Adestella
Investment Management

June 2024

Dear Fellow Investors,

Adestella gained 12% in the first quarter of 2024. Long positions gained 11.8%, our short book lost 0.4%, and currency fluctuations provided a modest tailwind. As has been the trend for the last few years, our domestic stocks outperformed, contributing 10.9% versus 0.5% for international ones. Gross and net exposure levels were consistent with recent quarters at around 125% and 90% respectively.

Markets continued their climb early in the year as indices posted their best Q1 since 2019. There were no major developments from an economic standpoint, although strong labor market and manufacturing data probably helped buoy investor confidence. In the end, no big news proved to be good news, as the S&P set 22 new records in the quarter. Despite large-caps once again outperforming their smaller, less-famous counterparts that tend to be more in our wheelhouse, we managed to post a good result for the period.

Portfolio Management Musings

While no aspect of active investing is easy, portfolio management around one's buy and sell discipline is a particularly tricky subject. But despite its complexity, it typically receives much less attention than stock picking; since it's not as fun or glamourous as trying to find the next 10-bagger, it falls by the wayside in one's investment process. Indeed, trying to reel in a big fish is more interesting than figuring out an efficient method of packing the icebox with your catches. And once you do get around to the strategy sub-segment of portfolio management, there's much more focus on the "primary" decision of deciding when to buy and in what size, as opposed to the inevitable "secondary" decisions that arise later. However, these follow-on scenarios are also worth consideration. When a thesis doesn't work out and a position is down a lot, how should you respond? If you buy a stock and it reaches your 2-year price target within a month, then what? Buy low and sell high is simple in theory, but the speed with which prices can change, the overwhelming number of potential alternatives, and the risk of being wrong make it messy in practice.

While perhaps smaller on an individual basis, these decisions accumulate to make a meaningful impact on net returns over time and are thus important considerations for professional investors. My own thinking on the topic has evolved over time, and will probably continue to do so, but always centers on minimizing the insidious investor biases that permeate all elements of market participant decision-making, both as they pertain to winning and losing positions. A few of our processes for doing that are as follows.

Winners

- *Selectively utilizing quantitative practices in position sizing.* For each of our positions, we set a price target that represents a reasonable midpoint of the range of outcomes for the stock. Combining that with an estimated holding period gives us an expected IRR, which we then adjust for a range of factors including growth certainty, downside protection, micro supply/demand, and the range of outcomes. This "risk-adjusted IRR" is then formulaically applied to create a suggested position size that is empirically scaled based on the exposure range we feel comfortable with. When this suggested position size deviates too greatly with the actual size even after updating for any positive developments, we trim the position.

- *Eliminating worse case scenarios.* There is an interesting cognitive heuristic called satisficing that considers alternatives until an acceptability threshold is met. Combining that concept with loss aversion suggests that trying to remove left-tail outcomes is likely the optimal way to try to manage the uncertain future, at least from a psyche standpoint. If we have a winning position that has approached our price target, we will usually use a trailing stop limit order to exit. If the stock continues going higher, we'll participate in the upside. If it doesn't, we're out at a satisfactory price. If the company is reporting earnings while that sell decision is already made, we may pause the trailing stop and cut the position to reduce exposure to the risk of a post-earnings plunge. Yes, these decisions will often prevent perfectly timed exits — but they'll also prevent the much more painful outcomes of terribly timed ones or missing our window altogether.

Losers

- *Implementing rules-based forced actions.* In poker, the play that maximizes expected value is almost always to either raise or fold pre-flop, rather than simply "limping" in to see what happens. I would guess most investors would also do better long-term if they proactively dealt with losing positions, rather than just leaving them there and hoping they will turn around. If a stock in our portfolio falls 30% from our cost basis, we force the issue by either buying more, or exiting the position completely. Having a clear rule with a binary decision point helps avoid "paralysis by analysis," which often reinforces a "wait and see" approach in the hope that the decision might be clearer in the future (which rarely comes to pass).

- *Only adding once.* If we do choose to add to a position pursuant to the rule above, we only do it once. Early in my career, I would often average down on poor performers multiple times, focusing on how I was lowering the cost basis instead of on whether I might have been wrong. There is no doubt that a stock can irrationally sell off even when truly undervalued, but at some point, you should consider what the market is telling you and reassess whether your estimate of intrinsic value was too optimistic. In the infinite game of investing, there will always be new opportunities in the future, and repeatedly throwing good money after bad is one of the quickest ways to be forced to stop playing.

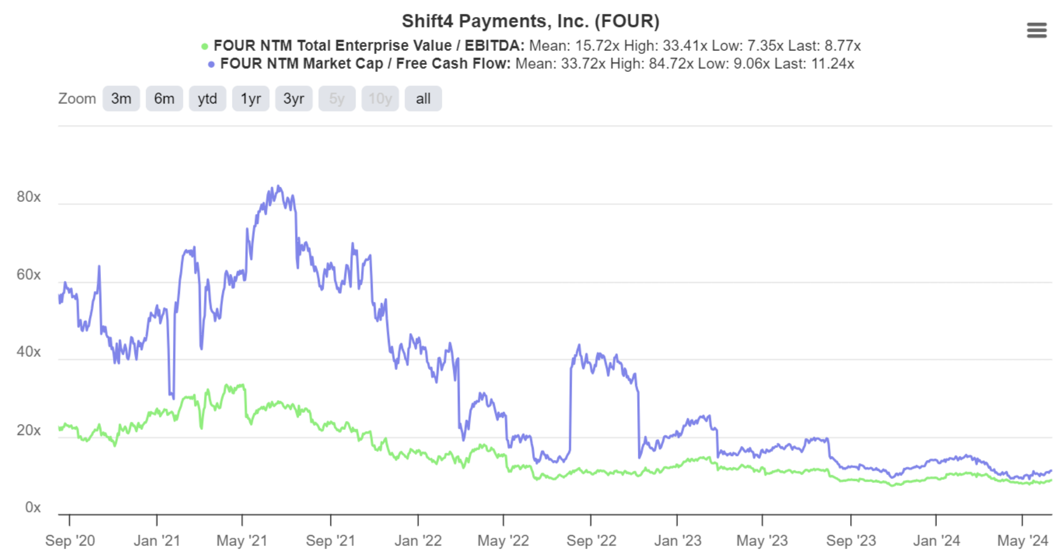
While we will still make plenty of mistakes, we have found implementing the points above has, more often than not, helped avoid round-trips, thesis creep, and bet sizing incommensurate with expected risk-reward. Most importantly, it helps us deal with the investor's worst enemy in a manner that allows us to stay even-keeled and focused on the long term.

A Shift4 the Portfolio

Shift4 Payments (FOUR): Shift4 provides software and payment solutions in North America and Europe. The company was founded by Jared Issacman as a teenager in his parents' basement, and he remains the CEO to this day. The company has been EBITDA-positive since 2004 and has grown payment volume and revenue by double-digits in every single year since its inception 24 years ago. FOUR's business can be grouped into three main verticals – restaurant, hospitality, and sports & entertainment. An overview of each is below:

- *Restaurant:* the company's flagship product is called SkyTab, a full suite of tools for modern restaurant management. It's a fully cloud-based platform with among the lowest total costs of ownership and the best reviews of any of its competitors. The segment is aiming for 30,000 system installs this year, and management recently commented that they're currently ahead of schedule in the first half of the year. FOUR recently broadened Skytab's POS capabilities by acquiring a smaller competitor named Revel for $250 M, the impact of which will begin to flow through the financials in the second half of the year (though no benefit from it is included in the company's guidance).
- *Hospitality:* FOUR's hospitality segment tends to focus on resorts and casinos for which there are a wide variety of commercial activities on site (think dining, retail, entertainment, etc.). The complexity of handling these different use cases means that few players have the expertise required to manage the 500+ software integrations needed to effectively compete.
- *Sports & Entertainment (S&E)*: FOUR's ability to seamlessly handle a range of revenue streams has also made them a leader in the S&E space, for which POS, mobile ordering, ticketing, and parking payment solutions are all required. Recent signature wins include the NFL's Chiefs, Ravens, and Rams. This segment is now starting to expand internationally as well; FOUR recently signed its first two European stadiums, including FC Barcelona's Camp Nou.

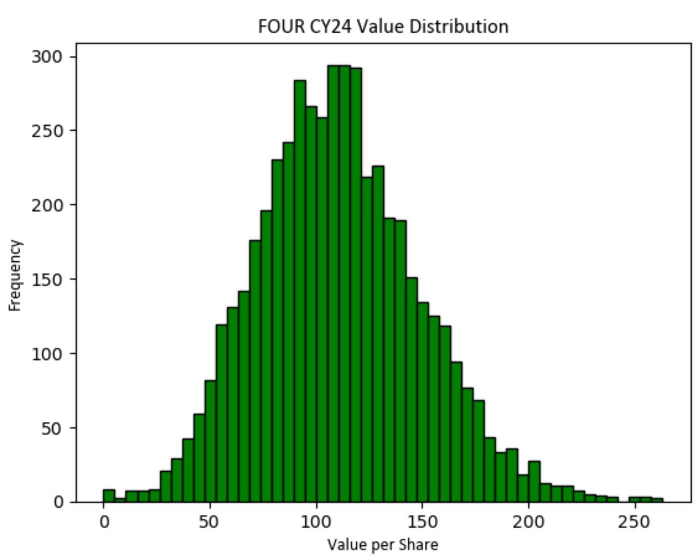
The combination of robust organic growth and thoughtful capital allocation has led to impressive financial performance. Since its [unceremonious IPO](#) during the throes of the pandemic, FOUR has deployed $2.1 B of capital to generate an incremental $570 M of EBITDA and $420 M of FCF. This dynamic of essentially paying a 3.6x EBITDA or 4.9x FCF multiple to expand the business while your stock trades far north of that has generated immense intrinsic value growth for shareholders. But despite these operational successes, FOUR stock remains well off its 2021 highs as its trading multiples have been compressed by more than half.

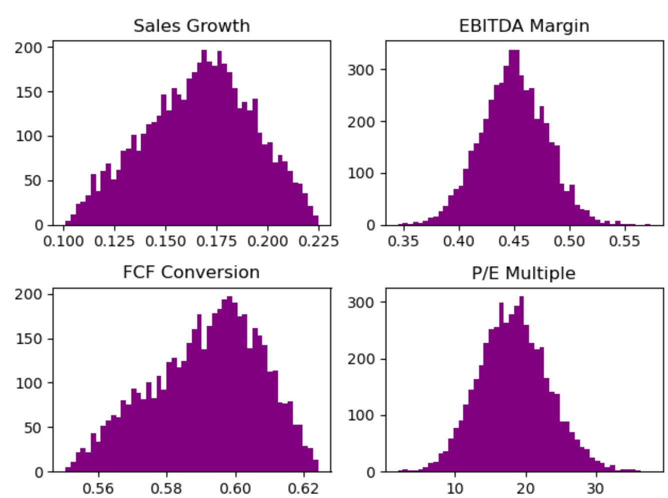


While the stock likely got ahead of itself in the heady days of near-zero interest rates, we think it's now overcorrected given the business's quality, performance track record, and whitespace for future growth. FOUR has guided to about $575-610 M in true EBITDA for 2024 as they continue to execute their [gateway sunset strategy](#). This puts the stock at 9.5-10x on this year's numbers – more than reasonable given the 25%+ organic growth and a deep pipeline of future M&A opportunities in the fragmented payments space. It's also a significant discount to other diversified software+payment peers.

Ticker	Name	NTM TEV/EBITDA	NTM P/E	NTM MC/FCF
LSPD	Lightspeed Commerce Inc.	33.6	40.6	80.0
ADYEN	Adyen N.V.	28.0	40.2	41.5
SQ	Block, Inc.	13.1	17.6	15.9
TOST	Toast, Inc.	45.6	53.0	51.0
SHOP	Shopify Inc.	61.6	63.1	62.4
	Average:	*36.4*	*42.9*	*50.2*
	Median:	*33.6*	*40.6*	*51.0*
FOUR	**Shift4 Payments, Inc.**	**8.6**	**17.4**	**10.9**

The range of future fair values is broader than usual here for two reasons. First, FOUR regularly does bolt-on acquisitions that make up a meaningful portion of total growth. This year, of their ~40% net revenue growth, 15% of it will come inorganically, a material amount. Second, payment peers have traded at a wide range of P/E multiples in recent years based on investor sentiment, and FOUR has not been public long enough to estimate true through-the-cycle median multiples; in the past four years, it's often traded north of 50x forward earnings, but I am not willing to underwrite that as anything more than a stretch upside case going forward. Rather, it's better to make our estimates based on just the existing business and apply a more conservative multiple based on organic growth and earnings durability, treating any additional M&A or investor euphoria as a bonus. A range of outcomes based on this framework is provided below.





We think fair value is somewhere between $95-105 per share discounted back to year-end, suggesting 35-50% upside from current prices. From the period between now and 2027, we assume material revenue deceleration, EBITDA margins and FCF conversion in line with current guidance, and a P/E ratio below the market and payment peers. This fair value range is where FOUR traded in 2021, when it was less than half the size by sales. Further revenue upside should be possible if the company continues with its roll-up strategy, but again, we prefer to project based solely on organic growth.

Finally, while FOUR is a well-managed business trading at a more-than-fair price, the biggest appeal of this investment to us is the potential catalyst of a sale of the business in the relatively near future. CEO Isaacman has made it no secret that he has no interest in handing the reins to his children or stepping aside for someone else to take control – his eventual exit will be from a sale, and it is just a matter of when. I would encourage anyone considering an investment in FOUR to review the company's latest shareholder letter – particularly pages 3-4, where Issacman explains both the recent strategic review and the path going forward. One of the Q&A-style responses in the letter makes it clear that private buyers seem to have reached valuation conclusions similar to ours (note that FOUR currently trades within 10% of its price on the letter publication date):

> **Was there interest?**
> Yes. The Board received multiple formal offers from strategic parties at a share price premium materially higher than levels at the time of the review and certainly where we are trading presently.

There are certainly risks to having an investment in a company with a super-majority voting structure, but the founder is also the largest economic owner here (and was recently buying more) and has earned the benefit of the doubt over 20+ years. And payments are a competitive industry, but FOUR has proven in the last two decades that they can handle it. Considering the valuation discount alongside the potential catalyst and effective downside protection from prospective buyers signaling interest even at higher prices, we think the risk-reward and potential IRR here are very appealing.

Outlook & Conclusion

Thus far Q2 is looking quite a bit like Q1: stocks grinding higher on "good-enough" news flow, and large-cap indices trouncing their smaller counterparts. We are currently in Year 13 of both the small-cap and international stock underperformance cycles. But trees don't grow to the sky, and at some point, this dynamic will change, even if the Magnificent 7 seem invincible for the moment. There is no guarantee that either of these reverse any time soon, but history suggests we're probably closer to the end of the tunnel than the beginning of it. All things considered, I think we've done a pretty good job since inception of what has often amounted to rowing upstream; in the meantime, we'll continue to paddle on.

While factor trends have remained constant, there has been some change afoot at Adestella. We've historically relied on registration exemptions to keep costs down, but as the business has matured and client base evolved it's become clear that the marginal benefits of registration outweigh the marginal expenses. The most obvious of these is the ability to expand marketing, of which we have done basically zilch, and to reduce the minimum account size to enlarge our potential client base. The process should be completed by the end of the next quarter; existing accounts will not be affected, but feel free to reach out with questions should you have any. I look forward to updating you on our progress in a few months, and hope everyone is having a good summer so far.

"I never worry about action, but only about inaction."

\- Winston Churchill

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Andrew Jakubowski

Andrew Jakubowski

Performance Summary:

	1Q 2024	Since Inception
S&P 500	10.4%	219.4%
Vanguard Total World Stock ETF	7.8%	120.5%
Russell 2000	5.0%	99.3%
HFRI Equity-Hedge (Total) Index	5.1%	74.3%
Adestella Investment Management	**11.7%**	**306.3%**

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