

Dear Shareholder,

In our last letter we noted the uncertain political backdrop this year, with elections creating a wide range of outcomes and implications for markets. One which we didn't anticipate was the French National Assembly elections, a surprise which caused a sell-off in French stocks and bonds, and **an opportunity for us to increase our positions, which we took.**

In June two of our stocks, **Vinci** and **Eiffage**, fell as much as 15%, although they have already begun their recoveries. The primary concern was a new government led by the right-wing National Rally who have previously discussed nationalising France's motorway concessions. Of course, quite the opposite has now happened as the left-wing alliance won more seats than anyone, although not a majority, resulting in a hung parliament.

This is another reminder of **our approach to macroeconomic affairs** – predicting outcomes, and subsequent market reactions, has a high failure rate and is something we won't attempt. Preparing for *inevitable surprises* and taking advantage of opportunities as they present themselves has a high success rate. Less "fortune favours the brave", more "fortune favours the prepared".

That said, we do discuss below the risks of nationalisation (and why we believe they are incredibly low) and the upside potential for both companies over the next few years as the durable, non-motorway businesses continue to grow as a percentage of profits and value.

Nationalisation Realisation

Nationalisation involves taking assets that are owned in the private sector and bringing them onto the public balance sheet, which is actually a misnomer in this case where motorway assets were never actually owned by the private sector. The French state own all the "freehold" to the motorways in France, while the *operation* of certain motorways was privatised under concessions in 2006 which have fixed terms.

To save money, the French government decided to delegate responsibility for finance, design, construction, maintenance and operation of the motorways to concession operating businesses. At the end of the concession the control of the motorways reverts to state control, debt free. In other words, if the government does nothing, control will revert to them anyway in around fifteen years.

If a newly galvanised populist government did want to force the issue sooner, they have no realistic options other than to fully compensate the concession owners.

It's not immediately clear that this would be a good use of funds given it is simply a premium for getting control back early, resulting in a loss of billions in annual revenue coming from taxes that the concessionaries pay.

The basic principle is that unilaterally altering the economics of the concession contract (itself a legally binding act of parliament) is not possible without fair compensation to the concessionaire.

Legality & Precedent

There are precedents of similar attempts in Europe to nationalise infrastructure assets and they have shown the difficulty of changing those contracts. In August 2018, Atlantia saw one of their bridges collapse, causing the death of 30 people. Despite a three-year process by various Italian governments to strip the operator of the contract, courts found in favour of Atlantia. If a company that hasn't performed effective maintenance is still legally allowed to retain its concession, it seems likely that Vinci and Eiffage will be afforded similar protection.

Especially given that toll roads in France have proven to be successful at providing well maintained and up-to-date infrastructure to the population, with low tariff hikes. During state control of the operating companies (2000 – 2006), tariffs rose +2.06% per year, compared to the era post the privatisation of the concessions where tariffs rose +1.80%¹ per year.

Moreover, a recently introduced additional tax from the Macron government (equating to 4.6% of revenues until 2030) is being challenged in court. Recently the French supreme court has allowed for hearings and a first decision on September 12th, sooner than expected. If this tax is overturned the possibility of nationalisation decreases further still.

Government Costs

The motorway contract provides clauses² to legally repurchase the concession before expiry if this is in the best interest of the public. The timing is such that the earliest time possible would be a year after a decision is taken which, given the likelihood of deadlock in French parliament, could be three to four years' time. The price to be paid is a function of the net present value of cash flows from the concession until expiry. Under reasonable assumptions the total cost to the government would be c.

¹ https://www.vinci.com/vinci.nsf/en/news-update/pages/understanding_the_debate_around_motorway_concessions_in_france.htm

² Article 38 of the concession contract

EUR 50bn, a prohibitive amount and frankly, at current share prices, a boon to both Vinci and Eiffage (these **payouts representing 41% and 105% of total market cap** today).

That latter point is worth dwelling on – 100% of the value of Eiffage today is represented by the fair value of their motorway assets, which represent far less than half of the total value of the company.

The final economic point is that, once nationalised, the state would likely lose EUR 7bn of annual tax receipts coming from the operators, while having to pay to maintain and expand the roads (with Vinci and Eiffage the most likely to manage that contract).

Finally, 10-20% of the shares are owned by employees, with meaningful blue-collar representation on the register. Any undervalued asset appropriation would be a serious financial hit for workers and cause a major backlash.

The Toll Road Business Model

Both Vinci and Eiffage derive about 30%³ of their value from French motorway concessions, down from about 60% fifteen years ago. Given these assets have fixed lives (i.e. until the concession agreement expires) and the remaining 70% of the businesses are growing strongly, this proportion will mathematically continue to shrink over the next few years.

There are two dynamics in the French toll roads we particularly like – **inflation protection** and **structural growth**.

Tolls on the French motorway network benefit from contracted increases in inflation that amount to 70% of CPI, which becomes increasingly valuable as inflation risks return.

Motorways also offer structural growth as more traffic, both light vehicles and heavy trucks, use the network. France is key to many trade routes in continental Europe and lorries are still a cost-effective way of moving freight. Over time traffic has grown steadily at 2%, and this is before any inflationary increase.

The Other Side of the Road

Both companies generate high levels of organic free cash flow and have shown incredible capital allocation over the past 25 years. Initially, when acquiring the concessions to diversify their civil works businesses and, more recently, their investments in broader infrastructure assets, energy contracting,

³ Latitude Internal Estimates

renewable concessions and construction. These new businesses are performing very well, with record order books and rising margins, supporting strong growth for the foreseeable future.

In effect, the cash flow from concessions have afforded these companies the opportunity to invest in a diverse range of new businesses with wide moats, and far longer duration than the concession assets themselves, resulting in major value creation for shareholders.

Despite this, and due to the political overhang, they trade at the **widest discount to intrinsic value** of the past ten years. Morgan Stanley estimate Vinci's upside to intrinsic value at 50%, and Eiffage's at closer to 80%, similar to our own figures.

Conclusion

Fundamentals are strong, the stocks have never been cheaper, while business mix is improving.

With strong balance sheets and growing dividend yields already approaching 5% (compared to long-term averages of 3%), the outlook for capital returns and capital investment are strong. Exposure to global growth themes such as rising air traffic, the energy transition and the need to replace and improve infrastructure will support growth over the next decade, with very limited competitive threats. We believe the upside potential for shareholders is currently material, and we earn defensive, inflation-linked cash flows while we wait.

As ever, please get in touch with anyone in the team if you have any questions.

Best wishes from all of us at Latitude,



Freddie Lait