

Electric Vehicles

A Sight for Sore Eyes



EXECUTIVE SUMMARY

The slowdown in EV penetration and increased competitiveness from state subsidies in China has thrown the OEM auto industry into disarray. Penetration levels have dropped below estimates implying many Western government targets will be missed.

Auto manufacturers are having to reevaluate production plans, the level of investment behind EVs and capital spending at a time when there are fears of a wider consumer slowdown. This has drawn the ire of governments who realise they may not meet their decarbonisation plans and fear job losses along with the resulting political fall-out.

At Latitude we have favoured the wider auto complex, having owned the used aftermarket car part provider AutoZone since inception of the fund. We see the defensive growth characteristics at companies like Alimentation Couche Tarde or Casey's as more attractive than the OEMs or other highly priced distributor companies that are either wrought with uncertainty over the future of EVs or priced for perfection.

PEDESTRIAN RETURNS FROM CAR COMPANIES

2024 | EVs

For the past five years, since Tesla became one of the largest companies in the world, electric vehicles ("EV"s) and the broader energy transition have put the overall auto market in a state of uncertainty not seen since the great financial crisis, when the entire U.S. automobile industry was on the brink of bankruptcy.

Latitude has so far shied away from investing in automakers despite their very low valuations, as the industry, with some exceptions, has usually been a difficult one to predict and one known to be both highly cyclical and highly capital intensive, always investing behind new technologies with uncertain financial outcomes just to stay alive. In fact, as Elon Musk rightly said, in the U.S. all automakers outside of Ford and Tesla have gone bankrupt at least once and while in Europe and Asia the situation has been better, total returns for the stocks in the industry have been relatively pedestrian.

With policymakers fully behind the EV transition and Tesla emerging as a disruptive force to the industry, at Latitude we observed the enormous supply-side response from the incumbents and maintained our position of not investing in Auto OEMs.

That said, the fund has a long-held position in the U.S. car aftermarket retailer AutoZone. Stocks in this sector have, despite excellent earnings growth potential, persistently traded at a discount to the S&P 500 *precisely because* of the eventual threat of EVs becoming the predominant mode of transport. We believe fundamentals (sales and penetration) of electric vehicles could be peaking for the time being and targets set for internal combustion engine ("ICE") cars to be retired in the mid-2030s could be extended substantially making the broader auto ecosystem (petrol stations, aftermarket, used cars and new cars) look both cheap and very investable. Therefore, there is also a possibility that the valuation gap with other quality sectors will be closed generating strong total returns for shareholders.

In order to prove the argument, it is necessary to look at three sets of data and combine them with recent events:

1. SLOWING PENETRATION

EVs initial penetration was very strong driven by a) novelty effect, b) Tesla miraculously getting through production challenges to release their premium, but mass-market vehicle (the Model 3), c) significant subsidies in both European and U.S. markets.

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As the initial phase of penetration has already happened (mostly at the premium end of the market) increasing penetration from here will require mass market models at the low-end. This is a difficult feat to achieve for a variety of reasons both economic, and technical. On the economic side:

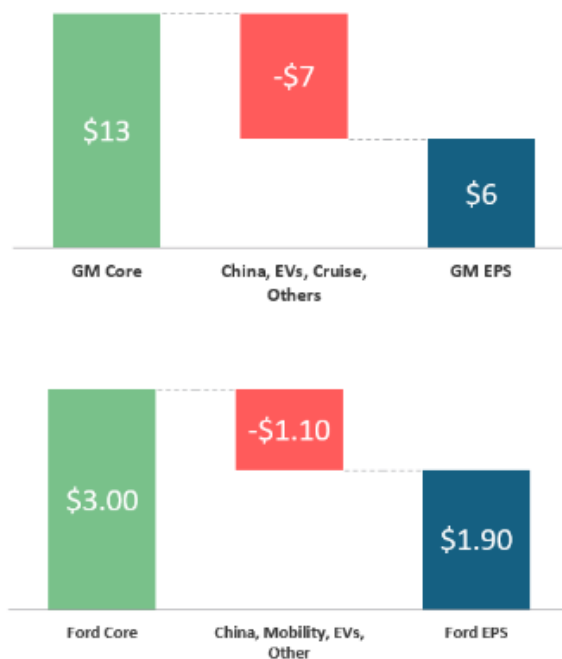
a) companies that usually do produce cheaper vehicles have been sceptical of EVs and opted for hybrid strategies (mostly Toyota and Stellantis) and the strategy is working with record profits, so there doesn't seem to be an incentive to disrupt the status quo at the low end of the market.

b) Tesla's profits are eroding, and the company doesn't have ICE profits to rely upon in order to fund very expensive production of mass market (< \$25,000) EVs (a Model 2).

c) US players GM and Ford are making record profits in the ICE division but losing record amounts in EVs and it seems just a matter of time before some activist investor gets involved and asks for capital efficiency to be re-established.

"A category killer product is one that usually doesn't require government subsidies to work and whose adoption is exponential following an S-curve. EVs do not seem to fit that description"

Exhibit 1 | ICE Profits Funding EV Losses



SOURCE: Morgan Stanley Research

On the more physical side of things, the battery is the most expensive component in an EV and simply the size doesn't scale down as much as a combustion engine, making EVs fairly regressive. That is, at the high-end it is almost indifferent to buy an ICE vs an EV, while at the low-end we are looking at almost twice the price.

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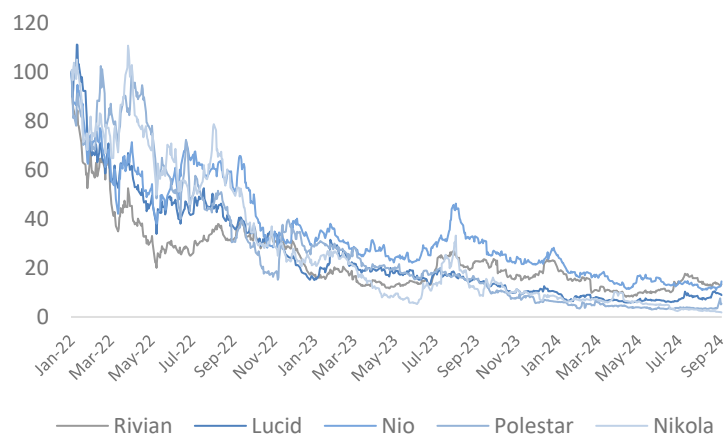
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2. EV COMPANIES ARE NOT IN GOOD FINANCIAL SHAPE AND ICE COMPANIES HAVE DIFFERENT PRIORITIES

Other EV companies that launched in 2020 are slowly going bankrupt and don't have the scale to increase production and drive penetration. On the flip side the share price successes of Toyota and Stellantis are likely to breed some imitation from competitors over time slowing down penetration even more.

Exhibit 2 | 2022 marked peak exuberance for the EV Sector

"The stock market appears to no longer be willing to provide funding for speculative EV ventures"



Without much innovation at the low-end, the other way to increase penetration of EVs is to import them.

Chinese EVs are materially cheaper as China has both a much lower cost of labour vs the rest of the developed world and a shorter supply chain as the components going into batteries are all available in the mainland making sourcing less expensive. So, in order to improve penetration of EVs, western governments could simply let free trade happen and Chinese vehicles would likely be adopted given the cheap price point. For some reason, given the recent rhetoric coming out of the U.S. it seems very unlikely.

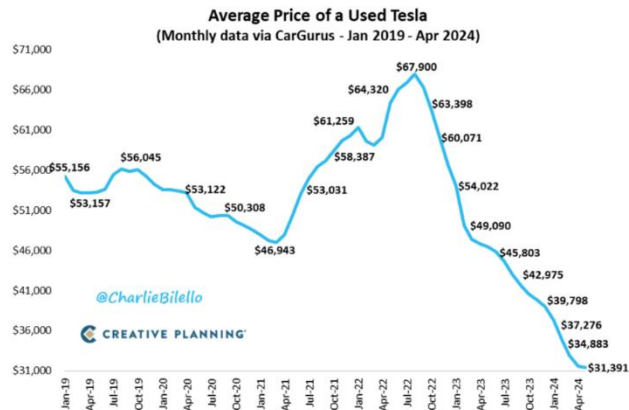
The used car market for EVs is showing **very poor residual values** tempering the initial enthusiasm for new purchases. While almost no one purchases a vehicle expecting it to appreciate (a phenomenon at the luxury end of the market) it is never a good sign that the used car market for a certain type of vehicle goes into free fall. This is happening to EVs right now. A combination of a) price cuts from Tesla, b) oversupply in the market of new vehicles especially on the rental side (aggressive purchasers of EVs in 2021), c) increased financing costs, d) unknown repair costs, e) rapid improvement of battery duration are all pushing down the value of used EVs to all-time lows.

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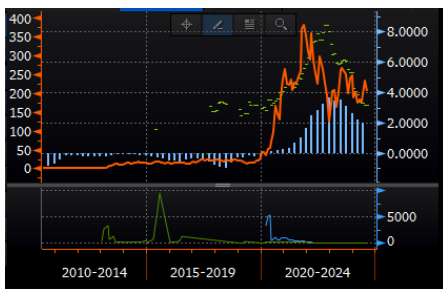
ELECTRIC VEHICLES

Simply put, sooner rather than later the consumer might be looking at buying used EVs rather than purchasing new ones, slowing down the rate of adoption.

Exhibit 3 | Average residual value of a used Tesla



Tesla Inc



3. TARGETS ARE BEING EXTENDED OR CANCELLED

These megatrends are such that a) sales of EVs have now slowed down meaningfully across the world (they are in negative territory in Europe now on a year over year basis) and b) some policymakers and automakers have started to agree on the idea of postponing the deadlines of the mid 2030s for phaseouts of ICE vehicles sales, rebalancing production away from EVs as demand wanes.

Exhibit 4 | Rowing Back– Newspaper headlines from 2024

WASHINGTON, March 20 (Reuters) - The Biden administration on Wednesday slashed its target for U.S. electric vehicle adoption from 67% by 2032 to as little as 35% after industry and autoworker backlash in the political battleground state of Michigan.

Volvo gives up plan to sell only EVs by 2030

Volkswagen warns of electric car sales chaos with 'a year, maybe two' left to adjust to waning demand

Market consensus as exemplified by Markit / S&P Global was seeing c.5m per year EVs and BEVs being sold per annum in the U.S. by 2030, around one third of the anticipated annual production.

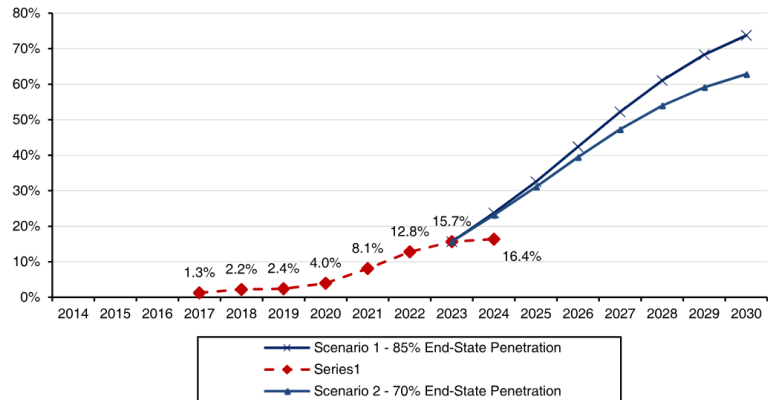
Latitude believes this number will not only be lower, but the cumulative number of EVs on the road could be only 4.5% of the total car park of > 290m vehicles.¹

Exhibit 5 | Penetration of EVs is Already Disappointing

¹ Statista: <https://www.statista.com/statistics/859950/vehicles-in-operation-by-quarter-united-states/>

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EV Penetration defined as BEV + PHEV as % of total passenger vehicles
Source: IHS, Bernstein Global EV Model (Roeska), Bernstein estimates and analysis

WE PREFER THE WIDER AUTO ECOSYSTEM

This has profound implications for certain stocks in the auto ecosystem.

EV centric OEMs outside of China are likely to continue to struggle with the supply demand imbalance, compounded by their weak financial positions and lack of appetite for continued equity financing.

Hybrid ICE / EV business models are likely to increasingly shift production back to the more profitable ICE segments.

Aftermarket retailers like AutoZone and O'Reilly have compounded their earnings per share for decades at c.20% per annum and despite this, they trade in aggregate at a 40% discount compared to similarly high-quality U.S. compounders. Latitude believes these companies to be extremely adaptable and while EVs might have a lower number of components the price of components is a multiple vs ICE, so total industry revenues wouldn't necessarily have to fall even in the case of 100% EVs on the road, a scenario that, as proven above, could take decades to happen or not arrive at all.

In a similar position as AutoZone and O'Reilly lie high quality convenience stores around the world ("petrol stations"). Industry multiples have been penalised in the public markets due to exposure to a terminal EV risk. The reality is a lot more nuanced, with the industry consolidating around companies of scale like Alimentation Couche-Tarde or Casey's. These stores are increasingly growing their offering to include food and quick impulse purchases, with 65% of transactions now independent of fuel.

So far even in countries like Norway, where EV penetration is much higher, the transition has proven beneficial with customers stopping for longer at the convenience store (charging an EV takes far longer than filling a tank) and spending more per trip vs ICE vehicles. The slowly declining nature of volumes (mostly a function of ICE efficiency gains and not EV penetration) is also beneficial to scaled players in the industry, as effectively no new capital is flowing into building new convenience

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stores and petrol stations, leaving existing players with significant pricing power.

Latitude is positive on these older industries and believes that investors, aside from receiving a defensive growth in earnings per share, might also benefit from a multiple re-rating going forward as the EV threat recedes and global quality investors come back to these sectors

Exhibit 6 | Relative Valuations and Relative Performance

<i>AutoZone vs. mid cap quality USA</i>					
<i>PE (x)</i>	<i>'24</i>	<i>'25</i>	<i>EV / EBITDA (x)</i>	<i>'24</i>	<i>'25</i>
AutoZone	19.0x	16.4x	AutoZone	14.2x	12.4x
O'Reilly	25.3x	22.6x	O'Reilly	18.3x	16.4x
Alimentation Couche-Tard	17.5x	15.1x	Alimentation Couche-Tard	10.0x	8.9x
Casey's	25.7x	22.8x	Casey's	13.9x	12.7x
Fastenal	31.5x	28.8x	Fastenal	21.8x	20.0x
Sherwin Williams	33.1x	28.7x	Sherwin Williams	27.2x	19.5x
Watsco	34.0x	30.2x	Watsco	22.4x	19.9x
Tractor Supply	27.1x	24.9x	Tractor Supply	16.4x	15.2x
Cintas	49.4x	44.4x	Cintas	31.4x	28.7x
Average	35.0x	31.4x	Average	23.8x	20.7x
AutoZone disc (%)	(45.7%)	(47.9%)	AutoZone disc (%)	-40.3%	-40.2%

EPS CAGR '07-'24

Fastenal	10.7%
Sherwin Williams	11.8%
Watsco	12.0%
Tractor Supply	18.1%
Cintas	12.1%
Average	12.9%

O'Reilly	23.0%
AutoZone	18.6%
Alimentation Couche-Tard	18.2%
Casey's	15.1%

We have owned AutoZone shares since inception and it has returned 20% annually since then, climbing the wall of worry surrounding EV penetration.

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