after they've already become behemoths is generally not a good idea, so we won't go chasing them. But I don't think we will need their contributions to do well over time. Boring can be beautiful when it comes to stocks, and if our businesses continue to execute, they will eventually be rewarded for their performance. I look forward to the day when market returns are distributed a bit more evenly amongst the underlying companies, but in the meantime, we will continue to look for opportunities wherever they present themselves.

I hope everyone is having a great summer so far, and look forward to writing you again in a few months' time.

Per Ardua Ad Stella,

Andrew Jakubowski

*"Don't watch the clock; do what it does. Keep going."*

\- Sam Levenson

Performance Summary:

| | 1Q 2023 | Since Inception |
|---|---|---|
| S&P 500 | 7.5% | 146.4% |
| Vanguard Total World Stock ETF | 7.2% | 79.6% |
| Russell 2000 | 2.7% | 66.7% |
| HFRI Equity-Hedge (Total) Index | 2.5% | 52.6%` |
| **Adestella Investment Management** | **5.6%** | **226.5%** |

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