

Dear Shareholder,

In 2022 our portfolio of companies fared well which was pleasing to see after a strong year in 2021. Portfolio earnings per share (EPS) were up an *estimated* 12%, and the net asset value (equivalently the price of the fund if you're invested in the UCITS fund) rose 1%. Since inception annualised performance net of fees has been 11.9% compared to 9.6% for global equities.

Year	Latitude Portfolio EPS	Latitude Portfolio NAV / Price
Nov 2016	£4.3	£100
Dec 2016	£4.7	£106
Dec 2017	£5.1	£118
Dec 2018	£6.0	£126
Dec 2019	£7.3	£145
Dec 2020	£7.9	£154
Dec 2021	£11.2	£197
Dec 2022	£12.6*	£198
CAGR	19.4%	11.9%

Source: Latitude

*We report the portfolio level EPS each year, allowing investors to track the underlying growth in value. The figure for the end of 2022 (£12.60) will remain an *estimate* until all the companies have completed their full-year reporting, and we will update you on the actual results once reported. Given over 75% of the results have already been reported, we don't expect the actual results to differ dramatically from this estimate.

Our earnings growth rate since inception has been **19.4%** per year, compared to an estimated **12.5%** per year for global equities. Over the long term price follows value, and we focus our attention on delivering demonstrable value growth (through earnings and cash flow per share) within the portfolio. While we obviously like to see gains in both, we will focus predominantly on building operating earnings within the portfolio, paying less attention to short-term changes in price.

These earnings numbers are unadjusted GAAP figures reported by the companies. In many cases we believe that *underlying* earnings are higher, often substantially, although the transparency and comparability of showing unadjusted figures is likely of more benefit to shareholders. Over time, GAAP earnings should converge to our estimates of underlying earnings.

It's worth stating that GAAP EPS is *one way* to consider the underlying intrinsic value of a business. We always ensure that our portfolio is converting these earnings into actual cash flow, and often consider other financial attributes as superior when analysing *individual* companies. That said, GAAP

EPS is a *reasonable* proxy to allow shareholders to track our performance over time and is the one we intend to show in the future.

Our businesses are, in general, investing for growth so the GAAP figures do not represent *maximal* free cash flow which they can generate today but the *optimal* (in the view of management whose opinion we trust!) amount to balance the rewards of today while protecting the rewards of tomorrow.

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Investing is a decision to swap a *certain* amount of cash today for *uncertain* amounts of cash in the future.

The ambition of any investor should be to maximise the future cash flows from their portfolio, which come in the form of dividends and the future realisable value of your investment. The tension here exists in the balancing of cash flows today, and those further into the future.

In investment jargon, this is the concept of “value” (lots of cash flow today) versus “growth” (less today, more tomorrow). However, these concepts are *not* distinct in our view. The process of maximising future potential is intrinsically linked to the price you pay today. Who wouldn’t want more cash today *and* more cash tomorrow? The concept of a singular focus on *value* or *growth* investing appears illogical to us at Latitude.

A good example is a trade we made this year, selling our holding in **Novo Nordisk** (Novo) and buying into **McKesson**.

We’ve discussed Novo in previous notes, it is the world leader in diabetes treatment and has recently reformulated these drugs to help treat obesity. Over the past twenty years, EPS has grown at a healthy 15% rate per year. This has been driven in large part by a meaningful operating margin expansion, from around 23% to around 43%. This is increasingly attracting the scrutiny of the regulators, particularly in the US.

McKesson has grown EPS similarly at around 15% per year for the past two decades, although this includes a more recent period of margin compression, which we believe could reverse.

Healthcare is the largest component of US GDP, representing 20%, so it’s unsurprising that we would try and find attractive investments in this area. The sector is clearly defensive given its mostly non-discretionary nature and tends to have strong pricing power but has, at times, been impenetrable when analysing regulatory risks and scientific implications of drug pipelines. We exclude a large number of companies in the sector due to this complexity.

The search for simplicity in exposure to US healthcare led us to analyse the US drug distribution businesses.

The industry is an oligopoly with three companies dominating 95% of all drugs distributed from the manufacturers to the pharmacies, hospitals, and doctors of the US. Of these McKesson is the largest with a 40% market share and more than 45% share in faster growing specialty pharmaceuticals. The company has developed the ability to serve each US pharmacy with drugs twice a week through a very

powerful physical network of distribution centres and trucks, which acts as a meaningful competitive advantage.

They are exiting a rather tough decade marked by attempts by Amazon to enter and disrupt the industry, generic drug price deflation hurting their revenue growth, and investigations into their business models due to the “opioid crisis” in the US. All these problems have now been resolved, with a settlement agreed with 49 of the 50 US states on opioids, Amazon giving up the attempt to disrupt the industry due to regulatory and physical barriers to entry, and generic pricing finally stabilising.

This has left these strong, century-old businesses, with well-capitalised balance sheets and high 30% returns on tangible assets available at highly attractive prices. They trade at a valuation significantly below that of the S&P 500, despite a mid-single digit revenue growth profile, with operating leverage back on the cards after a decade of investment and significant share repurchases driving a future growth profile similar to the past at 15% per year.

We invested in Novo in 2020 at a price of around 350 Krona when our estimate for their potential earnings in 2025 was around Kr30 per share. Our outlook has steadily improved to closer to Kr45 per share due to the successful roll out of the drugs in their obesity program, the benefits of inflation, and the rising US Dollar. A 50% pick up in expected earnings demonstrates three points. First, how high-quality businesses can really benefit from periods of heightened uncertainty, second, how important it is to consider a range of outcomes (at the time of our initial investment our upper range was Kr47 and our lower range was Kr25), and third, the importance of measuring upside potential as well as downside risk.

Over the same period the stock has performed very well, rising around 150%, 100% more than the underlying earnings. The stock now offers an earnings yield of around 2.5%. In contrast, McKesson generates a 7% earnings yield.

So, for every £100 invested we could be earning either £2.50 of underlying earnings today from Novo, with expectations for more in the future, or £7 today from McKesson, with similar levels of expectations for growth in the future.

The quality and durability of the franchises are similar. Novo is more concentrated, with margin risk from regulators, while McKesson is more diversified with margin upside as the headwinds mentioned above subside.

We understand that our estimates for future earnings growth for each business contain significant uncertainty, but the margin of safety is sufficient enough to entice us to enhance the earnings power of our portfolio through making the switch.

Finding investments which generate high and growing levels of future cash flow for many years is hard and, once you've found one, it pays to hold on to it.

However, the liquidity offered by public equity markets is a wonderful feature which affords patient investors an opportunity for still higher returns.

We believe this should be the limit of your trading activity. If, and whenever, you see a meaningful opportunity to improve your portfolios likely cash flows, you should be bold, otherwise you should be inert.

Repeat Business

In the pursuit of companies which can compound their returns and earnings durably into the future, we always look for any demonstrable and durable competitive advantages they may enjoy.

Over the past few years, we have been invested in a broad range of consumer companies, with a particular focus on beverage companies (**Coca-Cola, Heineken, and Diageo**).

One key aspect of all these business models is their repeat business of consumable items. This is clear in the case of the beverage companies, which have strong brands and wide appeal across the world. This brand power confers another competitive advantage, namely, pricing power. Over the year these three companies raised prices on average by 15% and have seen limited volume reduction as a result. Over time strong franchises can protect their margins through any inflationary environment, offering index-linked returns to shareholders.

In the case of many mature, defensive businesses it's likely that growth will be reasonably low, as expansion opportunities have been exhausted. We will pay no premium for businesses with very steady but slow growth prospects as, over time, these will not create the value we can achieve elsewhere. As is so often the case in the financial markets, what appears to be "low risk" has an increasing chance of disappointment as time goes by.

So, in the specific cases of the stocks which we do own there are, of course, characteristics of the individual business which we find particularly appealing today.

Coca-Cola has just finished a five-year transition to become a far less capital-intensive business, by divesting the majority of their bottling assets. Alongside this they are simplifying their brand portfolio which, alongside "Coke", consists of twenty-one other brands that generate more than \$1bn of sales each year. They also own 400 smaller brands, which will be slowly cut in half over the years ahead. This allows plenty of scope for the business to have exposure to "the next big thing" while focussing their attention on the core products. Together this is likely to enhance margins and returns on capital,

driving double digit growth on top of the 4% dividend which has been growing steadily at 10% per year for the past fifty years.

Consumer staples are generally perceived as dull and slow growth businesses, with significant pricing power, which tend to provide stable returns when the world turns turbulent. While this reputation has been a hard earned one through centuries of trading through crises (with 2022 proving no exception to that), beverage brands also offer an attractive growth profile, through premiumisation of consumer tastes in the developed world and increased per capita consumption of branded alcoholic beverages in emerging markets.

When century old brands like Don Julio, Guinness or Johnnie Walker are merged with significant barriers to entry in the form of a controlled and oligopolistic distribution infrastructure (most notably the “three-tiered system” in the US) the chances to realise a high single-digit organic growth in revenues and a low double-digit growth in EPS year after year becomes a possibility. Since bars and restaurants reopened in 2021, **Diageo’s** earnings have easily surpassed pre-covid levels by more than 10%, and thanks to savvy reinvestment into brand marketing and solid pricing power, 2023 should be another year of stable progress. This robust operational performance has been coupled with a sensible capital allocation policy. Namely, continued capital returns in the form of increased dividends and buybacks alongside clever and less risky small bolt-on acquisitions. Together, this gives us the confidence that Diageo should be a good investment for years to come, especially with the stock valued at around market multiples.

While growth in consumption of beer is definitely below that of spirits, there are some exceptions, with emerging markets and global premium brands being the best positioned ones to grow at rates in the mid-single digits. With **Heineken** producing most of its operating profits from the eponymous premium brand and from markets with strong dynamics like Asia, Eastern Europe, Africa, and Latin America, it seems that growth should accelerate over the coming years.

While the company has been decisively managed for growth over the past twenty years, Covid has introduced new discipline into the management team, who decided to introduce the first cost cutting exercise in the company’s history. If you combine this with a broader reopening in Asia Pacific, strong pricing power (the result of a highly consolidated industry) and potentially falling input costs over 2023, Heineken should grow its earnings substantially from today’s levels. This, coupled with a below market valuation should make the company a good investment for years to come.

Never Underestimate the US Consumer

Since the financial crisis, consumers (especially in the US) have de-leveraged substantially, allowing for incrementally higher disposable income. Obviously, the recent spike in energy prices and supply-chain bottlenecks have led to this being squeezed but, given the low levels of household leverage and the prospects of higher wages and reasonably strong employment, we expect the consumer to remain in reasonable health over the coming years.

This underlying view supports our exposure to retail stocks. In the US we are invested in **AutoZone**, **Dollar Tree**, and **Advance Auto Parts** and in the UK, we are shareholders in **Tesco**.

Retail has been a very unfashionable sector during the boom in E-commerce over the past decade. The lack of attention paid by investors, distracted by online growth elsewhere, has led to some very attractive valuations.

AutoZone has been a standout performer for the portfolio. Earnings growth has been nearly 20% per year for the past decade (and longer) and this continued in 2022 when the company delivered around 16% growth. The outlook remains strong and the recent investments made in their distribution facilities are paying dividends in the growth rates with their professional customers.

Advance Auto Parts (Advance) has, sadly, delivered less impressive results. The average earnings growth since launch has been closer to 8% per year and they were flat last year for various reasons. Management have blamed their recent changes in supply chain consolidation, which occurred during Covid, for poorer availability of products than their peers. It's clear that a huge amount of change has transpired within the business since the new CEO took over, and sales and gross profit per share are moving rapidly in the right direction. Given the overarching positive industry backdrop, and the dominance in Advance's professional business, we remain shareholders although we are looking vigilantly for signs of cash conversion and earnings inflection to come through.

Not all companies deliver subpar earnings growth while undergoing transition. We have been impressed that *despite* the underperforming Family Dollar business that **Dollar Tree** bought in 2014, the Dollar Tree group has generated 12% pa EPS growth. It is testament to quite how resilient and strong the existing format is, and a guide to the upside in earnings if Family Dollar can recover, similar to its main peer Dollar General. Indeed, the successful CEO at Dollar General has recently taken over as CEO at Dollar Tree, giving further plausibility to this recovery.

Despite all the threats from E-commerce (Amazon) and big box retail (Walmart), thus far it has turned out that low-price fixed-point retail with an exciting assortment has not been disintermediated. The same can be said of **Tesco**, our only UK supermarket holding. We have witnessed the rise of Ocado

and online grocery shopping but, despite the convenience of ordering from your home, many customers still like to go into store to shop.

Not only that, but what many seemed to miss is that even as E-commerce rises, an incumbent like Tesco has one of the best store footprints to serve customers via click and collect and online, without the large fulfilment centre rollout required by competitors, thus requiring lower capital intensity. We like Tesco's focus on the customer proposition, investing in price, Clubcard and store formats.

This seems to be working as their market share metrics have improved and customer satisfaction ratings remain strong. With an 8% free cash flow yield, growing market share and potential for improved margins over the medium term as their, mostly private equity owned, peers continue to suffer, there is strong momentum behind the business. Supermarket retail is a scale game and Tesco is the largest player in town.

Riding the Technology Cycle

While 2020 and 2021 was the best of times for the technology sector, 2022 was the worst of times, marked by rapidly increasing interest rates, slowing demand from the extraordinarily high levels of the previous year, and increased competition.

In this difficult period **Alphabet's** operating performance continued to be remarkable with the company benefitting in its core Google Search advertising business from regulatory changes introduced by Apple against tracking and monitoring customer apps activity. This allowed the company's search engine advertising business to grow 10% in constant currency following 40% growth in 2021. While YouTube's revenue growth slowed substantially due to competition from social media company TikTok, improvements are being implemented that should reignite growth in the coming years. The company's cloud business continued to perform well and has now grown to a scale of \$25bn of annual revenues. The company maintains a fortress balance sheet with \$125bn of net cash and could, for the first time in more than two decades, be implementing productivity measures aimed at cutting the overall \$3bn annual loss in the cloud division and the \$4bn loss in the company's futuristic other bets. While this is likely to remain a difficult environment for most technology companies, Alphabet is likely to perform better than the competition as market share gains coupled with one of the best AI platforms in the world are likely to reignite growth. With the valuation at close to a decade low and a significant capital return programme under way, returns should continue to be satisfactory for the technology giant.

These same dynamics described above were at play for competitor **Meta Platforms**, although the company was more significantly impacted by the changes to privacy implemented by Apple (a \$10bn

revenue headwind) and by competition from TikTok. These problems were compounded by the company's decision to reinvest at least \$10bn per year of its prodigious free cash flow into building the Metaverse, a virtual reality experiment, which is likely to be heavily loss-making for a long time and whose returns are difficult to assess even for a long-term investor. This uncertainty made us decide to sell the shares earlier in the year and invest in equally discounted companies with less uncertainty about the future development of earnings and capital allocation.

Our certainty over management's ability to deploy capital effectively is very different at **Texas Instruments** (Texas). The leading provider of lagging edge analogue chips, this business has generated an impressive 18% annualised EPS growth since 2009. Analogue chips refer to those that turn real world inputs (sound/light etc) into electrical signals. By and large, analogue circuits do not require ever-smaller transistors, saving them from the burden of continuous fixed capital reinvestment cycles (dictated by Moore's law), and the product lifecycle can be long-lived.

The result is that the fabrication equipment used by Texas will often outlast its useful economic life (something that TSMC can only dream of), and cycles in demand can be managed by building inventory that won't obsolesce. Not only that, but the chips themselves tend to be a small part of the end device's bill of materials and customers are fragmented (in Texas' case they have over 100,000 customers), creating a better environment for pricing and margin support.

Texas is currently deploying a significant amount of capital in building out fabs to support an estimated revenue base of \$34bn by the 2030s, compared to about \$20bn today. At the same time, they are expanding production capacity on larger 300mm wafers, creating a structural margin advantage that none of their competitors have at their scale. We like the fact that management think in the same way that we do about our investee companies: long term. The latest round of capex will put some investors off as free cash flow will fall, and margins may dilute in the short term. We see this as Texas merely further expanding their competitive moat and building the manufacturing base to service customer demand for decades to come.

"You build the bridge in old dollars, and when there is inflation, you don't have to keep replacing it — a bridge you build only once." – *Warren Buffett (on his aspiration to own a toll road as a child!)*

When the professional investor is asked what type of quality business they would like to be invested in, the frequent answer ends up being "a toll road" type business. So what better way than to invest directly into physical toll roads and airports? **Vinci** and **Eiffage** are two French, but increasingly global, integrated construction and infrastructure management companies. They own, build, and operate toll roads, airports, rail, and other infrastructure through concessions. The assets managed by both

(French toll roads and airports) are explicitly linked to the CPI / RPI of the countries in which they operate, benefitting directly from increases in inflation. This attractive characteristic is coupled with monopolistic operating margins in the 70% and should make the companies impervious to inflation.

Both companies have existed in a similar form for more than a century and have developed engineering skills that are hard to replicate. This has allowed them to also build greenfield infrastructure at attractive returns, locking out private equity and private infrastructure funds that are more often than not just commoditised suppliers of capital, as opposed to genuine operators. Both companies also generate increasingly large proportions of profits from electricity and energy transition contracting services, an area with high returns on capital, favourable organic growth dynamics and a long-term opportunity to consolidate the market through low-risk bolt-on acquisitions.

While the market might fret about the reinvestment of part of the free cash flow into new areas to prolong or maintain the duration of the concession assets, we take comfort in the history of several decades of prudent and shrewd capital allocation. A swift recovery in air traffic post Covid, inflation indexation and energy transition capex in Europe should provide a backdrop for continued low double-digit earnings and dividend growth, which, starting from a valuation of 10-12x EPS, seems almost too attractive.

As the world emerges from the pandemic it has become increasingly clear that the amount of capital expenditure allocated to industrial production and physical assets has been too low. These depressed investments have created bottlenecks and supply shortages in everything, from energy, to metals to semiconductors. An inevitable uptick in capex for these purposes and for the green transition are likely to follow.

No company is better positioned to benefit from increased industrial and green capex than **Air Liquide**. The company has been in existence for more than 150 years and has been a reliable supplier of industrial and medical gases to its customers since then. The industry is highly and increasingly consolidated, has strong pricing power (as shown by the double-digit price increases in 2023) and has favourable volume dynamics. After a decade or more of capex starvation it seems about time that a new investment cycle will emerge, which should allow Air Liquide to extend its enviable record of double-digit earnings growth into the 2030s.

Banking on the Future

Businesses heavily tied to the rate of economic growth – i.e. cyclical businesses – often produce lower than expected cash flows over a full market cycle. However, those with genuine *structural* growth

prospects, whose business model lends itself to surviving and emerging stronger, can offer fantastic prospective returns. This is especially true if purchased at the bottom of a despair cycle when prices can be well below fair value.

High quality US banks fit this description. **Goldman Sachs**, a stock we've held since 2016, has generated a compound growth in book value per share of 12% over the past twenty years, even growing it through the financial crisis. While the return on equity is indeed cyclical, it cycles around this rapidly growing capital base. A 13% return on capital today represents twice the profits of the same return on capital seven years ago, due to this growth in book value.

We also own **Bank of America** and bought into **JP Morgan** shares for the first time in March 2020 at a price of around \$80. The business was generating \$10 of EPS in 2019 and this year this has risen to \$12. The past ten years have been some of the hardest to navigate for banks out of the last fifty, with increasing regulation, collapsing interest rates, and the growth in private lending, and increasing fintech competition.

The US investment banks have taken meaningful market share from weaker international competitors in Europe and the UK. The level of technology investment which they have made dwarfs that of their failing competitors, reinforcing the moat around their growing businesses. Finally, they have taken great strides to improve the asset quality within their businesses (principally their loans) and it's our view that credit risk is lower than at any time in the past decade.

2021 was an exceptional year for these stocks, but 2022 proved more of a challenge as earnings fell back to a more normal level. What was earned in excess interest income is now being returned, in part, through higher deposit rates paid to customers. This is the same as every interest cycle in the past and likely in the future too, and it has little impact on the future cash generating power of these great franchises.

These businesses offer similar levels of prospective growth in earnings to our overall portfolio, yet trade on dramatically lower valuations due to their short-term cyclicity. While we wouldn't advocate for having an entire portfolio of such stocks, having some *lowers* our risk while enhancing expected returns.

Numbers do a poor job, on their own, of assessing the true quality of a business. If quality implies durability, then numbers can sadly mask increasingly weak competitive advantages – producing higher cash flows today perhaps at the expense of more meaningful future cash flow. Likewise, there are times where consistency of growth and clear evidence of durable returns within a company's financials are ignored due to the sector in which it operates. We believe this to be the case, with many investors

continuing to hold a position they have since the financial crisis of “never investing in banks” despite the solid outlooks.

Old Dog; New Tricks

Over the past decade fixed capital reinvestment rates have been too low, leading to creaking infrastructure and falls in the productive capacity of existing capital stock. The Energy sector is a perfect case study of this phenomenon. Global oil and gas capital expenditure peaked five years ago at around 10% of sales, or \$800bn per year, roughly half of which was attributable to “exploration” while the other half was required to maintain existing assets. At present, the total spend is closer to 5% of sales, or \$500bn which barely covers maintenance, especially given the recent price inflation in capital equipment. A combination of low oil prices and government environmental policies have driven this reduced investment.

For the first time in a century, the industry will not flood the world with new supply. The reinvestment motive isn’t there and, instead, free cash flow is being directed to renewable energy assets and being returned to shareholders through dividends and buybacks.

Even at current oil prices, our two energy companies (**BP** and **Equinor**) are easily generating sufficient cash flow to pay down debt, fund maintenance of their oil and gas assets as well as their renewable business investments, and acquisitions, while returning healthy dividends and excess capital through buybacks. This is where investors can observe a pivotal change in behaviour.

In 2020 when we invested in BP the company had a market capitalisation of \$100bn and net debt of around \$40bn. In 2021 and 2022 they generated a total operating cash flow of \$60bn. Historically the industry has spent 100% of operating cash flow on capex, ultimately using debt to effectively fund dividends, but this cycle appears very different. BP have used this cash flow to fund \$20bn of capital expenditure, reduce their debt by \$20bn, pay \$10bn in dividends, and reduce their share count by 10% through spending \$10bn on buybacks. Proceeds of sales from oil and gas assets have been reinvested into renewable infrastructure assets, accelerating their transition.

GAAP EPS was lower than cash flow in the first quarter due to a write down in the value of their business assets in Russia. This resulted in a non-recurring impact of around £2 to our overall reported portfolio earnings which, *ceteris paribus*, will drive portfolio earnings higher by this amount next year.

The energy sector was the only one to deliver positive returns in 2022, and our stocks were no exception, generating total returns of around 50% each. They enter 2023 with stronger balance sheets, clear priorities, and with undemanding valuations of 6x PE / 17% free cash flow yields; and this

assumes \$80 oil which, despite short-term cyclicity, seems a level which will act more like a floor than a ceiling over the next five years.

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We would like to thank you for your ongoing support and interest in Latitude. We believe that overall, it was a robust year for the portfolio, with around 60% of our stocks contributing positive total returns and strong levels of aggregated earnings growth across the board. As we look ahead to a turbulent world economy, continued over-valuation across large swathes of the financial markets, and rising risks of higher inflation, we believe that our portfolio companies are set to continue to thrive. The diversity of our exposure is an intrinsic strength, as we aren't tethered to the success of a single market environment or any one particular theme. This allows us to benefit from multiple sources of growth, measured over the years and decades ahead, as opposed to constantly changing our portfolio to reflect our outlook.



Freddie Lait

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