

Atai Capital Management



Q2-2023 Letter

Dear Partners,

July 12th, 2023

Atai Capital returned 8.32% in the second quarter and 13.06% year-to-date (YTD) net of all fees. Compared to a 16.89% total return for the S&P 500 YTD and an 8.09% total return for the Russell 2000 YTD. While I would classify our relative outperformance against the Russell 2000 as acceptable, and I am content with our absolute returns, we still ended the quarter lagging behind the S&P 500 by a modest amount. Nevertheless, as we mentioned in our last letter, returns over such a short period should not be heavily relied upon. I'd also like to emphasize that this principle applies not only to relative underperformance but also to relative outperformance.

In my previous letter, I expressed the belief that the intrinsic values of our companies were on the rise, and I am thrilled to share with you that this trend has not only continued but has also significantly accelerated in one case (more details about this company will be provided later).

Investing Is Simple, But Not Easy:

Value investing is straightforward in theory – just buy something for less than it is worth, but this simple concept is far from easy in practice because “real” opportunities to buy something at a substantial discount don't come around often. For example, if you were to run a screener for stocks trading at less than 5x Free Cash Flow, you'd get a list of hundreds, if not thousands back. If investing was as easy as buying cheap businesses, then everyone should be crushing their relevant indexes with these 1,000s of opportunities, but it's not, and they aren't. Most of these businesses trade cheaply for a reason and likely deserve their valuation. Therefore, I believe that investors should spend a significant amount of time understanding **WHY** something is cheap and if that disparity in valuation can/will be corrected. Put simply; I want to understand why the market is wrong but why they think they're right. Even in small-cap land, Mr. Market does not give out free lunches often, so there must be a reason why he is, and part of my job is to identify that reason. There are several reasons why Mr. Market might be offering me an opportunity to buy something at a steep discount. The exact reason depends on the situation of course, but our largest position makes for a good example.

So that raises the question, **WHY** is AstroNova cheap?

- \$100M market cap & illiquid (making it difficult for larger institutions to buy today)
- Earnings are depressed (the stock has no sell-side coverage and does not screen well)
- The business is boring and misunderstood (selling airplane cockpit printers probably doesn't come across as the best business in the world at first glance, and it definitely isn't a shiny new AI company, but it is a monopoly!)
- The company provides no guidance, and past results aren't exactly linear (This makes modeling future earnings with any sort of confidence time-consuming for those who are not already familiar with the story)
- Management is also far from promotional (but are solid operators)

The next question is **HOW** does AstroNova's valuation get corrected?

In my opinion, the value disparity is likely to be corrected by one of two scenarios; One, the market begins to take notice of this business and realizes EBITDA is likely to nearly double sometime over the next 12-24 months, or two, EBITDA doubles, and the market is forced to pay attention. In the unlikely scenario that the shares do not react positively to the anticipated EBITDA growth, the company could proactively retire shares or explore other alternatives to unlock value for shareholders.

As a quick update on the business, our fair value hasn't moved much since our last letter. Still, there have been encouraging developments in the business's product identification segment, and having caught up with management and with the thesis on track, I don't believe it unreasonable to say that AstroNova's share price should be starting with a three rather than the two we model.

The Big Tech Bandwagon:

While I prefer to avoid delving into macro or broader market developments in these letters, there is one current trend that might be worth mentioning. However, I'll do my best to keep it brief.

If we look at the S&P 500's 16.89% return year-to-date, 70%+ of that return can be attributed to just seven names – Apple, Microsoft, Amazon, Nvidia, Meta, Google, and Tesla. By comparison, the S&P 500 Equal Weight is up 7.03%. For some additional context, in a normal year, ten stocks usually account for 32% of the S&P 500's total return (data according to Goldman Sachs), and we're at 82% today. It should be noted that there has been a handful of other instances over the past two decades where ten stocks have made up ~80% or more of the S&P's total return, but in every one of those instances, the S&P was roughly flat or down on the year – certainly not up 16.89%.

However, these are just statistics, and they lack a lot of important context, so by themselves, they don't mean much. Furthermore, the past does not always indicate the future, so interpret these numbers how you will. We obviously have no exposure to these seven names but have found the continued piling into them by investors despite their being at or near decade-high valuations to be an interesting development considering a 5%+ risk-free rate.

It goes without saying that the future is unknown, and there is always a possibility that these companies could compound earnings at the high rates implied by current valuations. However, this seems unlikely and leaves little margin of safety in my opinion (at least in some of the names listed). When valuations and expectations for future earnings are high, the tide can turn quickly, and investors could be left swimming naked. I akin this situation to a bandwagon fueled primarily by the hype around AI. There are likely several other reasons for this continued buying, such as, Investors being scared of being left behind (aka FOMO), Managers don't want to risk looking too different from the index – meaning they have to buy these seven regardless of valuation, or they think earnings are going to compound at the high rates needed to justify their current valuations, whatever their reason for buying they aren't considering valuation much when making these purchases.

At some point, I think it is likely that the bandwagon will come to an end. Whether it's a slow stop with little to no injuries (the names flatline while earnings catch up), a hard and fast crash, or somewhere in between, I have no clue, but it seems like many investors in some of these high-flying names are hoping they can get off before.

Portfolio Commentary:

While we've made some progress on shrinking our cash position since I last wrote (it's no longer a majority of the portfolio), it's still much larger than I'd like, and we still have quite a bit to go. As stated previously, this cash position isn't related to macro concerns or the like, and our excess cash remains invested in short-term treasury bills. We did have some portfolio turn-over during the quarter attributable to a rather small position in CD Projekt (WSE:CDR) after shares inflected ~50% in mid-June. CD Projekt is a Polish video game developer and publisher listed on the Warsaw stock exchange. I won't opine on my reason for buying in this letter for the sake of time (as we no longer own it), but we are hoping to be offered an opportunity to own CD Projekt in the future once again. Activision Blizzard (ATVI) is also likely to leave the portfolio completely by Tuesday – more on this later in the letter.

While our cash position is still large, we do see an opportunity to decrease it materially just with what we own today. We have several smaller positions with the potential to earn a 50%-100% size increase upon further thesis confirmation. Increases of this size aren't likely to happen all at once, but as we hold these names for longer, get more comfortable with the businesses, and if the theses are playing out positively, we'll happily tack on materially more size. I've found I have a strong bias towards this approach rather than going "all-in" right off the bat – that isn't to say I won't start a position at a larger size, but those "all-in" moments just don't come around often. As a reminder, we usually cap our positions at ~15% for risk management purposes.

Bel Fuse Inc. ("BELFB"):

Bel Fuse is an electronic components manufacturer, and despite the rather large run-up in share price, we are still being provided with an attractive opportunity to buy a good business at a dirt-cheap price today. They design, manufacture and market a broad array of products that power, protect and connect electronic circuits. Like many industrials, they have 1,000s of SKUs (stock keeping units, which is just a fancy way of saying product), so I won't be diving into each product they make, but a few examples would be magnetic ethernet connectors for servers, fuel quantity monitors for aircraft, and cable assemblies + fuses for electric vehicles.

Most of their products aren't exactly "ground-breaking" or super differentiated, but this is true of any electronic component manufacturer. Despite selling some commoditized products, these companies benefit from a low-cost but high cost of failure product offering. For example, while a fuse itself is usually a cheap and commoditized product in relation to the product it goes in, it remains an essential safety device that can save several other components. Customers want and need these products to work, and work well. Furthermore, while the switching costs for most of

these commoditized products are usually low, it just doesn't make sense in most cases to risk failure and pick up pennies in front of a steamroller. However, because there typically aren't significant technological differences between fuses, connectors, etc., switching is easy. Hence, businesses offering these more commoditized components need to make sure inventory levels stay stable to maintain customers. If your fuses and other products are consistently in stock at distributors and affordable, it's unlikely customers have any good reason for switching. These more commoditized products are usually sold through distributors (~33% of Bel's business is through distribution) rather than to customers directly because these products tend not to be "custom built" for a specific end product. However, commoditized/distribution doesn't necessarily always mean low margin, and Littelfuse (one of Bel Fuse's competitors) is a good example of this. Despite having 75% distribution exposure in their electronic components segment, they still maintain low-twenties operating margins.

Then on the flip side of things, these companies also have long-standing large contracts/relationships for more custom-engineered products (~67% of Bel's business). These relationships tend to be balanced, but the customer does have more "pull" in some cases. Price-downs are commonly included in larger/longer-term contracts based on volumes, and price increases are usually only passed on to the customer when a contract ends/comes up for renewal. This means it might sometimes take a few years to pass on pricing to customers. In contrast, distributor pricing can typically be passed on within a couple of months to a year. As mentioned, this isn't a totally one-sided relationship, and manufacturers will usually negotiate some form of content growth in exchange for price downs as well. For example, if an EV manufacturer wants Bel Fuse to come down 5% on its cable assemblies, then Bel Fuse might say that is fine, but they'll want the EV manufacturer to offer them more content opportunities in exchange, such as Bel Fuse now supplying the fuses on that same EV – This is a benefit of these longstanding relationships and allows for both the customer and manufacturer to win.

Overall, these are pretty good businesses, with most sporting solid organic growth and strong end markets such as aerospace, networking, and electric vehicles (all of which Bel Fuse has a good amount of exposure to). They also benefit from the continued electrification of almost everything; look no further than Bluetooth/Wi-Fi-enabled temperature-controlled coffee mugs, and some even have LEDs! For these reasons, they usually trade around 10x-12x+ EBITDA (multiples have expanded some recently with LFUS and TEL at 15x and 13x, respectively), and some like Amphenol trade at a whopping 18x multiple, but to be fair, they are considered the gold standard.

The thesis here is straightforward, just like AstroNova, we believe Bel Fuse's EBITDA is going to expand materially over the coming years, from \$83M in 2022 (\$100M LTM) to \$120M in 2024, and we also don't think \$140M is out of the cards for 2025.

At the start of this letter, I stated that one of our portfolio companies had increased its intrinsic value significantly – Bel Fuse is that company. In the most recent quarter, EBITDA margins nearly

doubled y/y from 8.5% to 16.3%, and it's worth noting that Q1 is also their weakest quarter due to seasonality (Chinese New Year), but despite this, margins still increased 150bp sequentially! This quarter had smashed our expectations, and we subsequently increased our position. But how did margins double you might ask, and is that even sustainable? Well, Bel Fuse makes good products that customers want, but there was practically zero attention paid to the bottom line under the current CEO's tenure – this led them to actually selling some products at a loss (yes, really). However, a new CFO was appointed in early 2021 (Farouq Tuweiq), and he is now turning that around. Under his tenure, EBITDA margins have more than doubled since 2020, and Gross margins are up over 500bps and comparable to peers.

Another interesting note is that Bel has yet to have a quarter where one of its segments isn't dragging down the others. In this quarter, it was Magnetics, which is facing inventory issues that will eventually clear up but have led to a 670bp decline in gross margins sequentially in the interim. This isn't related to a demand problem however, but rather a bottleneck that some of their customers are facing. For example, Cisco might have enough Bel Fuse RJ45 connectors for their servers but can't get enough power supplies from Bel Fuse to get the product out the door, so once supply for these missing parts catches up with demand, magnetics should normalize. The company has also recently undergone some restructuring that should add ~\$5M in cost savings as we exit 2023, and as the company continues to benefit from more operating leverage and some final price increases, I believe they can get to 18% EBITDA margins or higher in 2024. I've spoken with Farouq many times and continue to be impressed with him, and he also continues to purchase shares in the open market. Bel Fuse's newly found attention to margin expansion can also be seen with the recent selling of their Jersey City headquarters in June of this year and their subsequent move to a less expensive property outside the city. While I doubt this moves the needle, it shows Bel Fuse's continued devotion to improving their bottom line.

Considering all the above, we see Bel Fuse doing around \$120M in EBITDA for 2024 (give or take a couple of million in either direction). This means that at the current share price of ~\$57, Bel Fuse trades at just a **~6.00x EBITDA** multiple while peers trade at 12.00x+. This large disconnect in value should close over time as the market realizes Bel Fuse's margin expansion is here to stay and isn't even done yet. While we don't believe Bel Fuse deserves a 12.00x multiple today for a couple of reasons (They still have lower margins than peers, and there is a controlling shareholder as well – whom we are slowly getting more comfortable with over time), we see no reason they shouldn't be trading at 9.00x-10.00x which implies a share price of \$83-\$92 before accounting for incremental cash gen (capex runs around just \$10M in a normal year, so the business is far from capital intensive). Bel Fuse has also traded at an average of 7x-8x EBITDA over the past decade (when it was a worst business, selling products at an actual loss and had materially lower margins). Even at an 8.00x multiple, you would still get to \$73/sh today.

If we look out a few years to 2025/2026, I don't think it takes egregious assumptions to get to **\$120+ a share**. LSD topline growth, 19%+ EBITDA margins, credit for incremental cash gen, and a 10.00x multiple get you there – those seem like reasonable assumptions to me today.

We wrote up Bel Fuse on SumZero back in February of this year and provided an update to our original post in late April – For those interested further, you can find a copy of the write-up [here](#).

Activision Blizzard Inc. (“ATVI”):

Just because something should happen doesn't mean it will happen, and this was precisely the case when the CMA surprised the market (and myself) by blocking Microsoft's potential acquisition of Activision. This deal shouldn't have been blocked by any regulatory body that acts objectively and is worth its salt (In my opinion that is), but the CMA decided to overreach and block the deal on the back of **Cloud Gaming** of all things. Regardless, we didn't buy Activision solely for the merger arbitrage opportunity and realized there was always a risk of the deal being blocked or shoved out a few more quarters when we initially purchased our shares. At the end of the day there are humans behind these anti-trust decisions; while they are supposed to act objectively and base their decisions on facts and evidence, they aren't objective decisions; they are subjective decisions, and if the CMA wanted to block the deal they could, and well, they did!

To my surprise however, the stock traded down to only ~\$79.00 before market open on the day the CMA released their decision not to allow the merger. At the time, I had decided it was best to lock in our gains, let the dust settle, and revisit the name once we had more regulatory clarity. A few days later, Activision traded down to ~\$74, and we purchased a small position with the intention to add over the coming days/weeks. We then added on the European Commission's approval of the acquisition and on Diablo 4's great overall reception and sell-through.

Then on July 11th, Judge Jacqueline Scott Corley denied the FTC's request for a preliminary injunction, and shortly afterward, Microsoft and the CMA submitted a mutual request for a pause of Microsoft's appeal in the U.K. Furthermore, according to CNBC, it appears Microsoft and the CMA have also already agreed on a small divestiture to help address the CMA's concerns. It now seems very likely that this deal will close by Tuesday of next week.

While the position wasn't quite the same size as it was previously, the strategy this go around was essentially the same (If Microsoft closed, we would generate a very solid IRR; if it went back to the drawing board and Microsoft wanted to extend the closing date it was my expectation that Activision would ask for a higher price, and lastly if the deal were to break Activision would get its break fee). It's also worth mentioning that our fair value had moved up some off the back of Diablo 4's success. We believed that Diablo 4 would help move Activision's "base earnings" up for several years via DLC, In-game skins, and other forms of monetization. On top of this, the mobile version of their popular battle royale, Warzone, will launch later this year, and I had also expected Activision to pursue a material buyback in the event of a deal break. But in the end, what should have happened originally looks like it will, and we're happy with the outcome.

Conclusion:

I'm happy to report (to my surprise) that our first letter had a more than positive reception, and our distribution list has grown substantially since then. After publishing our first letter, I had the opportunity to speak to several other portfolio managers and analysts who reached out to me to discuss ideas, and I enjoyed the many conversations I had.

As a quick reminder Atai Capital is open to new clients, and if you know someone who might be a good fit, please feel free to pass my contact information along and have them reach out.

As always, I am humbled by and grateful for the opportunity to invest your capital alongside my own, and I will continue to make every effort to compound that capital at attractive rates.

Cordially,

Brandon Daniel
Founder & Portfolio Manager
Atai Capital Management, LLC
bdaniel@ataicap.com

"People calculate too much and often think too little."

– Charlie Munger

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