

The Miatello Quarterly

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BMO Nesbitt Burns



 Let's connect

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Shapeshifting Markets

In the science fiction film Terminator 2: Judgment Day, the main antagonist was a shapeshifting android assassin, the T-1000, determined to kill John, son of Sarah. No matter how their protector, another android played by Arnold Schwarzenegger, attempted to eliminate him, the T-1000's liquid metal form would reconstitute and attack. Who amongst today's investors would not think the T-1000 in market form is coming for them?

The second quarter of 2022 saw the reversal of a ten-year secular trend that favoured speculative high-risk approaches to the capital markets. The catalyst was the realization amongst central banks that inflation was not transitory, effectively admitting that they had failed in their primary function and needed to raise rates rapidly. Why this failure happened will be the subject of many dissertations but is probably some variation of groupthink amongst the 300 Ph.D. trained economists at the US Fed and proportionate Ph.D.'s at other Western central banks.

For our part and our strategy, we did see this outcome and warned in the MQs of October 2021, January 2022, and April 2022.

However, even when you know a hurricane is coming, you can't completely escape. The most damage was sustained by non-profits techs (i.e., ARK type), Meme stocks, SPACs, and most recently the Crypto catastrophe. The next groups hit were high PE multiple profitable techs, then high multiple stocks of any sort.

Finally, even fairly valued stocks were caught up in the secondary effects of the storm but did not fall nearly as much as the general markets. This latter category is where our portfolio was. The sole sector that was slightly positive was the energy category but that has just reversed along with the commodity sector in anticipation of an expected recession crushing demand. Today, July 15, energy stocks are down ~28% from their high on June 8.

Not to be overlooked, the fixed income market delivered its worst two quarters in 40 years. In Canada, the broad bond market was -12.2% year to date on June 30th. If you thought no interest cash was a refuge, then inflation reduced your purchasing power by ~6%.

Capital market returns will continue to be determined by investors inflation expectations and resultant economic behaviour and the reaction of the central banks' response. Surveys reveal that the population is raising their expectation of medium to longer term inflation rates. This is poison for the bankers as it entrenches in the economic system and becomes ever harder to reverse. Central bankers are walking a tightrope here. Nobody really knows how psychology will move. A random exogenous event could determine the course of everything.

Another consideration is whether central banks will try to return to the 2% normal inflation rate or accommodate a higher rate of up to 4%, which we discussed as the likely outcome in the MQ of October 2021. The former target of 2% would likely require a crushing recession given the long-term secular forces allied against this number. Settling on a stable 3% to 4% would seem to offer the least economic damage.

Under the circumstances, we believe that our long-standing practice of buying a diverse set of companies in global markets, with growth possibilities but paying a cheap price, offers the best approach in the decade ahead. Beware the Pied Pipers suggesting a return to yesterday's methods. More specifically, last decade's winners will be this decade's losers.

In the Spotlight: Cellnex Telecom, S.A.

Cellnex Telecom (CLNX) is a Spain based company engaged in the wireless communication industry. The company IPO'd in 2015 and since then has been involved in continuous M&A activity. It operates 103,000 wireless towers in Europe across twelve countries covering 250 million people. There is a trend across the telecom industry to sell passive infrastructure for quick cash. Cellnex acquires towers from mobile network operators including Telefonica, Iliad, CK Hutchison, Bourgues, and Altice. Cellnex's strategy is to buy the portfolios from the operators and then lease the towers back to them through long term contracts, which provide high cash flow visibility and inflation protection.

This year Deutsche Telecom has decided to sell up to a 51% stake in its tower business of 40.6 thousand towers, that generated high interest. Cellnex has a disciplined M&A valuation strategy that limits bidding on acquisitions to 25 x EV/run-rate EBITAaL. Partnering with Canada's Brookfield Asset Management, this worked out to an €18 billion bid.

Cellnex dropped out of the bid in the face of a higher KKR-lead private equity consortium bid of € 20 billion. At the last minute, Brookfield Infrastructure Partners partnered with US based Digital Bridge for the winning bid at € 21 billion. The Private Equity space is drowning in cash and they are evidently overpaying for assets. There is more on the looming disaster of the Private Equity industry in the next section.

Cellnex has € 9 billion cash available for other M&A. Revenue growth over the next decade is a predictable high single digit annually. High cash flow will allow deleveraging from 6.9 x today to less than 2 x by 2030. Alternatively, leverage could be only partially reduced allowing for €15 billion in dividends out to 2030.

There are secular tailwinds that provide more growth possibilities for Cellnex. These include anticipated organic mobile data usage increases of 4% annually; higher frequency, shorter wavelength 5G waves requiring more towers to cover the same

area; and rural coverage legislation in several countries. Thus, the future for tower owners looks more lucrative than a static look at the present would indicate. Current share pricing does not fully consider these trends.

Cellnex's stock trades in Madrid with a market cap of € 29 billion. The most appropriate valuation method is a discounted cash flow method preferred to a PE measure due to high depreciation/amortization expenses depressing earnings. In this regard, the stock trades at 16.8 x 2023 Recurring Levered Free Cash Flow (includes interest and debt repayment expenses.)

We own the stock.

Ask Brian about Private Equity

Dear Brian

With the troubles in the stock market, why not turn to the private equity market? I hear the returns are better and they are far less volatile.

Regards,
Larry

Dear Larry

In Homer's Odyssey, the protagonist Ulysses heeds the advice of the goddess Circe to be lashed to the boat's mast so that he can enjoy the songs of the Sirens on the island without being drawn to his death by the monsters that they are. Consider this answer your lash to the mast.

The private equity claims on offer are seductive. Who wouldn't want those investments?

Private equity encompasses a spectrum of risk and reward from high to low. The public equity markets are the same but would, for the most part, exclude the high-risk segment of private equity that includes seed and mezzanine financing for venture stage companies. The failure rate at this end of the spectrum is very high. Usually on offer to Canadian investors are investments in mid to large cap companies that are not public. These companies would typically be outside Canada since the market here is not large.

What is the operational difference between similarly sized companies in the same industry, one public and the other private? The answer is nothing. As a result, the profitability of each would be the same save for the compliance drag of a public listing. The claim for lower volatility of returns is bogus. Both companies are subject to the same macro and micro forces and would respond in the same way. If one were to compare returns to investors over the term of the investment, pre fees, they would be the same. The public market measures the returns daily. Private markets may do an appraisal occasionally but the true value, theoretically, is only available on sale. The private equity route demands higher payments to managers with all sorts of charges that can be substantial. In addition, there is the illiquidity. Any other security offers a premium for illiquidity

and arguably private equity returns should consider this as an imbedded cost. Another issue with private equity is their method of reporting returns which is an IRR (internal rate of return). This methodology can be manipulated to shine the best light on the manager's "prowess."

How are private equity investments exited so that everything winds up and the General Partner takes their last fee in the fee parade? It used to be wholly via a sale in the public market. However, that is expensive, bothersome, and public markets are not always receptive, like now, to new issues. From a business point of view for the General Partner, it is not very efficient. It would be far better to have more certainty for exit timing. Thus, was born the practice of PE firms selling to other PE firms which is much simpler. This can be done many times at higher valuations with Fee Parades occurring with each new owner. Anecdotally, I have personally heard of this occurring in the Toronto area which involved a well-known company being bounced around other well known PE firms at higher prices. Information from an inside source revealed that the PE firms added ZERO operational or strategic value through their ownership.

In recent years the PE industry has further refined and optimized its business model. It is an alarming development involving sell-to-yourself. Today most PE firms have developed secondary funds within their organization to which the original fund sells their investment at the new higher price. This news was reported last month in the *Financial Times* by Helen Thomas. Participants in the new fund are the same original investors, sovereign funds and funds operating in the secondary market where original LPs are traded. The secondary market was originally dismissed by the PE industry but has now been co-opted to enable their optimized business model. This new area now constitutes over 50% of the market for Primary fund exits. The PE organizations are headed by clever people and they have an elaborate story justifying the development but, at its heart, it is a failure of the original model to deliver to investors what the Offering Memorandum documents promised.

This is a story of smart people who have a ton of new money flooding into them and trying to make the most money possible for themselves by exploiting regulatory holes. A reckoning is out there.

Thanks, but I'll choose public equities every day.

Sources: Financial Times, New York Times, Washington Post, BMO Capital Markets, RBC Capital Markets, J.P. Morgan, Barron's, Wall Street Journal, The Globe & Mail, National Post, Morningstar, Bloomberg, Cellnex Telecom

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