



Anatomy of a busted thesis (ADA)

As we no longer hold a position in a previous largest holding, Adacel Technologies (ADA), I thought an autopsy might be in order, if only to glean any potential lessons, positive and negative.

We first bought shares in ADA in early-mid 2015 between ~52c-62c after the shares had already popped higher following an earnings upgrade. Our thesis at the time included cheap (<10 PE) growth on contract wins in an industry with tailwinds (including increasing FAA mandated air-traffic controller numbers) which had been held back by delayed government spending post the GFC and new shareholder-friendly management in the form of significant shareholder Thorney. Upgrades followed and we continued buying in the 70c region (at prices that were on a lower multiple given the upgrade than our purchases in the low 60c region) through to ~\$1.10. We stopped buying here until one further purchase at \$1.80 participating in the director sell-down. So far, so good, we followed our strategy of watering our flowers as the business continued to perform well.

Importantly, the bedrock of our thesis was that the historically lumpy nature of the business masked the underlying positive trend. The services side of the business was long-term sticky revenue and every win on the systems side added to future services business. Modelling future “locked-in” revenue in this way proved an accurate base going forward, with systems contract wins oscillating around this upward sloping trend. ADA’s moat included the fact that they owned the systems software code (with the R&D often charged to the client), making it very difficult for them to be displaced, evidenced by the very long tenure of some of their customer relationships.

We started trimming our holding for portfolio management reasons in early 2016 near the mid \$2 range, selling just shy of about ~20% of the

original position. We sold almost another 20% of the original position in May 2017 around the mid \$2.20s following a lowered 1H update, maintaining the rest of our holding as the update indicated a timing delay in Systems segment contract wins. (In fact this explanation meshed with the down part of the sine wave in our oscillating around an underlying upward trend thesis). We sold another small amount (~7%) in the \$2.40s in November 2017 when ADA announced at their AGM that they'd lost an FAA services contract but said it would not have a material impact that financial year. We sold another ~20% of the position in August following a miss on their full year results (+30% realised vs +35% guided) and finally sold the rest of the position (~high 30% region) at ~\$1 following the shocking downgrade early this month.

So using 20/20 hindsight, what can we learn? We managed to follow our process of continuing to buy higher as the business performed which was a positive. Arguably not buying in the high \$2s and above \$3 was also a positive, as well as trimming for portfolio management reasons which proved helpful. As usual, execution at this stage could have been much better as we never sold any above \$3, and our crystal ball remains as cloudy as ever.

However the serious error in judgement occurred at the loss of the FAA contract as this basically blew a hole in their moat, negating our underlying sticky services revenue thesis. The guidance of no material impact coupled with the lower share price lulled us into maintaining the position until at least the next results. It's cheaper down here = probably the definition of thesis creep or value trap, take your pick. We should have sold the entirety at that stage. We fell into the same trap at the results announcement for missing guidance again, only selling ~20% of the original position (although a much larger percentage of the remaining position) as it became even "cheaper". Perhaps the only positive takeaway was getting the last ~high 30% remaining holding away at ~\$1, given where the shares trade today.

Arguably, ADA has a strong legal case vs their competitor and can possibly regain their moat, rendering today's share price attractive. However we are happy for that to play out without us.