barrage capital

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2024 Semi-Annual Letter

Barrage Fund

Management report

For the period of January 1st to June 28th 2024, the S&P/TSX index posted a return of 5.92% (including dividends) while the S&P 500 generated a return of 19.63% (in Canadian dollars and including dividends). The return of the Barrage Fund for the same period was 33.56% before fees and 26.44% after fees.

Market commentary

We are seeing more and more interesting stocks. Without having officially fallen into recession, the American and Canadian economies as well as other regions of the world are showing signs of weakness, which has partly contributed to significant declines in the shares of several companies. For example, the yoga clothing retailer Lululemon saw its stock drop from a high of $511 to $233. The stock of cosmetics leader Estée Lauder fell from $368 to $91. Specialty retailer Five Below share price reached $66, from its peak of $215. These are just a few examples.

However, when we make our security selection decisions, the past price does not matter. We are always forward looking. Several of our stocks, be it Meta, Amazon or Alphabet, pass our evaluation test better than most other stocks, despite the decline in several of the latter.

It is certainly tempting to conclude that given their size, these companies offer few growth prospects. For example, Amazon now has a stock market value of US$1.9 trillion, and has generated a compound return of 26% per year over 20 years! Doesn't every good thing come to an end? Yet in their results we see revenues that continue to impress us, and artificial intelligence will likely help them reach new heights for some time to come.

Let's look at the other side. Buffett's partner, Charlie Munger, who died last year, used to say:

"All I want to know is where I'm going to die, so I'll never go there!"

Let's take these 5 companies: Alphabet, Meta, Microsoft, Amazon and Apple. An average increase of 12% in their revenue alone would translate into more than US$200B.

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This is indeed "new" revenue. However, if these companies perform so well, it is because they are gaining market share in different sectors. Even taking into account inflation and population growth, we can assume that this US$200B will cost other companies opportunities.

Refusing to invest in these companies under the pretext that their size constitutes too great a barrier to their potential can lead to the selection of companies which will suffer from their domination. We certainly cannot always know which ones will necessarily be affected, however, by eliminating the least interesting companies one by one, we end up with those that we hold in our portfolio. Pulling out the flowers rather than the weeds on the grounds that they are too pretty won't result in a beautiful garden.

Some of these companies have become so dominant that regulators could prove their biggest obstacle. Alphabet is currently facing threats to break up its divisions by the United States Department of Justice. However, this type of scenario could favour shareholders in the short to medium term. In the 1930s, Standard Oil was divided into 34 companies, greatly enriching its founder, John D. Rockefeller. In the 1980s, the separation of AT&T into 8 companies also proved beneficial in the long term!

Note, however, that recent stock market variations have started to create opportunities, and we hold new positions in our portfolio! In the following text, we discuss one of them in a little more detail.

Results of our companies

Introduction to Starbucks

We have 3 new stocks in our portfolio, including Starbucks. When it began in 1971, this company sold coffee beans and certain equipment, as the founders intended. It was not a destination where people could relax and drink coffee. This initiative came from their head of marketing, Howard Schultz, who greatly contributed to the brand's popularity in the 1980s.

In the 1990s, Starbucks positioned itself as the "third place." After visiting espresso bars in Milan, Italy, Howard Schultz wanted to recreate the atmosphere: a comfortable and pleasant place where people would want to spend time. The third place therefore constitutes a location, between home and work, to socialize, build relationships and relax in upholstered seats. In 1995, Schultz found that America lacked this kind of space among retailers and restaurants. There was nowhere to go. So he replicated this model almost everywhere, with the number of stores reaching 30,000 units in 2019.

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The atmosphere was really special. The employees who prepared the coffee were called baristas, and wrote the customers' first names by hand on their containers. This way of doing things brought employees and customers closer together. It was something that didn't really exist in other chains.

After some success, however, new strategies are sometimes attempted to boost sales growth, in the hope of continuing the magnificent momentum. With the digital age in full swing, it was hard to resist the temptation to deviate from the original mission.

Third "digital" place

A few years ago, when Schultz retired from the company, management set out on a mission to increase efficiency for large volumes. They turned to studying data, and then investing in online orders as well as drive-thru orders. They started referring to a "digital" relationship with the customer.

As for the restaurants, upholstered seats were replaced with hard wooden benches. For several locations, customer names were no longer written by hand on the cups: a machine could do the job well. They even designed several restaurants where seating was eliminated, since they simply wanted a place to receive orders, and see the customer leave quickly afterwards.

The recently fired CEO, Laxman Narasimhan, had even previously declared that the famous "third place" now had a broader definition. Initially, it referred to a place to meet people, but this was no longer appropriate in today's context. So rather than trying to keep customers in the establishment as long as possible, Starbucks preferred to speed up turnover and prioritize sales volume. In the United States, cell phone and drive-thru sales penetration reached 70% in company-owned stores.

In conclusion, the company's mission had changed and the service offered had become a commodity. In such a context, it positioned itself on the same level as the competition. Paying more for a latte without the unique atmosphere that Starbucks had is a less attractive proposition for customers.

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Source: Tikr.com

The recent results have sounded the alarm. Comparable transactions in North America declined 6% in the quarter ended June 30. The company continued to open new branches, particularly in China where it aims for sustained growth. Despite this, revenues barely increased, and operating profits declined for the company as a whole.

Howard Schultz, although no longer active within the company, spoke publicly through an open letter. He argued that the answer lay not in the data, but in the stores. He wanted a return to emphasis on the customer experience. Subsequently, we have just witnessed a significant change in management. Brian Niccol, who had been at the helm of Chipotle since 2018, was hired to revive Starbucks. Niccol is recognized for his success with the Mexican food chain, where he had to deal with the E. coli outbreak scandal. Since his arrival, Chipotle's sales have more than doubled.

We started acquiring shares of Starbucks in April. Although short-term results were deteriorating, we had the opportunity to begin an investment in this great company while the stock was trading at around 20 times earnings. Following the announcement of Niccol's arrival, shares quickly rose nearly 25% in a single day. Will this change in leadership be enough to get the company back on track?

It’s not just the results in America that have suffered. In the international division, which notably includes China, there was a drop in comparable sales of 7%. Competition is very high in this country. Its big Chinese rival, Luckin Coffee, saw its comparable sales fall by 21%. At the same time last year, they were “growing” by the same percentage! Clearly, we are seeing some slowdown in this division.

What happens internationally should be temporary. However, the problem plaguing the United States stems more from Starbucks' past strategy, and we believe new management will take the necessary steps to address it.

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Allied Properties

Interest rates have started to fall in Canada, with two cuts of 25 basis points in the last three months. However, REITs have not necessarily reacted to the news. As Allied Properties' stock has remained essentially at the same price for several months, it still generates a dividend yield of above 10%. However, when interest rates fall, the returns on REITs become more attractive.

As for the occupancy rate, it remains stable at 87%. Note that in the first quarter of 2022, when the stock was trading between 2x and 3x the current price, the occupancy rate was 89%, only 2% higher. As for the payout ratio, although it has increased recently, management is reassuring. They anticipate an improvement in their operations, and therefore believe the distribution can be maintained without future issues.

Meta and Alphabet

It was once again a very good quarter for Meta, which has almost 3.3 billion daily active users. Compared to the same quarter last year, earnings per share increased by 73% and revenue grew by 22% (23% in constant currency).

Although 2023 turned out to be "the year of efficiency," Mark Zuckerberg increased investments in Reality Labs, which will amount to approximately US$40B for 2024. Thanks to this division, they can work on a set of projects, such as the development of their own artificial intelligence *Meta AI*.

"*Meta AI is on track to achieve our goal of becoming the most used AI assistant by the end of the year."* - Mark Zuckerberg, CEO

With this AI, Meta not only offers new tools to its users, which compete with ChatGPT, but the company also introduced it into its various platforms. This makes it possible to increase user retention through better content recommendations, or to make advertisements more profitable by placing them in the right place at the right time.

You may have heard of another Reality Labs project, Meta Smart Glasses, in partnership with Ray-Ban. These glasses allow you to capture photos and videos, take calls, listen to music and above all, interact with the real world. For example, you can ask questions to obtain information about what you observe. Guess what's behind those lenses…*Meta AI*!

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In one way or another, Reality Labs' different projects can complement each other. Here, data collected online allows artificial intelligence to better understand and better describe the real world through glasses. Reality Labs is therefore not banking on a single large project, but rather carrying out multiple projects that will allow the company to seize new business opportunities.

At Alphabet, revenues increased 14% year-over-year (15% in constant currency) and earnings per share increased 31%. Google Cloud grew 29% and operating margins improved significantly, from 4.9% in the 2nd quarter of 2023 to 11.3% for the quarter ending June 30, 2024.

Microsoft and Amazon

In the last quarter, Microsoft's revenues grew by 15% and profits by 10%. The growth of Azure and the cloud division continues, with a 29% increase compared to the same quarter last year.

For Amazon, revenues increased by 10% and AWS grew by 19%. The operating margins of the cloud division division greatly improved last quarter, with margins of 35% compared to 24% last year. AWS maintains its dominant position in the cloud computing market.

Netflix and Spotify

On Spotify's side, the number of monthly active users grew by 14% compared to last year. Operating margins stood at 7%, a record level for the company.

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USER & FINANCIAL SUMMARY	Q2 2023	Q1 2024	Q2 2024	Y/Y	Q/Q
USERS (M)					
Total Monthly Active Users ("MAUs")	551	615	626	14%	2%
Premium Subscribers	220	239	246	12%	3%
Ad-Supported MAUs	343	388	393	15%	1%
FINANCIALS (€M)					
Premium	2,773	3,247	3,351	21%	3%
Ad-Supported	404	389	456	13%	17%
Total Revenue	**3,177**	**3,636**	**3,807**	**20%**	**5%**
Gross Profit	766	1,004	1,112	45%	11%
Gross Margin	**24.1%**	**27.6%**	**29.2%**	**--**	**--**
Operating (Loss)/Income	**(247)**	**168**	**266**	**--**	**--**
Operating Margin	(7.8%)	4.6%	7.0%	--	--
Net Cash Flows From Operating Activities	13	211	492	--	--
Free Cash Flow*	**9**	**207**	**490**	**--**	**--**

Source: Spotify Shareholder Presentation, Q2 2024

Spotify's innovations, such as audiobooks, AI-augmented playlists and video podcasts, not only enable better customer retention, but also improve profitability.

"We keep on innovating and showing that we aren't just a great product, but increasingly also a great business. We are doing so on a timeline that has exceeded even our own expectations." - Daniel Ek, CEO

These good results are reflected in the stock price, which is up 79% since the start of the year.

Netflix saw excellent revenue growth last quarter, an increase of 16.8% year-over-year (or 22% excluding currency effects). This growth can be attributed to the 16.5% increase in the number of subscribers to the service over the past year.

In their latest shareholder letter, Netflix shared research from Nielsen's The Gauge:

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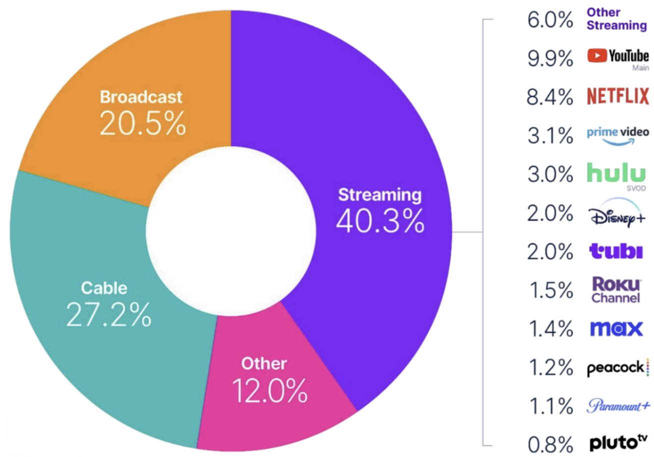
Nielsen's The Gauge: Share of US TV Screen Time (Total Day - Persons 2+, June 2024)



For June 2024, online streaming services accounted for 40% of total television viewing time in the United States. YouTube and Netflix were the two players that dominated this category.

" *The challenge for so many of our competitors is that while they are investing heavily in premium content, it's generating relatively small viewing on their streaming services..*" - Netflix Letter to shareholders (Q2 2024)

Thanks to its strong lead in the category, Netflix is now starting to diversify through different services, such as advertising, video games and live events. This represents other growth levers and makes it possible to reduce churn by offering more services to its subscribers.

Sincerely,

Patrick Thénière

Rémy Morel

Mathieu Beaudry

Maxime Lauzière

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