The Miatello Quarterly

April 2024

BMO Nesbitt Burns

Let's connect

Miatello Investment Management
BMO Nesbitt Burns

Brian Miatello, CFA
Senior Portfolio Manager

1 First Canadian Place
39th Floor
Toronto, Ontario
MSX 1H3

Tel: 416-359-5793
brian.miatello@nbpcd.ca

www.miatello.ca

Market Rampage

Mid-October 2023 was a sad time in the investment world. The returns for the year at that time were negative for both equities and bonds. After a very disappointing 2022, it was hard to take. And then, magic happened via the US Federal Reserve when Chair Powell pivoted his inflation outlook positive. Since the low on October 27th, global markets have advanced about 25 percent as did our portfolios to March 31st. The global MSCI index returned 7.7% in the first quarter, the best in five years. Investors were buoyed by hopes for no recession and AI enthusiasm.

An old market saying is that a bull market climbs a mountain of worry. We have just had another example. Positive equity market periods are time-duration concentrated affairs. Markets are stagnant most of the time. If you step out of the room, you may miss the main course.

Now what? A period of consolidation would be reasonable consisting of downwards to sideways action. Indeed, early April results are weak because of a strong economy that caused the Fed to say that rates will be "higher for longer." Since multiple expansion drove the advance since last October, not especially earnings growth, we need time for earnings to catch up. This is an entirely normal playbook in market history.

There were notable events in the quarter. The Magnificent 7 became the Fab Four. The four companies Nvidia, Microsoft, Meta, and Amazon, accounted for 47% of the index year to date returns. Exiting the scene were Apple (sales drop), Tesla (slowing EV growth rate), and Alphabet/Google (lagging compared to Microsoft in the AI wars). US market leadership became more diffused with the earlier leaders ceding ground to all the other stocks. This evolution is also not surprising and is entirely normal. It will continue.

In the private equity ("PE") universe, troubles continue. Many funds are approaching maturity and need to be liquidated. Historically, the method was a buyout by a larger player, public or private, or an Initial Public Offering. The impasse is that PE mangers do not like the prices on offer. Prices offered are lower because PE operates in a levered operational environment. With higher rates, the advertised returns do not exist. The forty-year period of low rates is history. PE funds need the high valuations because the imaginary prices were what they in effect promised the fund subscribers. Now they could just settle for less but that would imperil sales of their newly launched funds. The whole edifice could be severely damaged. There is evidence that the ecosystem is deteriorating. One of the largest global operators, Tiger Global, recently closed its latest VC fund 64% below its target of $6.6 billion. Globally in 2023 there were $112 billion of PE transactions in the secondary market, 99% of which sold at discounts averaging 9%. The PE industry has devised a solution to the maturity problem which is to introduce a new round of investors via vehicles called Continuation Funds. Presumably, they would pay the posted net asset value to the exiting subscribers. Should you be offered anything of that description, I would suggest you run.

If you missed Nvidia and the whole AI theme, do not fret. You may have heard of Amara's Law, coined by the late futurist Roy Amara. Amara said that analysts overestimate the impact of technologies in the short term and underestimate them in the long term. This has proven to be true as experts missed 10 year-forward market sizes by 40% for the internet, the cloud, smartphones, and PCs. Artificial Intelligence will be the most transformative technology unleashed in generations and in this case, I expect the errors will be multiples of 40%. We have barely taken the first step. Productivity improvements will be across industries. The best way to profit is to be owners of a global variety of companies. That is what we do.

In the Spotlight: Amadeus IT Group SA

Booking a trip with Air Canada? You will be using the software system platform Amadeus Altéa. The same system is in use with over 400 airlines around the world. Amadeus provides software solutions for the travel and tourism industries globally. It is dominant, with greater than 40% market share in both GDS (Global Distribution Systems) and PSS (Passenger Services Systems) for airlines. Madrid Spain headquartered with offices in 190 countries and 18 thousand employees, 2024 revenue is expected to be €6.05 billion. This number should produce Adj. EBITA of €2.3 billion, Adj. EPS of €2.83 and Free Cash Flow of €1.224 billion. Market cap is €25.8 billion.

The purpose of the company is to make the travel experience better for everyone by offering more information, choice and autonomy. Amadeus is at the centre of travel, linking travel providers and travel sellers. The providers include 184 airport operators, 105 tour operators, over 1 million hotel properties, 137 ground handlers. 25+ rail operators, 30 cruise and ferry lines, 400+ airlines, 41 mobility providers, 22 insurance provider groups, and 41 destination management organizations. Travel sellers include physical and online travel agencies, management companies, tour operators, meta search and media players.

Amadeus offers innovative technology solutions that help its customers succeed. This is continuously possible as over €1 billion annually is invested in R&D. Travel providers are helped to package and deliver content across direct and indirect (travel agency) channels and provide sellers access to a massive range of global travel. In recent years Amadeus has made significant advances in the hotel space. In 2018, Amadeus obtained the hotel chain IHG as a client and co-developer of the Amadeus Central Reservation System (ACRS). In 2021, Marriott hotels contracted for ACRS, ditching its own proprietary system. These hotels are two of the three largest global hotel chains. The win confirmed the company's decision to push in this direction. The ACRS was built to help and promote attribute-based selling by offering differentiated personalized offerings generating incremental hotel revenues. It is based on cloud architecture that is now moving to Microsoft Azure. As the metaverse evolves, Amadeus will incorporate these features into its software so travellers can inspect the hotel room before leaving home. It is estimated that the total addressable market for hotel IT is €7 billion, and Amadeus should be able to take a 25% share.

Passenger volumes in 2024 are expected to hit 104% of 2019 levels and thereafter grow ~9% annually. Growth rates will be geographically disparate with Asia-Pacific much higher than average and North America much lower. Competitors include Sabre and Oracle. I would discount Sabre as it seems a candidate for bankruptcy while Oracle is a more substantial threat. There is also disintermediation risk where airlines and hotel chains develop their own systems. In the long term I would discount this possibility as it would be uneconomic compared to hiring Amadeus.

We started buying the company in March 2022 and have selectively added since. Our cost price is a PE multiple of 18.6/16.4 times consensus 2024/2025 earnings per share estimates.

Ask Brian about MQ Stock Picks

Dear Brian:

In every one of your newsletters, you write about one company in your portfolio. Could I construct my own portfolio by buying the same hot stocks as you? A side benefit would be not paying you a fee.
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Best
George

Dear George:

Have you ever looked at the night sky with a telescope fixed in position? The telescope offers you an enhanced view of the object in your focal range. You think of visiting the place. Is that a promising idea? What about everything else out there? What star cluster and in what galaxy does it belong? What about the dark matter and dark energy that make up 95 percent of the universe? We say "dark" because it is invisible. Danger exists but is, thus far, unknowable. There literally is a universe of interactions possible that could affect the object you view.

Buying a company for a portfolio is quite similar. What we are continuously managing is a company collection that must have coherence, a philosophy, and distinct components. If there is too much of one component, or if too many companies are alike based on the same idea or subject to the same risks, then there is an increased risk of your portfolio blowing apart. Risks are what I manage.

Thirty four percent of the portfolio weight is in companies whose shares trade outside of North America. That includes Amadeus discussed above. For these securities, there is no trading in North America aside from non-sponsored American Depository Receipts that are non-qualified for registered accounts and suspect for taxable accounts. For retail accounts, many dealers cannot execute trades in Paris, London, Madrid, or Tokyo. We have arrangements to do so.

The securities are not “hot stocks.” Many portfolio companies have challenging circumstances that have depressed the stock price. In some cases, a new CEO has been brought in to set a new course, but it will take time. As we know, the market is not patient and thus there is opportunity to buy a company in transformation at bargain prices. The average hold period for the stocks in our portfolio is currently running at 2.7 years.

There is no pattern as to when in the hold period the companies appear in the MQ. It may be quite a while after the purchases.

In summary, cherry picking my stock ideas exposes you to several risks including the addition of a component that is a mismatch with your goals, timing of entry and exit, sizing of position, high positive correlation with other of your positions and, of course, inability to buy the security.

Interesting thought George, but it will not work well.

Regards,
Brian

Sources: Financial Times, BMO Capital Markets, RBC Capital Markets, Scotia Capital Inc., J.P. Morgan, Barron's, Wall Street Journal, The Globe & Mail, National Post, Morningstar, Bloomberg, Amadeus IT Group