Atai Capital Management

Q2-2024 Letter

Dear Partners, **August 22nd, 2024**

Atai Capital experienced a decline of 0.6% in the second quarter net of all fees. This compares to a 4.3% total return for the S&P 500, a 3.3% decline for the Russell 2000, and a 5.3% decline for the Russell Microcap.

	Atai Capital	Russell Micro	Russell 2000	S&P 500
Q2-2024	-0.6%	-5.3%	-3.3%	4.3%
YTD	-2.0%	-0.8%	1.7%	15.3%
Since Inception	16.9%	8.4%	19.0%	45.6%
Annualized	11.0%	5.6%	12.4%	28.7%

As mentioned in previous letters, we've now closed our Founder's Class fee structure to new partners, and our returns in the table above now reflect a 2.00% management fee instead of the prior 1.50% under the Founder's Class fee structure. Please remember to check your individual account statements, as returns will vary based on the timing of your initial investment, the impacts of additions and withdrawals from your account, and your individual fee structure.

As you're aware, I typically refrain from commenting on macro or broader market trends, and many financial pundits have already weighed in on the continued underperformance of small caps, as well as the other market anomalies from this year and last. So, I don't have anything particularly new to contribute to the discussion. Nonetheless, I'd like to share some noteworthy data points I've come across and my general take on the current situation.

The first half of this year was marked by the Russell 2000's worst half in history relative to the S&P 500 while also being on track for its third consecutive year of underperformance. Such a prolonged period of underperformance has occurred only once in the past 45 years (1997-1999), after which the Russell 2000 would go on to outperform the S&P 500 every year over the next five years. At the end of the second quarter, the S&P 500 had increased by 15% year-to-date, and approximately 60% of that return was attributable to just five stocks (the equal-weighted version of the S&P 500 had increased just 5% for comparison). Forward-looking multiples for the S&P 500 are at the higher end of their historical range, while the S&P 500 equal-weight appears more reasonably valued. Meanwhile, the Russell 2000 appears undervalued, with multiples sitting near the lower end of their historical range. To be clear, I am not insinuating that small caps are cheap or that we are setting up for five years of outperformance like what happened after 1999. While it is true that small caps are towards the lower end of their historical valuations, I believe looking at broad market multiples usually lacks a lot of nuance and context. Thus, I don't necessarily agree with most of the small cap dislocation discourse I've seen floating around. Many investors are looking at the valuation and performance gaps between small and large caps and frame the entire conversation as small caps being incredibly cheap today. However, I think a likely better framing of the current situation is that large caps (at least those at the top) are potentially overvalued and account for most of the dislocation we are seeing.

Regardless of the context above, our underperformance relative to the S&P 500 remains frustrating, and while most of our positions continue to perform well business-wise, their share prices have struggled this year.

Portfolio Commentary:

We added one new position during the quarter, sold out of two small tracker positions, and trimmed another position. We continue to find attractive opportunities in the microcap space, and as of writing, ~50% of our portfolio consists of businesses with market caps smaller than $250M, and our top five positions make up ~65% of our portfolio.

AstroNova Inc. ("ALOT") Update:

AstroNova declined ~20% following what optically seemed to be a disappointing quarter. The top line declined ~7% y/y on a consolidated basis, with both of their segments also showing y/y revenue declines. However, pulling back the curtain reveals that the business is still trending in the right direction, and the issues plaguing the quarter were one-time in nature. Their test and measurement business experienced shipment delays from a supplier, and narrow-body aircraft production continues to be on a slow ramp. Product identification had a $4.5 million order pushed out a quarter, which led to an ~8% decline in revenues that would have instead been double-digit growth. However, despite this revenue decline, operating margins still expanded by 290bps for the segment. Furthermore, the company reiterated this year's guidance of mid-single-digit organic growth, 13%-14% EBITDA margins, and 100bps of margin expansion in each of the next two years.

Before the quarter, AstroNova made a ~$26M acquisition of MTEX, a Portugal-based label, packaging, and printing solutions manufacturer. This acquisition expanded AstroNova's product lines to large format printing, direct-to-fabric printing, and direct-to-film printing, to name a few. While we don't know the exact financial breakdown of MTEX yet, older annual reports from the company point towards them potentially boasting 20%+ EBITDA margins (after adjusting from Portuguese accounting standards to GAAP). Furthermore, if we read through their website and product offerings, they utilize their own printhead and ink delivery technology, which allows them to have better control over their supply chain as well as higher margins on their ink. We would not be surprised to see AstroNova utilizing MTEX's printhead, ink, and delivery systems in their new and updated product offerings. MTEX has also been growing its topline at a very healthy double-digit clip the past few years (more than doubling revenues since 2020 while also walking away from some lower margin business), and management believes this growth trajectory will continue into future years. Based on our rough estimates, AstroNova likely paid 9x+ EBITDA and 2x+ this year's revenue for the business. Given the healthy multiples paid and the lack of information we have today, I am not assigning any additional value to this acquisition, but I believe if they can continue their double-digit growth rate, this could prove to be a highly accretive acquisition with numerous quantitative and qualitative benefits.

AstroNova has been the firm's largest position since launch, but sadly, its share price performance has been lackluster, to say the least, being up only slightly from our cost basis. This is despite their EBITDA growing from $8M at the time of our purchase to $17M as of the most recent quarter. Put differently, they have more than doubled their EBITDA in less than two years, but their stock hasn't moved. Furthermore, this year's guidance implies strong margins exiting the year, and with the acquisition of MTEX, normalization of Aerospace, and the numerous cost-saving initiatives we've spoken about in previous letters, future margin levels should be materially higher than today's. We expect that AstroNova will continue to grow their topline at mid-single digits while growing the bottom line faster, leading to $30M+ of EBITDA in 2026. Based on these estimates, we believe AstroNova is trading at an incredibly undemanding valuation of less than 5.0x EBITDA and 6.0x UFCF before any incremental cash generation.

Enad Global 7. ("STO: EG7") Update:

Enad also announced weak quarterly results primarily attributable to ToadMan and the timing of revenue recognition at Daybreak Games. ToadMan's underperformance was not a shock to us, given the industry-wide layoffs and numerous project cancellations this year (As a reminder, Toadman is a work-for-hire game studio). However, after the quarter, Enad took corrective action that impacted over 100 staff at Toadman, bringing it to immediate profitability. Daybreak's live service portfolio of games was a mixed bag, with both the Everquest titles outperforming our expectations while games like DC-Universe Online struggled to retain players. My Singing Monsters performed better than we expected this quarter, growing revenues sequentially, and with the game's seasonality (related to its anniversary updates), revenues for the game should be stronger in the second half of this year.

Shortly after quarter end, Enad acquired the game studio Singularity 6 and their free-to-play live service title Palia. Palia is a "cozy game" where players "craft, cook, fish, and farm with friends." For those unfamiliar with the title, it'd fall into the same genre as Animal Crossing and Stardew Valley. Palia is still in early access (meaning it's incomplete) and is only available on PC and Nintendo Switch today. Enad paid $5M to acquire the company and will be investing an additional $10M to expand the game as they prepare for its official release across all platforms in 2025 (PC, Switch, Xbox, and PlayStation). Included in the acquisition is a contingent consideration where Ji Ham once again proved his ability to structure deals favorably and in a risk-averse fashion. Like the Cold Iron deal, Enad will fully recoup its $15M investment into Palia before any contingent consideration is paid. Afterward, Enad will split the cash flow from the title for five years following the closing date of the acquisition. Enad expects Singularity 6 to operate at a breakeven or slightly positive EBITDA level for the remainder of the year and to turn cash flow positive during 2025.

Another development worth mentioning is that on August 16th, the movie Aliens Romulus was released in theatres to good reviews and a $100M+ box office. This bodes well for Cold Irons' upcoming Aliens title, set to release in 2025, and essentially functions as free marketing for the game.

Despite the weak quarter, Enad reiterated their full-year guidance of SEK 1.8B in revenues with 22-25% EBITDA margins. Whether they hit these numbers will mostly depend upon the performance of Mech Warrior Clans, which is slated for release later this year.

Conclusion:

Our sluggish start to the year continued through the second quarter, but as mentioned in our last letter, I remain optimistic about our portfolio's prospective returns. Almost all of our positions are performing well business-wise, and we added a new investment after the quarter that I am excited to share with you all at a later date.

As a reminder, we are open to new clients, and if you know someone who might be a good fit, please feel free to pass along my contact information.

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

"In all my 55 years on Wall Street, before I retired to do something vastly more important, I was never able to say when the market would go up or down. Nor was I able to find anybody on Earth whose opinion I would value on the subject of when it would go up and down."
– John Templeton

Disclaimer:

This letter expresses the views of the author as of the date cited, and such views are subject to change at any time without notice. The information contained in this letter should not be construed as investment advice, and Atai Capital Management, LLC ("Atai Capital") has no duty or obligation to update the information contained herein. This letter may also contain information derived from independent third-party sources. Atai Capital believes that the sources from which such information is derived are reliable; however, Atai Capital does not and cannot guarantee the accuracy of such information. References to stocks, securities, or investments in this letter should not be considered investment recommendations or financial advice of any sort.

Any return amounts that are reported within this letter are estimated by Atai Capital on an unaudited basis and are subject to revision. Atai Capital's returns are calculated net of a 2.00% annual management fee and reflect a client's performance who would have joined the firm on its inception date (01/03/2023). Actual Individual investor returns will vary based on the timing of their initial investment, the impacts of additions and withdrawals from their account, and their individually negotiated fee structure. Atai Capital believes showing returns net of a 2.00% management fee better reflects actual performance as of 8/22/2024 since no account that Atai Capital currently manages is charged a fee more than the stated 2.00% management fee. Past performance is no guarantee of future results.

Index returns referenced in this letter include the S&P500, Russell Microcap, and Russell 2000. Atai Capital's returns are likely to differ from those of any referenced index. These returns are calculated from the respective provider's websites, spglobal.com for the S&P500 and ftserussell.com for the Russell Microcap and Russell 2000, and include the reinvestment of all dividends in both cases.