

## Patient Pursuit

Freddie Lait and Jacopo Di Nardo of London's Latitude Investment Management describe their emphasis on identifying “durable and knowable” businesses, when cyclical and turnarounds can be particularly interesting, why they caution patience around investing in artificial intelligence, and what they think the market is missing in Vinci, BP and Dollar Tree.

### INVESTOR INSIGHT



**Latitude Investment Management**  
Freddie Lait (l), Jacopo Di Nardo (r)

Latitude Investment Management's Freddie Lait isn't fond of being labeled either a value or a growth investor. “A decision to invest in either ‘value’ or ‘growth’ stocks carries an implicit assumption that value stocks do not grow and that growing companies cannot be cheap,” he says. “This is demonstrably false, and we think is a limiting distinction for an investor to make.”

Labels aside, Lait has delivered for investors since launching his global strategy in 2012 – first at a previous firm and since 2016 at Latitude – earning a net annualized 13.6% return, vs. 11.6% for the FTSE All World index. Among areas in which he's finding opportunity today: infrastructure construction and management, energy and dollar stores.

To start off, generalize about the types of companies and the situations they're in that tend to attract your attention as an investor.

**Freddie Lait:** We're generally looking to invest in a diverse portfolio of businesses with strong and durable growth prospects at the lowest possible price. I know that's hardly revolutionary, but such an approach is difficult to apply in a disciplined way through market cycles. If you can do it, we think it can give you an advantage over time.

Durable businesses to us are those with competitive advantages in growing industries, where the industry structure is attractive and there doesn't appear to be significant potential for disruption. It's difficult to answer analytically if a company can pass the ten-year test – where you expect it to sustainably grow in an organic way and still have substantial growth ahead of it after ten years – but we spend a considerable amount of our research time on that. If we can't credibly know what a business is going to look like in ten years, we shouldn't invest in it.

This focus on durability and knowability around the growth prospects, combined then with valuation discipline, is meant to improve our chances of success. We don't want to own stocks trading on 12x P/Es just because we think they should be trading on 18x. That's satisfying if it works, but if something isn't going to re-rate quickly we still want the potential to make a decent return. Our return over a ten-year period is very likely to come much more from underlying returns on

capital and cash flow that can grow over time than it is from changes in the P/E.

You've cited AutoZone [AZO], which you've owned since becoming a portfolio manager in 2009, as the type of business you find attractive. How does it fit the bill.

**FL:** There are a number of aspects that make AutoZone's business attractive. The auto-supply market grows consistently at 3-5% per year, a function of miles driven, the expansion of the vehicle pool and a bit of inflation. Three companies – AutoZone, O'Reilly Automotive and Advance Auto Parts – are by far the biggest players, but they still have considerable runway to take share from mom-and-pops that don't have the scale to compete on parts availability and service and that still make up 50% of the market. The business model is defensive, with 85% of revenues tied to non-discretionary parts and service.

The market gets nervous from time to time that the increasing sophistication of cars means they'll require less replacement parts and service. More recently, the worry is that electric vehicles will have fewer parts to replace and service. Through all this the company over the time we've owned it has compounded earnings per share at nearly 20% per year. Despite increasing EV sales, the core market of 6- to 12-year-old internal combustion engine cars will grow for at least another 10 years. All in, we think AutoZone can continue to grow earnings per share by 15% per year or better going forward.

It's a bit more expensive today [at the current price of around \$2,600], but the

stock typically trades at around 16-17x earnings. That has been, and we continue to believe still is, an attractive valuation to pay for the growth it can deliver.

**Describe your thought process last year in deciding to sell Novo Nordisk [Copenhagen: NOVO.B] to buy McKesson [MCK].**

**FL:** Healthcare in the U.S. is a sector we generally would find interesting, given its size, secular growth, the non-discretionary nature of demand and the pricing power for its products. That said, it's often impenetrable due to the regulatory risks and the scientific knowledge necessary to examine drug pipelines. We exclude a large number of companies in the sector due to this complexity.

An area we believe we do understand that provides exposure to U.S. healthcare is the drug distribution industry. The three major competitors – McKesson, Cencora [COR] (formerly known as Amerisource-Bergen) and Cardinal Health [CAH] – control 95% of all drugs distributed from manufacturers to pharmacies, hospitals and doctors in the U.S. McKesson is the largest with a 35% market share overall and a 45% share in the faster growing area of specialty pharmaceuticals. As a group, these are competitively advantaged century-old businesses with well-capitalized balance sheets and high-30% returns on tangible assets.

We had followed the business for a long time, particularly in the past decade as Amazon tried to enter and disrupt the industry, as generic drug price deflation hurt revenue growth, and as the companies became embroiled in the opioid crisis. In the end Amazon gave up and generic pricing finally stabilized, but it was only last year that the opioid issues were sufficiently resolved that we were able to establish a position in McKesson. The stock traded at a discount to the market, for a business that had grown EPS at around 15% per year for the past two decades and we believed through revenue growth, operating leverage and share repurchases had a similar growth profile going forward. The shares [recently trading at around \$455] are up

30% or so since we established our stake, but we still believe they're very attractively priced given the durability and knowability of the growth profile.

**Are you kicking yourself for selling Novo Nordisk?**

**Jacopo Di Nardo:** We had owned the stock for a few years, in part over the potential of its anti-obesity medicines Wegovy and Ozempic. Enthusiasm for these drugs obviously went viral and the stock went up rapidly, such that at the time we sold it the shares were trading at around 40x trailing earnings, while McKesson shares traded at maybe 13x. We love both companies, but while Novo Nordisk will certainly grow faster over the next couple of years, the trend in growth rates over time is very similar between the two companies in our models. Novo is up probably 50% since we sold it, so we've missed out in a sense relative to McKesson, but we still believe we're on the right side of the risk/reward asymmetry on the trade.

**You seem rather more willing to invest in cyclical and turnarounds than the average investor focused on business quality. Is that true?**

**FL:** The band of what we'll consider in each is narrow, but we are quite willing to pursue opportunities in companies with higher earnings volatility or where the stocks trade at low multiples of what might be considered normal earnings.

With cyclical we're looking for situations where there is cycle-to-cycle structural growth, where we believe the business is becoming less cyclical, and where we expect the company in question to emerge stronger when it passes through the eye of an inevitable downcycle. Texas Instruments [TXN] in analog semiconductors would be a good example. JPMorgan Chase [JPM] is another.

With turnarounds, we'll very rarely look at stocks that haven't actually delivered historically. One exception to that would be if the entire industry has gone under industrial repair and we expect the



**Freddie Lait**

## Clean Slate

After earning a Mathematics degree from Oxford University, Freddie Lait held analyst and fund management positions at Goldman Sachs, Rothschild & Co. and Odey Asset Management before deciding to go out on his own in 2016 in founding London-based Latitude Investment Management. The impetus was straightforward: to create a firm from the ground up that invested the way he wanted to invest and with a culture he believed enhanced the probability of winning.

As he explains: "The larger firms I've come across in this business have a variety of institutional imperatives around asset raising, short-term performance, benchmark performance and a number of other things that I think rob our industry of its joy, and its success. We had a driving desire to have a culture that fostered independent thought, that allowed us to take the time to think deeply about businesses with a genuinely long-term view, and that allowed us to wait for opportunities to fully present themselves without any fear of missing out. I'd like to believe we've created that type of environment, which has served us well and I think increases our chances of success in the decades to come."

competitive dynamics going forward to be different than they were in the past. That's happened in U.S. railroads. It's happened in the videogame industry and in semiconductors. We own some energy today,

where we believe supply-side constraints will drive a capital cycle of stronger returns for shareholders over the next five to ten years. These types of things don't happen often, but the rewards from identifying them can be quite high.

**Betting on a turnaround at U.K. grocery chain Tesco [TSCO] has been a frustrating experience for many over the past ten years. Why do you think the time is right to do so today?**

**FL:** The company in its day was a Walmart-type success story, but it made an elementary mistake in relaxing its low-price obsession, which gave oxygen to the German discounters Aldi and Lidl, who launched here 20 years ago and now have roughly 15% of the market. Tesco bled market share for years and profitability in what was already a low-margin business wasted away.

You're right that there have been many false starts, but we believe the company has finally fully reset its strategic focus solely on the U.K. and has done a very good job in resetting its cost structure and pricing architecture to re-claim its position of price leadership on par with the German discounters, but with more product choice and breadth. Over the past 18 months we've seen market share gains for the first time in a decade and we believe those are repeatable and can continue. We don't think the market appreciates all that in pricing the stock [at today's share price of around £2.85] with a 10% or so free-cash-flow yield.

**JDN:** We think the industry dynamics are also changing for the better. Big competitors Asda and Morrisons have been taken private and are focused on improving earnings as they struggle under high debt loads. Aldi and Lidl also appear to have concluded that further market share gains will be more difficult and are starting to prioritize profitability over growth. We think that leaves Tesco in a sweet spot in the U.K. food retail capital cycle. Super-market retail is a scale game and Tesco is still the largest player in town.

**How generally would you characterize the investment opportunity set today?**

**FL:** The question for us is how to optimally find the balance between the price you pay today and the growth you are likely to get in the future. One of the greatest and weirdest things about the market at the moment is that people don't seem to care as much about that balance. They want to

## ON ARTIFICIAL INTELLIGENCE:

**We think to profit in a more durable, knowable way we can be more patient than the market makes you feel you can be.**

own what everyone else owns and there still seems to be a hefty premium being ascribed to many of the last cycle's winners.

If you look at the Magnificent Seven or try to put together another Nifty 50 equivalent, we believe that at today's prices if you bought all of them and held them for ten years you would likely significantly underperform the market. They're almost all priced like they're all going to work and only some of them will. These types of stocks are certainly not on our prospect list, but generally I'd say we're finding a lot that's interesting almost anywhere but in the commonly held market favorites.

**How are you thinking about the investment opportunities presented by artificial intelligence?**

**FL:** Our overarching view on this today is that it's a hype cycle as opposed to a game changer that will structurally drive productivity higher across the global economy. If you look back at 100 years of productivity metrics, they have basically oscillated around the mean. And over that period we have invented or commercialized electricity. And phones. And cars. And computers. And pharmaceuticals. All of these were just as transformational and didn't produce step changes in sustainable

productivity improvement. We're not so sure AI will be any different.

From an investment perspective, you could have invested in e-commerce kicking off in 1995 as the hype cycle started, but you would have been better off waiting 15 years and buying Amazon as the clear leader – from there you would have made 30% compounded annually over the next ten years. In the early 2000s you could have taken a flier on various mobile phone companies or just waited until 2007 and bought Apple. With hypergrowth new technologies, so much capital rushes in at the beginning that it's difficult to pick winners and losers. You tend to have a lot of time to wait as the related industries evolve and consolidate around the dominant players. We think to profit in a more durable, knowable way from AI we can be quite a bit more patient than the market makes you feel you can be.

**How does France's Vinci [Paris: DG] fit your profile of a high-quality business trading at an attractive price?**

**JDN:** The company has been around since the late 1800s and today has three primary business lines. It operates almost 40% of the toll roads in France, which accounts for roughly 45% of total operating profit. It's the largest private owner and operator of airports – including Gatwick in London and the entire airport system in Portugal – accounting for 20% of operating profit. Most of the rest is Vinci's historical business of construction contracting, the majority of which today is energy related, but they're also big in building bridges, roads and other non-energy infrastructure.

The toll-road business is a classic safe and steady business, with inflation-linked earnings streams with some upside from capital improvements made to better facilitate things like electric vehicles and just-in-time logistics. The airports business is somewhat similar, with long-lived concessions and upside in this case from being tied to secular growth in air travel.

The more volatile part of the company – creating opportunity in the stock from time to time – is the legacy construction

business. This has been more or less of a drag on the overall business for the last 15 years, when a relatively weak European construction market coupled with a bubble of private capital availability in infrastructure assets meant the market didn't place much value on the type of engineering expertise and long track record of on-time and on-budget project management that Vinci brings to the table, especially in brownfield and greenfield concession development. In an environment with increased construction costs and higher interest rates, we think that gives Vinci a leg up in winning new business around

the world and that there will be a structural improvement in the rates of return it can earn on infrastructure projects and on general contracting business.

We consider the company's culture to be a big positive. Firms like this often go through extended periods where they've taken on too much business at too-low margins, but that hasn't ever really happened with Vinci. It has been managed very much for the benefit of long-term shareholders, with aligned incentive systems and consistently smart capital allocation done in a countercyclical and value-accretive way. Employees own about

10% of the company and some level of ownership goes very deep in the employee base. A recent example of smart capital allocation was the acquisition announced in April of 2021 to buy the energy-related construction business of Spain's ACS for just under €5 billion – a deal done in the middle of the Covid crisis that we believe has materially enhanced the company's earnings power.

**How are you looking at valuation from Vinci's current share price of just over €112?**

**JDN:** While earnings have gone up fairly significantly since we first bought the stock in March 2020, the valuation today remains at about a 15-year low. The P/E on our €9.50 EPS estimate for next year is less than 12x.

Price/Earnings multiples mean less for businesses with concessions that have finite lives, but today's valuation seems too attractive for a company we believe through combined earnings growth and the dividend – the current yield is just under 4% – can generate a low-double-digit to mid-teens annual shareholder return over the next several years. And that assumes little incremental benefit from management's ability to reinvest or return the €5 billion or so in annual free cash flow that's currently being generated. If history is any guide, that should provide real additional upside.

**You mentioned earlier seeing opportunity in the capital cycle relative to energy. Why do you consider BP [BP] a good way to play that?**

**FL:** The reinvestment rates of global energy companies have fallen to a multi-decade low. Annual oil and gas capital spending worldwide peaked five years ago at around 10% of sales, or \$800 billion, roughly half of which was attributable to exploration while the other half was required to maintain existing assets. Today the total spend is closer to 5% of sales, or \$500 billion, which barely covers maintenance given the recent price inflation in

## INVESTMENT SNAPSHOT

### Vinci

(Paris: DG)

**Business:** Global design, construction and management of large-scale infrastructure assets such as toll roads, airports, energy-related facilities and telecom networks.

### Share Information

(@11/29/23, Exchange Rate: \$1 = €0.91):

<b>Price</b>	<b>€112.12</b>
52-Week Range	€91.88 – €112.40
Dividend Yield	3.6%
Market Cap	€64.01 billion

### Financials (TTM):

Revenue	€66.54 billion
Operating Profit Margin	10.1%
Net Profit Margin	6.7%

### Valuation Metrics

(@11/29/23):

	<b>DG</b>	<b>S&amp;P 500</b>
P/E (TTM)	14.3	20.4
Forward P/E (Est.)	13.0	20.4

### Largest Institutional Owners

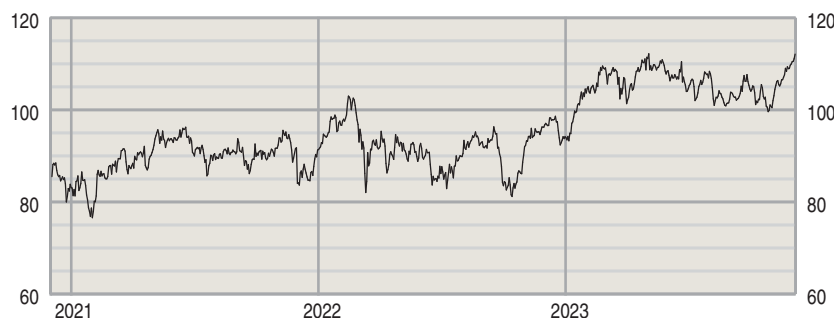
(@9/30/23 or latest filing):

<b>Company</b>	<b>% Owned</b>
BlackRock	5.1%
Qatar Holding	3.4%
Vanguard Group	3.3%
Amundi Asset Mgmt	2.4%
Norges Bank Inv Mgmt	2.1%

### Short Interest (as of 11/15/23):

Shares Short/Float	n/a
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## DG PRICE HISTORY



## THE BOTTOM LINE

While it has rock-solid toll road and airport concession businesses, the company's stock is often influenced by its construction arm, says Jacopo Di Nardo. He thinks that business is structurally improving and a valuation re-rating could add to the otherwise low-double-digit annualized shareholder return he expects to earn from profit growth and the dividend.

Sources: Company reports, other publicly available information



capital equipment. We expect this dramatic change in capital allocation policy to stick because it's highly rational, and is also reinforced by policies of governments and investors alike.

Predicting oil prices is notoriously difficult, but with incremental supply hard to come by, we don't think it's unreasonable to assume the current \$80 or so oil price is more of a floor than ceiling assumption going forward. At that price, big integrated oil companies like BP easily generate sufficient cash flow to pay down debt, fund maintenance capital spending and renewable-energy investments, and still re-

turn healthy dividends and excess capital through buybacks.

Putting numbers on that for BP, when we first invested in it in 2020 – when oil prices were negative, by the way – the company had a market capitalization of \$100 billion and net debt of around \$40 billion. In 2021 and 2022 it generated total operating cash flow of \$60 billion, of which it spent \$20 billion on capex, \$20 billion on debt reduction, \$10 billion on dividends, and \$10 billion to buy back 10% of the outstanding shares. It also sold some non-core oil and gas assets, reinvesting the proceeds into renewable infrastructure assets.

**Did the recently announced resignation of BP's CEO, Bernard Looney, throw a wrench at all in your case for the stock?**

**FL:** It's a shame because we rated Bernard very highly as a clear thinker and a good operator. But he wasn't in the job for that long and we expect the business to continue along its current path and to thrive without him. One positive may be that he leaned particularly strongly into the renewables and green side of things, maybe overstepping in certain areas in spending surplus free cash flow in 2021 and 2022. It might be helpful with respect to investor perception for a new CEO to come in with a relatively clean slate.

**How inexpensive do you consider the shares at the recent U.S. ADR price of just over \$36?**

**FL:** At today's oil prices we estimate that the core upstream and downstream businesses are generating about \$30 billion of annual operating cash flow. After roughly \$15 billion in capex and \$5 billion paid out in dividends, there's \$10 billion in surplus cash flow for reinvestment spending and buybacks. If we assume 60% of that goes to buybacks – a smart investment when the shares trade at a free cash flow yield of about 20% – at today's price you're getting an 11-12% capital return on top of the high free-cash-flow yield and the potential return from investment spending.

The best-in-class U.S. peers trade at about twice the P/E of BP today. Investors appear to like the clarity that companies like ExxonMobil and Chevron give on not spending too much on renewables. But even if you assume BP's renewable assets are worth \$0 – which they aren't – its underlying oil and gas assets still trade at a sharp discount to similar assets of U.S. peers. We don't think that makes sense.

We actually don't want the stock to go up too quickly. We're getting twice the value creation from a BP buyback than an Exxon shareholder would be getting at today's prices. Our message to management is to not worry about anything but

## INVESTMENT SNAPSHOT

### BP Plc

(NYSE ADR: BP)

**Business:** Global integrated energy company focused on developing and delivering "resilient hydrocarbons, convenience and mobility solutions, and low-carbon energy."

### Share Information (@11/29/23):

<b>Price</b>	<b>36.07</b>
52-Week Range	33.14 – 41.38
Dividend Yield	4.1%
Market Cap	\$101.59 billion

### Financials (TTM):

Revenue	\$226.03 billion
Operating Profit Margin	15.4%
Net Profit Margin	11.4%

### Valuation Metrics

(@11/29/23):

	<b>BP</b>	<b>S&amp;P 500</b>
P/E (TTM)	4.0	20.4
Forward P/E (Est.)	6.5	20.4

### Largest Institutional Owners

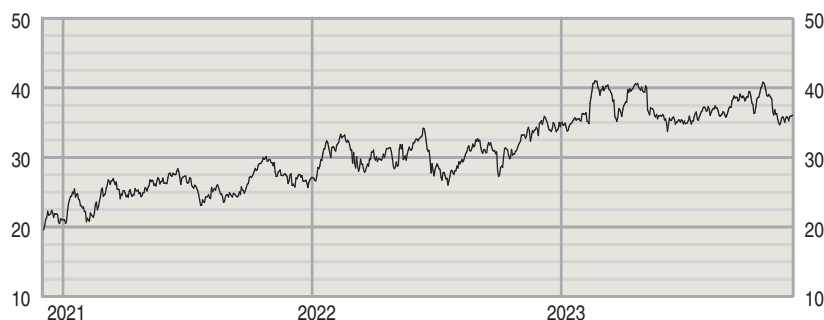
(@9/30/23 or latest filing):

<b>Company</b>	<b>% Owned</b>
BlackRock	9.9%
Vanguard Group	4.9%
Norges Bank Inv Mgmt	4.5%
State Street	2.9%
Capital Research & Mgmt	2.2%

### Short Interest (as of 11/15/23):

Shares Short/Float	0.2%
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### BP PRICE HISTORY



### THE BOTTOM LINE

Assuming as he does that today's oil prices are closer to a floor than ceiling for the next several years, Freddie Lait believes the company's stock today trading at a 20% free-cash flow yield and with potential annual capital return of 11-12% are inexpensive in absolute terms, and also relative to U.S.-based giants like Exxon and Chevron with similar assets.

Sources: Company reports, other publicly available information

making the best value-accretive decisions to protect and grow long-term intrinsic value. The share price will eventually follow and we'll all win.

**You've been a long-time shareholder of U.S. specialty retailer Dollar Tree [DLTR]. Why do you find its shares particularly interesting today?**

**FL:** The narrative for some time around Dollar Tree is that its 2015 acquisition of Family Dollar has been pretty much of a bust and has held the company back. But

even with one leg in a splint they've still been running pretty fast. Since we first bought into it in 2009 the company has grown earnings per share at a fairly consistent 16% per year. We think that's a great testament to the Dollar Tree brand and value proposition.

The long-term thesis here feels very much intact to us. The company still has plenty of opportunity to roll out new Dollar Tree and combined Dollar Tree/Family Dollar stores in counties with between 200,000 and 500,000 inhabitants and where GDP per capital is below the U.S.

average. Management two or three times since we invested has upped their ultimate store-count goal, and while at some point the business runs out of growth in that way, it's way more than five years away. And getting there doesn't seem like such a terrible place to be – at that point this likely becomes an extraordinary cash machine with significant potential to continue to drive intrinsic value growth through share buybacks and dividends.

With Family Dollar the emphasis is more on operational blocking and tackling to improve same-store sales. They're reorganizing the store footprint to better maximize inventory turns and potential margin. They're investing to reduce shrink. They're cross merchandising to put Dollar Tree items in Family Dollar stores. These initiatives as well as the new combined formats have already proven successful in the field and management is rolling them out more broadly in a methodical and organized way.

**How does all this translate into shareholder upside from today's \$121 price?**

**FL:** If we assume consistent top-line growth and 12% operating margins, the Dollar Tree business three years out can produce around \$2.2 billion in operating profit. For Family Dollar the key is that we think it can get back to historical 7%-plus operating margins, which on \$16 billion or so in revenue would translate into more than \$1.1 billion in EBIT. The \$3.3 billion in total operating profit would result in earnings per share of close to \$10.

So the shares today trade at 12x our estimate of earnings three years out. At that point you'd have a business with a strong competitive position, demonstrable top-line growth, and likely still compounding earnings at more than 15% per year. If we're right, we would expect the shares at that point to trade at quite a bit better than 12x earnings.

I understand there's more risk in this because it's more of a turnaround. This stock in general has been volatile over the time we've owned it, with good opportu-

## INVESTMENT SNAPSHOT

### Dollar Tree

(Nasdaq: DLTR)

**Business:** Owner and operator of more than 16,000 general merchandise discount stores in North America operating mostly under the Dollar Tree and Family Dollar brand names.

### Share Information (@11/29/23):

<b>Price</b>	<b>121.12</b>
52-Week Range	102.77 – 161.10
Dividend Yield	0.0%
Market Cap	\$26.65 billion

### Financials (TTM):

Revenue	\$29.31 billion
Operating Profit Margin	3.9%
Net Profit Margin	4.2%

### Valuation Metrics

(@11/29/23):

	<b>DLTR</b>	<b>S&amp;P 500</b>
P/E (TTM)	22.0	20.4
Forward P/E (Est.)	17.8	20.4

### Largest Institutional Owners

(@9/30/23 or latest filing):

<b>Company</b>	<b>% Owned</b>
Capital Research & Mgmt	11.7%
Vanguard Group	10.8%
BlackRock	6.8%
Mantle Ridge	5.2%
Nomura Holdings	4.7%

### Short Interest (as of 11/15/23):

Shares Short/Float	3.6%
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### DLTR PRICE HISTORY



### THE BOTTOM LINE

The company's growth thesis is intact and its Family Dollar operation appears finally to be improving profitability and same-store sales, says Freddie Lait. If earnings over the medium term compound at the 15% annual rate he expects, he thinks the company's shares will trade at significantly higher than the current 12x his normalized 2026 EPS estimate.

Sources: Company reports, other publicly available information

nities to take profits and good opportunities to rebuild the position. We think the latter is the case today.

**You've been pessimistic about the equity market outlook for the next ten years. What's behind that and how do you believe your strategy positions you to do well in a potentially challenging environment?**

**FL:** That pessimism comes primarily from two observations. One has to do with the margin of safety, particularly in the U.S. where the market CAPE ratio calculating

P/Es on 10-year average inflation-adjusted earnings are at all-time highs, implying total shareholder returns over the next ten years in the low single digits.

Another observation we refer to as the safety of margin. Profit margins are close to all-time highs as well, but looking ahead at the world as we see it there are a number of challenges to that, including deglobalization, increased taxation, higher labor costs, higher and more volatile input costs, and slower or anemic demand growth. We've all been modeling for years there will be operating leverage that grows

the bottom line faster than the top line. What if that goes into reverse?

One reason we believe we can succeed in such an environment is our valuation discipline, which is ever important but particularly so now. Since we launched Latitude seven years ago the portfolio has traded at an average of 16x earnings and underlying per-share net income and cash flow growth has averaged 18-19% per year. The portfolio today trades at 12x earnings and we think the growth outlook for our companies is comparable to what it has been.