Adestella
Investment Management

September 2023

Dear Fellow Investors,

Adestella gained 6.7% in Q2. Domestic stocks led with a 5.5% contribution, and international positions added another 1.2%. Long holdings gained 7.3% but were partially offset by 54 basis points of loss from the short book. Currency fluctuations had a negligible impact over the period.

Our benchmarks rose 6-9% the period, with most of the gains being made in June. Fervor related to the AI revolution helped mega-cap information technology lead the way, a group of companies which was already the largest sector represented in size-weighted indices like the S&P. Also benefiting were what many would call "story stocks," which can be characterized as deeply unprofitable entities whose appeal comes from the tempting upside they may produce in future years. Many such firms were quick to latch onto this new buzzword to create excitement within their investor base. We managed to finish with a decent result despite being having basically zero (and, at times, negative) net exposure to these types of names, and less exposure to the broader market in general.

Hydro-Logical: A Discussion on Flows

I've long talked about how incentives matter in investing. One typical way these incentives and mandates manifest in the stock market is forced buying and selling. Sometimes these forced actions are true in a literal sense, like when an investor is obliged to close a short position because he can no longer put up the collateral required by his brokerage firm to keep it, or when an index fund rebalances to include new constituents. But often, the motivation from an incentive provides just enough of a force to push an investor along the path of least resistance toward whatever goal he may be pursuing.

For example, many, if not most, institutional firms are focused on asset gathering above all else, creating an urge for managers to take actions that minimize the risk of losing clients, and thus assets. To do this, they need to chase performance and avoid too much benchmark deviation, which leads them keep buying stocks like Nvidia even at nosebleed multiples for which the return math is dubious at best. They may not technically be forced buyers, but if their main priority is showing that you're on top of the current zeitgeist, or to not zag too far out of line, they may as well be. The likelihood that a given company is currently trading at a discount to the present value of its future cash flows is of secondary importance; top of mind is maintaining one's career and/or the fear of missing the next big trend.

We don't follow the crowd for investment ideas. However, we need to be aware of what others are doing too; burying our heads in the sand and pretending everyone is playing the same game we are does our investors no favors. In the end, stock price changes in a given period manifest themselves as the net difference between supply and demand for the issue over that timeframe. If there is some non-fundamental reason for a discrepancy, we need to ask ourselves whether we are on the side that stands to benefit from it, and whether there may be some catalyst that has the potential to dam or reverse the flow. This is why we covered several short positions this quarter where the stock remained egregiously overvalued, but the flow-based supply and demand dynamics made the timing (and thus IRR) of any payout much less certain. Even if the idea eventually works out, you'll be looking at a much lower IRR and a higher opportunity cost, along with much more stress. Ego is the enemy of success in the stock market, and holding on to positions just to try to prove we're more rational than others is not a recipe for outperformance in the long term.

We have never played the trading sardines game and won't start now. But I think it also makes sense to spend a moment thinking of how we can use these flow dynamics in our favor, even if it is just to add to a list of potential catalysts. For instance, larger institutions often set hard market cap and dollar-value-traded floors for their investible universes. Below those thresholds, the effort required to build a position and monitor it is no longer a good use of time and resources. The precise levels they set are not important; the idea is that in the high nine-figure or low ten-figure range, there are stocks that, if they continue to execute well, are likely to start generating incremental interest from a larger pool of buyers that are able to transact in the shares. This in turn increases the likelihood that sell-side firms or the financial media start picking up coverage, and can lead, at least temporarily, to a virtuous cycle for an existing shareholder where incrementally larger buyers are jumping in and tilting the supply/demand balance. A $1B market value sounds like (and is) a large firm, but in the context of today's $2T giants and $50-100 B+ index funds that have continued receiving inflows in earnest, it is firmly in the small-cap space, and just beginning to become investible for many institutions.

Of course, in the long-term, one does not need to have the benefits of flow on his side; the weighing machine of underlying business performance will eventually rule the day. However, if we find stocks that are attractively priced and positioned, and that also may be able to benefit from a surge in demand that is not entirely fundamental, it can be an extra benefit and a free option on an enhanced IRR for the position. Two such stocks that I believe are likely to enjoy this bump in the near future are discussed in the following section.

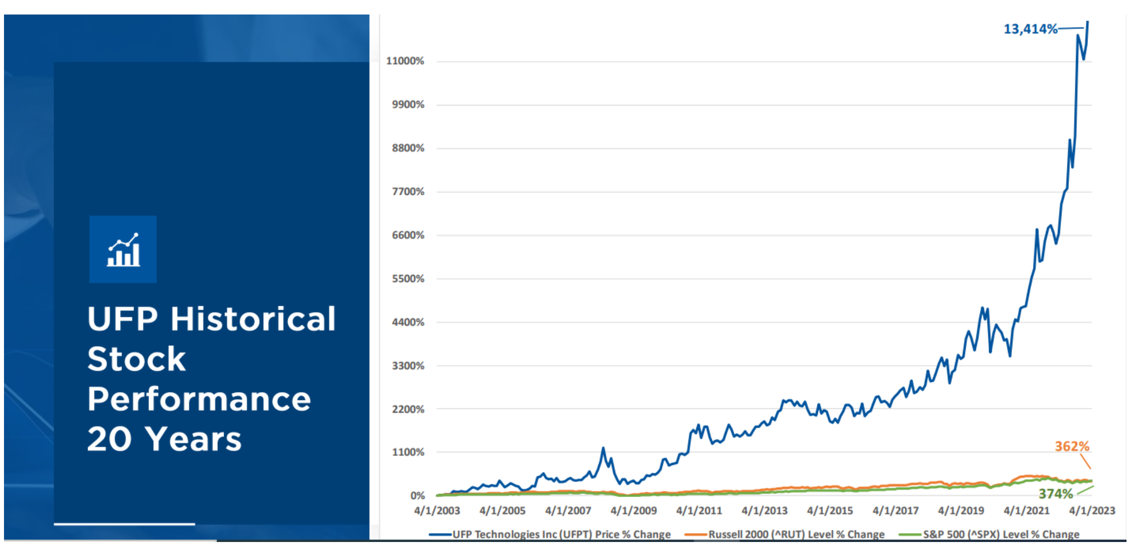
A Few New Ideas

In his book *One Up on Wall Street*, Peter Lynch lists what he considered to be the 13 attributes of a perfect stock. The first item on that list was that it has a dull-sounding name. The second was that it does something dull. Further down along it was that institutions don't own it and analysts don't follow it. All three of these points go hand in hand, and describe the same types of stocks - ones that are easily overlooked and receive minimal attention from most market participants.

All of Lynch's points are correct — the radar is essential to navigation for ships and airplanes, but not at all so in the investment world. But there's one addendum that I suggest might occasionally apply. It's great to find a company that's currently under-owned and under-followed, but wouldn't be nice if those dynamics changed once you'd managed to find and buy it? An investor doesn't make any money just by owning a cheap stock; he only profits once it re-rates closer to its fair value. This can happen mechanically through cash flow generation over time, or occasionally there's an obvious catalyst in place to take care of it. But sometimes a quicker, subtler way is for the stock to surpass those size thresholds larger firms set and to start to show up in an increasing number of investible universes. As discussed above, a great company that is also on the right side of investment flows offers an additional shot on goal for an attractive IRR. As it happened, this quarter we found a few opportunities that fit this profile.

UFP Technologies (UFPT): UFPT is a Massachusetts-based company that designs and manufactures highly-engineered products, primarily for medical applications. 85% of sales are from its extensive portfolio of single-use, single-patient medical devices and sterile packaging solutions. The company was started in 1963 as United Packaging Corporation by three entrepreneurs in a garage with a band saw and a deli slicer. It changed its name to United Foam Plastics four years later to better reflect its specialties, and it made its public debut in 1993. Continuity has been a hallmark of the business in recent decades – it's still run by the son of one of the founders, and the CEO, CFO, and president have all worked at UPFT for 25+ years.

UPFT's moat comes from decades-long customer relationships, for which it is often providing customized products built into the OEM's designs, have allowed it to enjoy strong returns on capital and operating leverage dynamics. Combining that with its secularly growing end markets and strong execution, over the past five years the company has managed to grow sales at 20% and EBITDA at 30%. Over that period, the stock has risen nearly 5x, a great result for any investor. Yet it pales in comparison to the returns seen by longer-term holders, who have been rewarded with an over 13,000% return in the past 20 years (see chart below). Despite this tremendous performance, UFPT continues to go mostly unnoticed. Its market cap is only slightly over $1B, and only two analysts from relatively small shops cover it. The company is not promotional; its only press releases are generally to report its quarterly results. I've never seen it discussed on CNBC or online forums, and I had never even heard of the company until it showed up on a screen I ran this summer.



Even more importantly than its sterling record thus far is its bright outlook for the years ahead. The global medical device market is forecast to grow 5.5% over the rest of the decade, and UPFT sees an opportunity for further penetration of its current client base, which already includes 25 of the 30 largest medical device manufacturers in the world. The combination of these growing markets and the company's success in winning new business from existing customers has led them to target 12-18% revenue growth (organic + M&A) over the next 3-5 years at an 15-18% operating margin (versus just over 12% in 2022). Given the industry tailwinds to its core MedTech segment, its strong track record of accretive acquisitions, and its history of conservative guidance, we think these numbers are certainly attainable. Thus far in 2023 the company is on the right track, posting 19% sales growth at 17% operating margins in the first half of the year.

UFPT's current 25x LTM P/E multiple is clearly not deep value, but one must consider the context and positioning of the underlying business. Healthcare equipment and supply companies have traded at a premium across a wide range of economic climates thanks to very limited cyclicality and the inevitable demographic trends in their favor. A key statistics summary of smaller American companies in the industry ($500M – $10 B MC range) that have managed to post a 5%+ 5-year sales CAGR, 5%+ EBIT margin, and 5%+ ROIC is posted below. These companies trade at a median of nearly 50x earnings; including large caps pushes that number even higher.

Summary Statistics	Last Market Capitalization	Revenues CAGR (2017 to 2022)	Trailing P/Diluted EPS before Extra LTM	EBIT Margin % LTM	ROIC LTM
Mean	$3.53B	13.72%	58.31x	13.45%	8.12%
Median	$3.16B	9.89%	49.36x	14.04%	7.56%
High	$9.72B	25.70%	137.53x	18.93%	13.79%
Low	$833MM	5.39%	24.40x	8.58%	5.51%
Standard Deviation	$2.85B	8.08%	37.93x	4.27%	2.60%
Count	9	9	9	9	9

9 / 67518 (0.01%)

Meanwhile, UFPT's current multiple is near the floor despite its being above the peer medians across all three of the screening metrics.

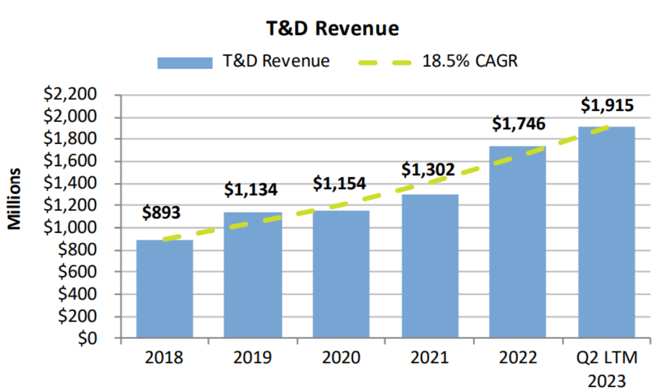
Ticker	Company Name	Last Market Capitalization	Revenues CAGR (2017 to 2022)	Trailing P/Diluted EPS before Extra LTM	EBIT Margin % LTM	Country	Industry	ROIC LTM
UFPT	UFP Technologies, Inc.	$1.23B	19.07%	25.00x	15.06%	USA	Healthcare Equipment and Supplies	17.51%

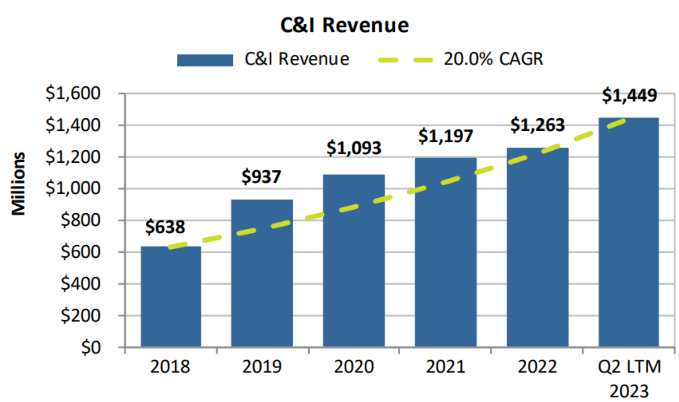
Given its higher proportion of recurring sales, faster growth, and durable competitive niches, one could argue for a premium multiple for UFPT. However, even assuming a discount to peers, the upside is considerable. If the company manage to hit its targets, it should produce around $10 in EPS three years from now. At a 30x multiple, this would be worth $300, representing a 25% IRR from current prices. Further upside is possible if the company finds other deals as accretive as their recent ones, or if the stock finds its way onto a few more investor radars – something we think is likely now that it's crossed the $1B MC threshold for the first time.

As with many firms that have been in a family for multiple generations, there are some risks related to certain aspects of corporate governance, such as restrictions on stockholder proposals and director election requirements. That said, it's easier to give a firm and its leaders the benefit of the doubt when it's produced exponential returns for common shareholders over a multi-decade period. Plus, the incentive alignments we want are there, such as reasonable levels of executive compensation and bonus incentives geared toward worthy metrics such as returns on capital. Taken together, I find the risks acceptable when considered in the context of the managers' track records and incentives, and relative to the potential returns from buying shares at current prices.

MYR Group (MYRG): Like UPF Technologies, the MYR Group has a rather non-descript name and goes about its business in relative anonymity. The company provides electrical construction services, which leads many to associate them with boring, staid utilities. However, with 20% sales and 25% EPS CAGRs over the past five years, and many tailwinds for further strong performance, the reality is quite different.

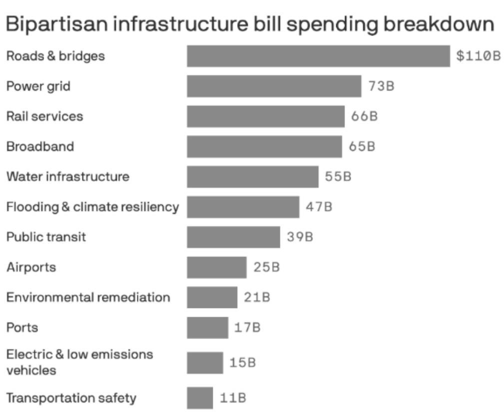
MYRG's operations are fairly evenly split between two divisions. The slightly larger of the two, Transmission & Distribution (T&D), provides a wide range of design, construction, upgrade, and maintenance services to the electric utility industry. The segment enjoys significant recurring revenues from Master Service Agreement work (50% of segment total) that utilities are often required to purchase – particularly in the wake of the PG&E scandal. The other division, Commercial & Industrial (C&I), offers electrical contracting services, again spanning the gamut from initial design to ongoing MRO, for large, complex projects like airports, stadiums, and hospitals. Both have seen robust, consistent growth in recent years.





The future looks bright for the company as well. MYRG will be able to ride several powerful long-term secular growth drivers with lots of white space ahead, particularly aging infrastructure and grid decarbonization. Capital expenditures for electricity distributors (one of the most important revenue drivers for MYRG) should continue to grow around 6% in the years ahead, with expansion across all ownership segments. Meanwhile, the DOE estimates US transmission and transfer systems will need to grow capacity by 57% by 2035 in order to meet clean energy targets in currently enacted laws while maintaining moderate load. One particularly important source of growth will be utility-scale solar projects, for which supply chain constraints are finally easing and tax credits from the Inflation Reduction Act are incentivizing significant investment.

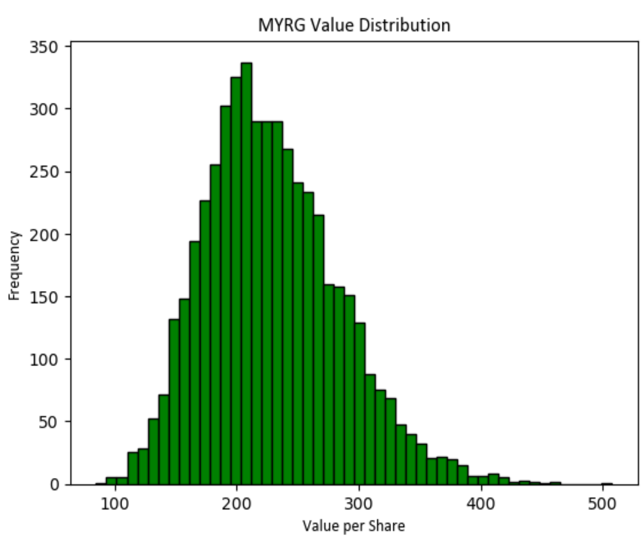
Both its segments also stand to benefit greatly from the Infrastructure Investment and Jobs Act (IIJA), given its $73B investment in electric grid and energy infrastructure and significant funding for a wide range of public works projects that are also in MYRG's wheelhouse. This incremental demand from the initial disbursements seems to have already started showing up in the company's financials, with its backlog setting yet another new record in its latest quarter. Continued high readings of the Dodge Momentum Index (which is a leading indicator of non-residential construction spend) also augur well for the company.



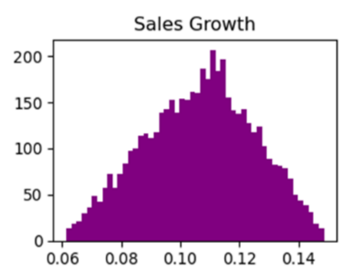
Based on its current backlog and management commentary, MYRG should be able to generate low double-digit organic revenue growth the next few years. Margins have been slightly pressured in recent years by the inflationary environment, but with newer contracts including provisions tied to those pressures, these are likely to tick higher as the older projects roll off. Putting it together, we think MYRG can approach $8.50 in EPS within a few years.

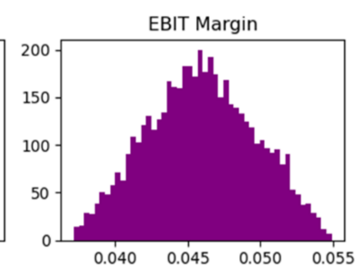
	MC	3-Yr. Sales CAGR	3-Yr. EPS CAGR	LTM P/E	EV/EBITDA	LTM EBIT Margin %	ROIC
EME	10,500	6.5%	12.1%	22.1	13.3	5.8%	25.3%
PWR	29,984	12.1%	23.9%	52.4	22.8	5.0%	8.8%
DY	2,874	4.5%	27.8%	15.5	8.6	6.9%	14.7%
Mean:	*14,453*	*7.7%*	*21.3%*	*30.0*	*14.9*	*5.9%*	*16.3%*
Median:	*10,500*	*6.5%*	*23.9%*	*22.1*	*13.3*	*5.8%*	*14.7%*
MYRG	**2,316**	**13.3%**	**29.5%**	**26.2**	**13.4**	**3.6%**	**16.5%**

A growth and valuation table of MYRG's closest electrical construction comps is provided above. The group trades at an average of 30x P/E, with Quanta Services (PWR) receiving the large-cap premium that MYRG will hopefully someday attain. Assuming the more modest median multiple of 22x earnings, which seems fair considering both current industry dynamics and MYRG's best-in-class growth profile, suggests a price target of about $195. This corresponds to roughly a 20% IRR over two years. This would not seem to be the most exciting of potential returns, but it should be a relatively conservative estimate considering our assumed slowdown of revenue, multiple contraction, and very modest margin expansion. Running a [Monte Carlo simulation]() that flexes these values across reasonable ranges (based on peers and the company's own history) suggests the skew of outcomes is in our favor here; my two-year target is only in about the 30th percentile, and the average result produces about a 30% IRR instead.



Target Price ($ 195) Percentile: 29.14

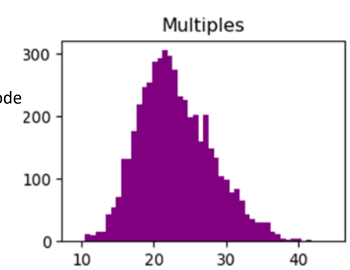




-Sales growth: triangle distribution with mode at low-double digit growth

-EBIT margin: triangle distribution with mode at 2021 actual EBIT margin

- P/E multiple: skewed distribution with longer right tail that would represent a valuation more in line with closest comp. PWR



CEO Richard Swartz has been at the company for more than 40 years, and since he took over the top job in 2017, MYRG has more than doubled the S&P's return. During his tenure capital allocation has been strong, as the company has executed a consistent, multi-faced shareholder return program while posting ROICs in the 15-20% range. Over time I've come to a greater appreciation of firms that have a track record of performance, particularly if the same jockey is still at the helm, so MYRG certainly scores points here as well.

At its current $2B MC, MYRG has reached a size where it's likely starting to get more looks from larger institutions, particularly given the stability of its operations and the straightforwardness of the investment thesis. The company is also a backdoor play on the growth of data centers and related computing infrastructure, hot trends that many investors are looking to increase their exposure to. Finally, the company is executing a $75M buyback and has seen its share count decline modestly over time. All these factors are minor when taken alone, but combined should serve to push the supply/demand balance in our favor here.

Outlook & Conclusion

I recently visited the Panama Canal, and at the Miraflores Locks visitor center there was an interesting video about the waterway's history. Some of you may already know that it was France who took the first attempt at completing this then-unprecedented feat of construction. Their plan was to make a massive cut 30 feet below the sea level, across the entire 50-mile length of the isthmus, through the turbulent Chagres River and a mountain range of solid rock. After nine years of work, the cost overruns and frequent engineering setbacks led the French to abandon the project. While disease was a major factor, the very slow, highly expensive process of digging a trench a mile wide and 300 feet deep through unforgiving terrain did them no favors either.

When the Americans purchased France's holdings and resumed work in 1903, chief engineer John F. Stevens took a different approach. Rather than trying to fight against the flood-prone Chagres, Stevens dammed the river to create a new lake, one large enough for ships to sail through. This greatly increased the venture's prospects, as now boats crossing the isthmus could simply float over a significant portion of the route for which excavation was originally required. It was this breakthrough (along with much improved worker health) that allowed the passage to finally be completed.

With the tropical disease problem under control, France's sea-level canal probably could have succeeded if enough time and money was thrown its way. But Stevens' approach was far savvier, using the power of the water to his advantage rather than trying to battle against it. Similarly, I think we can outperform over time by focusing on nothing beyond discount to intrinsic value. But if investment opportunities present themselves to augment a value-based approach by taking advantage of flows, there is no sense in choosing the more difficult route—markets don't award points for theoretical purity.

Returning to the present era, investors appear to be getting more sanguine over economic prospects in recent months as consumers have seemed to weather higher interest rates quite well thus far. This has helped indices grind higher and led forecasters to upgrade their outlooks for the rest of 2023. The nice thing about both UFPT and MYRG is that they should have no problem in any economic environment. How soon they receive the credit they deserve in the market is another question, but with their frequencies beginning to pick up on the investment radar, I'm guessing it will be sooner rather than later.

I hope everyone had a great summer and look forward to writing you again in a few months' time.

"How you live depends on which seeds you water."

— Jack Kornfield

Per Ardua Ad Stella,

Andrew Jakubowski

Performance Summary:

	2Q 2023	2023	Since Inception
S&P 500	8.7%	16.8%	167.8%
Vanguard Total World Stock ETF	6.0%	13.7%	90.5%
Russell 2000	5.3%	8.1%	75.5%
HFRI Equity-Hedge (Total) Index	3.1%	5.7%	57.4%
Adestella Investment Management	**6.9%**	**12.8%**	**248.9%**

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