



Gondolin Capital, LP

Fourth Quarter 2021 Investor Letter

January 10, 2022

Dear Investor,

In 4Q21, Gondolin returned **+5.8%**, versus +10.6% for the S&P 500, +1.9% for the Russell 2000, +6.4% for the MSCI World Index, and +1.1% for the Bloomberg All Hedge Fund Index. **Since fund inception (Feb 23, 2021)**, Gondolin has returned **+18.7%** (*net of fees*), comparing with +22.8% for the S&P 500, +0.6% for the Russell 2000, +12.0% for the MSCI World Index, and +5.1% for the Bloomberg All Hedge Fund Index.

	4Q2021	YTD	Since Fund Inception*
Gondolin Capital, LP	5.8%	n/a	18.7%
S&P 500 (US Large Cap)	10.6%	26.9%	22.8%
Russell 2000 (US Small Cap)	1.9%	13.7%	0.6%
MSCI World Index (Global)	6.4%	16.8%	12.0%
Bloombg. Hedge Fund Index	1.1%	9.9%	5.1%

*Fund was incepted February 23, 2021

Note: returns are net of performance and management fees

Administrative Matters

- *For the calendar year 2022, Gondolin Management, LLC will continue to pay for the administrative fees (tax/audit, accounting, and legal) of the fund, until the assets grow bigger in size. Annualized, these fees currently amount to ~1.5% of total investable assets, which would otherwise be in addition to current 1% annual management fee.*
- The number of limited partners has now grown to 17, while current Assets under Management (AUM) has reached \$3.4M, with ~91% of the capital invested and ~9% being held in cash as of December 31. Our positions remain entirely on the long side (no shorts) and we currently have no outstanding options activity. In 2021, Gondolin stayed away from short selling given record levels of cash inflow into the stock market and ongoing crowdedness in shorting the companies we find overvalued. *Beginning in 2022, as the global, multi-trillion dollar stimulus and zero-rate era both end (which always finds its way into the stock market), the fund will increasingly utilize short positions and higher levels of cash to act as a risk/capital buffer. Details on the strategy changes are detailed over the next few pages.*

Performance Commentary for 2021

2021 was another strong year for the equity markets, in particular the S&P 500, which saw an unprecedented amount of capital inflow into the largest tech companies such as Google, Microsoft, Apple, Amazon, Nvidia, and Facebook. The largest five companies now account for ~24% of the total “market”, mostly considered to be the S&P 500, so I continue to refer to the “market” as such. The S&P 500 is now up an astonishing +48% since December 2019, just before COVID-19 arrived, reflecting an immense amount of capital invested into US equities, but particularly - the vast majority - towards the aforementioned mega-cap US technology stocks. This also implies that hundreds of smaller capitalization, non-technology focused businesses and industries have seen significantly smaller flows and thus changes in valuation over the last couple of years, creating a significant arbitrage opportunity in the near-term; e.g., the Russell 2000 small cap index is now just 48% of the value of the large cap S&P 500, versus a prior 20-year range of 43-65%.

Gondolin’s five biggest winners in 4Q21 were lumber distributor Builder’s First Source (+66%), software provider New Relic (+53%), engineering/design firm NV5 Global (+40%), modular space renter Willscot Mobile Mini (+29%) and homebuilder DR Horton (+29%). With the exception of New Relic and NV5, most of the fund’s biggest winners were able to push the most price beyond their rising costs. The five biggest losers were software provider Domo, online video platform Vimeo, satellite manufacturer Viasat, casino Penn National Gaming, and rental “smart-home” product manufacturer Smartrent, all down 20-40% in 4Q21, but were generally smaller positions at the time. Domo, Vimeo, Viasat and Smartrent have been performing well but saw an exodus of capital from smaller cap, higher growth, technology-related sectors; because of this indiscriminate selling (which is ongoing in the early part of 2022), we have been adding to these latter positions as their long-term prospects are the same.

Relating to our inflation protected businesses: Lumber-related positions **West Fraser Group (WFG)** and **Builder’s First Source (BLDR)** have performed well in 2021 fundamentally and we are slowly reducing exposure as lumber begins another enormous ascent well >\$1000/mmbf ahead of the spring homebuilding season. Steel-related positions **Cleveland Cliffs (CLF)** and **Graitech (EAF)** have also performed very well, with significantly rising prices (well ahead of costs) expected for 2022. Similarly, US natural gas was squeezed to its highest level in a decade (\$6.30/bcf) and still remains >35% above average 2018/2019 levels, aiding our ongoing involvement in **EQT Corp (EQT)**, **Kinder Morgan (KMI)**, **Cheniere (LKG)**, and **Chesapeake (CHK)**. Distributors **Beacon Roofing (BECN)** and **US Foods (USFD)** benefitting from higher oil and food prices had mixed performance (flattish) as only modestly higher prices offset modestly rising costs.

In 4Q21, we added residential real estate platform **Zillow Group (ZG)**, smartphone chip manufacturer **Qorvo (QRVO)**, specialty cold warehouse landlord **Americold (COLD)**, solar field electrical parts manufacturer **Shoals Technologies (SHLS)**, and software provider **New Relic (NEWR)**. We exited Bed Bath and Beyond (BBBY), Brightview Holdings (BV), Hawaiian Airlines (HA), and Latch (LTCH) mostly after perceived inflation in 2022 is likely to bite into profits and uncertainty around future margins persists.

Expectations for 2022: Expect a turbulent year ahead...

Critically, the federal reserve has finally acknowledged that inflation is running well ahead of their original predictions earlier this year and they have finally begun a plan for raising interest rates in mid-2022, with a goal (so far) of three times in the year, and with another set of increases set for 2023 to stave off inflationary pressures. **That will be a key theme for 2022 as capital flows back into debt instruments and broadly reduces the valuation of expensive equities.**

For Gondolin, the other most important themes for investing successfully in 2022 will be:

- **Quickly rising prices (or rents) to offset significantly rising costs;** driving higher margins, instead of seeing margin pressure. I believe that this dynamic reared its head somewhat in the second half of 2021, but that 2022 will be significantly more impacted by higher costs and prices than 2021, and the extent to which volumes and demand are exchanged for higher priced goods and services. This is a theme that is not yet fully appreciated by the investment community, hence our very long exposure to inflation-protected business and industries.
- **Idiosyncratic and event-driven growth stories:** growth in communications and global internet expansion (and associated data, software, and hardware), data analytics tools, sports betting, renewable energy and associated grid re-work, construction, and design are all key growth themes over the next decade. While many of these are in the midst of popping their valuation bubbles developed in 2020 and peaking in 2021, we will continue to pivot harder into these trends as valuations continue to decline and industry structures improve, some faster than others. I believe the most successful growth stories will evade the impact of rising interest rates, lower Chinese/emerging market demand, ongoing tight (high cost) supply chains, and rising materials/wage inflation.
- **Avoiding Chinese exposure:** the CCP-led, slowly orchestrated popping of China's \$1 trillion construction bubble is likely to last many years and impact their consumer spending/GDP growth for some time, to a still largely unknown degree as the data coming out of China remains a black box and they are re-stepping away from the public equity spotlight. The communist-driven mentality in China has yet again proven to take a front seat over the desires of equity investors and any form of durable cash profits, while cross-aisle support both for (A) ongoing high US/China tariffs (e.g., Trump's section 232 steel tariffs, approved also by Biden) and (B) for rising defense spending against Chinese aggression in the South China Sea create a cloudy outlook for how one can "win" investing in China in at least the near future.

Gondolin averaged 13% of the fund in cash in its first year, and had 9% cash in 4Q21, while maintaining no equity shorts. *In 2022, the fund will generally hold a larger target cash level of ~10-15% and begin looking for short positions (ETF-based or company-specific) as interest rates rise (sending capital from equities -> debt) and shorted positions are gradually unwound from failed 2021 hedges.* The end of the "free money" era that has reigned during COVID-19 is likely to alter how important profits and cash flows are today, instead of tomorrow or in ten years; it will also magnify how important it will be to offset one's significantly rising costs, with rising prices or significantly rising volumes to offset cost growth over the near-term (e.g., Tesla). There is of course still the potential to return back to the low-cost/disinflationary disruption theme that pervaded the 2010s era but that path remains to be seen how we get back there.

Macro Backdrop: Inflation Check

Another re-look at what's still inflating since Sept 30

In 4Q21, there was a small "cooling off" of natural gas prices (electricity, heating) and steel, while others (lumber, corn, beef) continued to surge ahead. The spring production season for many of these goods and materials will be a key indicator for 2022 trends. Wages continue to accelerate slightly, now +5.9% YOY.

Type	Material	Unit	Historic Averages:			Current	Difference from:		
			20Year	5Year	PriorQtr (9/30/21)		20Year	5Year	(9/30/21)
Energy	Oil	\$/barrel	\$61.71	\$55.01	\$75	\$78.43	27%	43%	5%
Energy	Gas	\$/mcf	\$4.58	\$2.89	\$5.87	\$4.09	-11%	42%	-30%
Material	Lumber	\$/bcf	\$324	\$485	\$628	\$1,160	258%	139%	85%
Material	Steel	\$/ton	\$683	\$825	\$1,900	\$1,415	107%	72%	-26%
Material	Copper	\$/lb	\$253	\$302	\$409	\$436	72%	44%	7%
Material	Aluminum	\$/ton	\$1,929	\$1,974	\$2,850	\$2,908	51%	47%	2%
Food	Wheat	\$/bushel	\$510	\$530	\$726	\$763	50%	44%	5%
Food	Soy Bean	\$/bushel	\$947	\$1,015	\$1,256	\$1,377	45%	36%	10%
Food	Corn	\$/bushel	\$386	\$410	\$537	\$599	55%	46%	12%
Food	Beef	\$/lb	\$103	\$115	\$121	\$136	32%	19%	13%

*data provided by Bloomberg and Platts

Unit	Type	Average Growth:		Annual Growth Last Five Months				
		20Year	5Year	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22
\$/hour	Wages	2.7%	3.4%	4.5%	4.8%	4.8%	4.7%	5.1%
\$/hour	Wages ex*	2.9%	3.4%	5.5%	5.8%	5.9%	5.8%	6.3%

*excluding supervisory wages

**data provided by St Louis Fed and Bureau of Labor

Gondolin's "inflation-winning" positions did well in 2021, but I am expecting more gains in 2022 as exceptionally high commodity pricing have been holding up

"Inflation-Winner" Stocks Owned; results for Gondolin in 2021							Current
Ticker	Type	Initiated	Cost	Price	Return%	Wt. Avg.	% of AUM
CLF	US Steel Manufacturer	1Q21	\$19.77	\$21.73	10%	5%	
EQT	US Natural Gas Producer	1Q21	\$18.85	\$21.82	16%	4%	
WFG	US/Canadian Lumber Mill	1Q21	\$73.42	\$94.31	28%	3%	
EAF	US Steel Graphite Manufacturer	1Q21	\$11.47	\$11.86	3%	3%	
BLDR	US Lumber Distributor	2Q21	\$50.50	\$83.49	65%	3%	
CHK	US Natural Gas and Oil Producer	2Q21*	\$51.36	\$66.55	30%	2%	
USFD	US Food Distributor	2Q21	\$34.72	\$35.62	3%	2%	
BECN	US Roofing Distributor (Oil-made)	1Q21	\$49.42	\$57.01	15%	2%	
LNG	US Natural Gas Exporter	1Q21	\$69.15	\$102.49	48%	1%	
KMI	US Gas Pipeline Operator	1Q21	\$15.62	\$16.35	5%	1%	
*Formerly VEI; acquired by CHK						16%	27%

Exited Positions

CRK	US Natural Gas Producer	1Q21	\$5.54	\$8.65	56%	Sold
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Portfolio Holdings as of December 31, 2021

The image shows a table with multiple columns and rows, representing portfolio holdings. The text is extremely blurry and illegible. A yellow highlight is visible at the bottom of the table area.

Equity Initiations in 4Q21

Adds Stock	Company Name	Sector	Share Price	MktCap (\$M)	Weight% Portfolio
ZG	ZILLOW GROUP INC - A	Real Estate	\$62	16,164	2.2%
QRVO	QORVO INC	Information Technology	\$156	17,238	1.9%
COLD	AMERICOLD REALTY TRUST	Real Estate	\$33	8,747	1.6%
SHLS	SHOALS TECHNOLOGIES GROUP	Industrials	\$24	4,054	1.4%
NEWR	NEW RELIC INC	Information Technology	\$110	7,193	1.0%

- Zillow Group (ZG):** Zillow is the largest residential real estate platform in the United States, catering to buyer's agents around the country and currently has ~13% market share of the collective US real estate advertising budget spend. Zillow spent ~3years growing a home flipping business in order to better use its ability to predict real estate pricing trends, but after a recognition that record high inflation (repair work wages and associated components) will last, in addition to incoming mortgage rate increases, Zillow has decided to exit the business. Net net, they will have generated a large cash profit net of restructuring costs as they will have sold the aggregate home value well over home cost and group exit costs, leaving the legacy business with ongoing +8-10% growth, record high margins (>30% cash flow margins), and a strongly net cash balance sheet of ~\$2B. I value this real estate platform oligopolist with ~90% gross margins at 25x free cash flow, versus just 18x at our cost.
- Qorvo (QRVO):** Qorvo is a leading manufacturer of mobile device and infrastructure chips and components, including switches, power amplifiers, filters, and antennas. Qorvo has been one of the largest investors over the last couple of decades in technology around cheaper and smaller, but more efficient and effective components that ultimately deal with growing the range and complexity between the connectivity of our devices. Qorvo's end markets (mobile phones/handsets and aerospace/defense) are higher growth (>5%/yr CAGR), while QRVO's ongoing taking of market share in the space will allow to continue generating >10% growth in profits and cash flows. QRVO is just 13x its free cash flow in 2023, versus >20x for the S&P 500, where it should be trading at a premium to the market, not a 35% discount.
- Americold (COLD):** Americold is the second largest cold storage warehousing REIT in the United States, with ~20% market share of pallet positions nationally. Americold works together with cold food producers (Smithfield, Conagra, Danone), cold food distributors, and cold food retailers (Kroger, Whole Foods, Unilever) to temporarily store and re-ship cold food producers from farm/factory to grocery store. This high margin, resilient business recently saw significant occupancy reductions tied to food shortages that begin in Summer 2021 and are slowly healing, allowing us to pick up shares ~30% lower. As food inflation continues to ramp, COLD is in prime position to be able to immediately raise its rent per pallet position and offset growing electricity costs and wage inflation, which it also saw at the end of the year. I see COLD returning to ~25x multiple (cash flow) versus just 18x today on cash flow estimates for 2023.
- Shoals Technologies (SHLS):** Shoals is the largest manufacturer of electronic balance of systems products (EBOS) for utility field solar arrays. Utility field solar arrays house thousands of solar panels that all require individual connections to a single feeder point to route the power into the

inverter and convert the DC power into AC power, which is then usable for our electric grid. The problem today is that materials costs and increased electrician wages are growing the cost of solar installation significantly, hampering the ability to cost effectively grow our demand for solar power generation. SHLS' products and technologies saves \$millions for utilities and solar field developers since they have developed an EBOS product array that reduces the need for redundant wires and conduits, dramatically reduces the time to install the electronic wiring network, and even simplifies the process so much that you no longer need a licensed electrician to install the EBOS anymore, all of which can save 5% off project costs that can tab into the \$Billions. The stock is down ~50% from highs nearing \$40, providing us with an opportune time to start acquiring shares on this unique, high-margin, long-term hold for Gondolin.

- **New Relic (NEWR):** New Relic is one of the largest developers of network infrastructure monitoring and product/IT "observability", where companies can now in real-time see how well their many software platforms are working as well as how much and how well customers are using and working with software products provided. In the past, salesmen and engineers would need to visit customers offices to discuss issues with software products and how well they are integrated into the functions of the client's business – but today, almost all of this can be monitored and accomplished digitally using observability solutions like New Relic, Datadog, and App Dynamics. While New Relic was originally a pioneer in observability solutions, they've recently lost share to Datadog and others, and have since re-engineered their way back into meaningful growth (>15%/yr) and higher margins, allowing further re-investment back into the business. NEWR's turnaround is likely to put its enterprise value / sales ratio under 7x, versus peers at 10-12x.

Please reach out to myself via email (aballantyne@gondolincapital.com) or by phone (248-719-3843) if you have any questions or would like to discuss the quarter's results further.

Sincerely,



Adam Ballantyne
Founder and General Partner