Annual Review 2018

LATITUDE
INVESTMENT MANAGEMENT

FREDDIE LAIT
LATITUDE INVESTMENT MANAGEMENT

Dear All,

Equities, in the long term, earn investors returns by delivering "risk premium" above the risk free rate. When risk free rates are near zero, expected returns reduce to purely that risk premium. Moreover, since interest rates breached their zero bounds, market participants have lost their compass. The result has been an increase in volatility across asset classes, accentuated by the prevalence of quantitative strategies and a rising proportion of fund managers chasing shorter term returns. So expected returns are lower and expected risk is higher. Portfolio construction and risk control are more important than ever.

Our fund is centred on a portfolio of single stock equity investments, with cash and non-equity investments alongside which are intended to produce ample returns while reducing downside risks. We embrace volatility at the individual investment level, while continuously endeavouring to reduce it at the portfolio level. This can be done without the need for short strategies or leverage by using the primary findings of diversification theory, behavioural finance, and by taking a genuinely long term approach to every investment we make.

Latitude is small but thriving. Our team has expanded to seven, our assets are above £100m, and we're enjoying working with all of our clients to invest in partnership for the future.

We look forward to working with many more of you this year and into the future, and thank you all for your continued support.

Freddie Lait

Outlook

Entering 2019 our outlook is, as ever these days, uncertain. Our confidence in our process and our philosophy remains high, and we believe the fund's long term diversified approach is very well suited to the current environment. It is clear that expected returns are low from this point in the cycle for traditional asset classes, given their elevated starting valuations. A variety of risks will increase over the coming years, and our belief is that focussing on fundamental single stock analysis is the greatest way to avoid overarching market risks. We discuss all of our equity investments in some detail below.

Review:

There has never been a better time to be exceptional or a worse time to be average. Average companies around the world are failing as larger, more efficient, competitors dominate them from above, and disruptive start-ups prey on them from below. Modern capitalism tends to create duopoly and monopoly market structures and, at this stage, they are increasingly prevalent. Despite, and partly due to, the extraordinary level of disruption, particularly from the broadly defined technology sector, many of the industries in which we invest continue to consolidate. Cheap debt and easy access to VC funding seem likely to accelerate this trend for longer than many anticipated. Heavily consolidated markets benefit from greater bargaining power with suppliers and customers, more efficient cost structures, and higher barriers to entry, all of which benefit shareholders through wider margins, more sustainable returns on capital, and higher cash conversion.

Stocks caught in the middle of this battle royal are struggling and the majority of this cycle's value stocks fit into this category. For ten years these businesses have struggled to keep pace with the higher quality growth stocks and our working assumption is that this can continue as long as the economy stays steady and interest rates remain low. That said, there are value stocks with altogether different characteristics, and this is where we find the most interesting ideas. It's not a coincidence that all of the stocks in our portfolio which may be classified as value (Tesco, Nokia, Sony, Advance Auto Parts, Imperial Brands, Goldman Sachs) operate in concentrated markets where the long-term supply side appears constrained, and the demand side is generally predictable (Nokia being the cyclical exception to this second point).

The remainder of our stocks are, in our opinion, exceptionally strong businesses with impressive business strategies operating within favourable long term, defensive industry dynamics. These core holdings form a lower risk ballast for the portfolio. Over the coming years we expect the prospects for our value stocks to improve, and to be writing about them as core holdings once again. One of the key reasons why we believe that to be the case is the industry structures and long-term supply / demand outlooks are in their favour.

Over the course of 2018 we sold two stocks (Royal Mail and KPN), one was bid for (TDC) and we added one new position (Starbucks). We closed our investment in a basket of Emerging Market currencies earlier in the year, and dramatically increased our holdings in US TIPS (inflation protected bonds) and Gold. We continue to have around 20% of the portfolio held in cash equivalents (currently yielding around 0.75%) allowing us to be nimbler as markets change.

Following a rocky fourth quarter, in which the S&P 500 fell almost 20% from its peak, it seems clear that the market narrative has shifted. The Federal Reserve has become dovish once again, and rate rises are likely a thing of the past. This will continue to support asset prices and the economy, although returns from here are still expected to be low for both equities and bonds given their starting valuations. At this late stage of a cycle it is critical to remain diversified, and to not rely too heavily on forecasting the future. The quantity and range of possible outcomes from here is high, and highly unpredictable.

Sony is a name which needs no introduction but a stock which is often misunderstood. The business has been around for seventy years and over the past ten years has suffered. Growth in net asset value has been negligible as cumulative earnings were close to zero over the period, which led to a meaningful de-rating. Sony is effectively a global holding company comprised of fabulous businesses, many with strong structural advantages. These include market leading positions in console gaming (PlayStation), music, movies, and CMOS sensors used for smartphones and electric vehicles. They also have a large financial business in Japan which generates cash that is used to invest across the other franchises. We highlight the gaming business below as one business which stands out as offering particular value. PlayStation is one of three remaining console providers alongside Microsoft and Nintendo. Despite being in the late stages of this console cycle, with nascent competition from streaming services such as Google, the operating profits are high at 13% and growth trends remain strong with 20% revenue growth driving 57% operating profit growth over the past year. The digital transformation and move to server-side gaming will also help Sony, as they make 30% net revenue from digital game sales compared to 12% previously. Shifting consumption towards a subscription model with higher gross margin and incremental revenues from in game purchases is another important driver of future returns. PlayStation Plus already has around 40m paid subscribers which is impressive even when compared to global leaders in the music and movies verticals: Spotify has 80m and Netflix has 130m. Considering the strength of this and Sony’s other individual businesses a simple "sum of the parts" model of Sony shows a stark discount to intrinsic value, despite the recent successes. Over the past two years operating profit is up 67% and earnings per share, which had oscillated around zero for many years, are now Y600 and could reach Y1,000 if management continue to execute.

Dollar Tree is a US dollar store which has enjoyed fantastic tailwinds for the past decade. Recent issues with the stock price are due to their 2015 acquisition of Family Dollar. The Dollar Tree management have failed to drive synergies from the deal, and failed to raise the profitability at Family Dollar. The acquisition is likely to prove a mistake but it appears that, with the help of Starboard Investors (an activist investor who has recently taken a stake), management have grasped the nettle. There is an ongoing strategic review to see if they can sell the business to private equity or possibly a competitor. If they manage to it would almost certainly fetch a higher valuation than implied in the current share price. They will likely also explore options to “break the buck” and sell some items for more than $1, which seems intensely logical to us in a world where $1 has decreasing levels of purchasing power. The underlying Dollar Tree banner already has strong same store sales growth, which would likely rise in a recession due to the defensive nature of the earnings. We expect them to grow EPS in excess of 10% per year for the coming years which is clearly not what the market believes given the stock trades on 15x PE. A successful sale of the Family Dollar business will unlock value which, when combined with a re-rating of the underlying business and the likely buyback, could add up to 40% to the fair value in the near term.

Imperial Brands has a 7% market share in the consolidated global cigarette market. The industry finds itself, not for the first time, at a difficult juncture. The effects of tough regulations are increasingly visible and there is a major shift in product cycle towards Next Generation Products (NGPs) like vaping. In return for this uncertainty, investors willing to take a longer-term view are rewarded with a 10% free cash flow yield, which leads to a 7% dividend yield. This is set to grow at 10% per year under management targets despite higher levels of investment. The market clearly believes that the business is ex-growth, while we believe that the fruits of recent investments are soon to be harvested. Recently Imperial has been reducing the number of brands in their portfolio, focusing on high return and high growth markets, while simultaneously reducing debt and increasing the growth prospects for their vaping product, Blu. It's true that cigarette volumes do continue to decline, however, overall nicotine consumers have been rising since 2014. According to BAT this has been in excess of 1% per year, and pricing remains strong on top of that. The Blu product range is #2 in global vaping market share, and set to grow rapidly, generating as much as 30% of sales by 2025. If the management team can demonstrate top line growth (and note recent management LTIPs imply a range of 4-10%) then upside from a re-rating as well as increased earnings potential is huge. If this defensive business can prove to the critics that it is slowly turning a corner the share price could react dramatically, and investors will be paid a very attractive dividend to wait.

Our US banking stocks (**Bank of America (BoA) / Goldman Sachs**) performed poorly in 2018 as investors focused myopically on one aspect of their investment case: their sensitivity to bond yields. As yields fell at the end of the year, investors' short-term expectations of net income at the banks fell, and the shares fell with them. While it's clear the businesses, in particular BoA, are interest rate sensitive, this reliance on spread income has fallen dramatically following the recent hiking cycle. The businesses continue to manage costs exceptionally, and generate ample returns on capital despite having heavily capitalised balance sheets. Ever since the 2016 CCAR banks have been allowed to return c.100% of earnings through dividends and buybacks, and the average capital return across the sector last year was c.8%. Barriers to entry have been growing in recent years due to investment in technology as well as the effect of regulation. Banks are better capitalised, more liquid, and have far higher quality assets (loans) than pre-crisis, yet trade on half the valuation. Some commentators suggest that this is due to threats from a big tech challenger who will attempt to disrupt banking itself. If so, a disrupter would require two things: capital and expertise. BoA's tangible book value is c.$172bn compared to, for example, Amazon's at $25bn. Above this required capital, the challenger would need to raise deposits to offer out as loans. Some would come naturally from their existing customer base, but most would require a higher rate to tempt them to switch. If on average, the deposits cost 50bps more, this would imply net income margins of around 200bps for the challenger v 250bps for BoA. Given the lack of credit history and underwriting experience, plus the fact that early adopters of challenger banks tend to be lower quality borrowers, it's fair to assume a required provisioning of 100bps compared to BoA's 50bps.

Therefore, even giving a challenger the benefit of the doubt on capital efficiency, cost efficiency, average loan yields and more, we see that returns would be less than half the level of the incumbent while requiring huge capital investments. BAC currently generates a return of 11%, this is insufficient to attract genuine competition, yet under-priced at the current valuation.

Shiseido. We first looked at this company in 2015 when the new CEO, Masahiko Uotani, presented all the essential initial ingredients that we believe are necessary for a successful turnaround. Sales growth in the preceding 8 years had been roughly zero, while competitors had grown at 4% per annum. Hard decisions needed to be made, and the results are impressive. Since 2014 sales have grown by 43%. R&D had always been seen as the focus for the business, but at 2% of sales it is far less important than marketing costs which sit at 36% of sales. A shift in focus to brand positioning and marketing has generated huge incremental returns on investment, and looks likely to continue to do so for many years ahead. Despite the recent success, the stock still trades at half the multiple of sales of their main peers L'Oréal and Estée Lauder, despite growing more rapidly. The market remains sceptical of their margin expansion plans but the wind is in their sails and momentum in sales growth across their regions should drive operational leverage for the next few years. While Europe and the US have been slow to recover, their China and Travel segments are posting record profits, despite the recent issues involving a crackdown on Chinese tourists purchasing products in Japan to bring home. When investing in businesses which are undergoing restructuring, we prefer to buy businesses with strong management, strong balance sheets, selling long lived products in a consolidated market, and Shiseido fits all of those criteria. They have very little debt, and cosmetics are not only long-duration products, they are also a very defensive sales category (the market grew during the 2008/2009 recession) which continues to benefit from the structurally growing middle class in Asia. The key to growth from here is expanding their manufacturing capabilities, reducing costs and controlling product availability. The continued amplification of their brand portfolio through intelligently placed concessions in their Travel segment is a master stroke in marketing which will allow their investments in manufacturing expansion to contribute extremely positively in the medium term and beyond.

Investors are worried about increased online regulation which, as we've said in numerous newsletters, is probably overdue. Despite the recent fines we continue to believe **Alphabet** (Google's parent company) is one of the best value long term investments in the market. Since their 2004 IPO their income statement has been a testament to their zero operating leverage business model - margins don't rise as revenues do, because investment in the business rises commensurately. As a result, returns on equity and future growth continue to surprise positively. Over the past 14 years, sales have grown 43x - a compound growth of 29% per year, and earnings per share have increased exactly in line with sales. Last year they grew 20% and it seems likely they will continue at this pace for many years as search revenues are ploughed back into monetising Android, Maps, YouTube, computer gaming, cars, medtech and many other things beyond.

Recent broker valuations for their autonomous car unit, Waymo, are as high as $250bn on a standalone basis, compared to a total market cap of $800bn. Unlike many of its large cap tech peers this is not a "concept" stock. It trades on 16x next year's operating profit which we believe undervalues both the defensive nature of the business and the growth potential for the next decade and beyond. We have been invested in Google for more than six years and, while the share price often ebbs and flows with the global advertising cycle, a regulatory cycle of its own, and intense competition within all of its businesses, its staying power will surprise bears for years to come. The threat from disruption is genuine, but the duration of the current phase of their life cycle is longer than many predict and, even in a scenario where a break up becomes inevitable, there is sufficient value to justify the current price.

Visa has one of the deepest moats in the world, and operates in one of the most profitable global industries. This is principally due to the highly concentrated market structure and the huge barrier to entry due to the incumbent network and accumulated capital invested in technology, security, and consumer awareness. Between them and Mastercard they dominate the global (excluding China) payments industry and extract a very small amount of economic rent from processing more than $11tn of payments each year. Visa partners with banks and merchants alike, ensuring control of both ends of the payment value chain. Banks issue their cards, and assume credit risk, while paying a small toll for using their networks. The merchant agrees to accept their cards (almost ubiquitously) and pay fees for the pleasure of being able to accept secure card transactions. Visa earns its place in the world by investing 50c of every $1 it earns back into the business, to enhance security, functionality, analytics and drive technological advances such as contactless payments and spend analytics. Although similar in size, Visa is twice as large as Mastercard and six times as large as American Express. Visa earns profit margins of 50%, grows EPS at 20% and is likely to even grow at 10% during a recession. Revenues grow at about 10% per year which is the result of winning share and winning new customers in new countries where the addressable market itself grows faster than underlying GDP as digital transactions continue to displace cash. The stock is reasonably price on 18x Operating Profit given the highly defensive nature of these earnings and their growth.

Starbucks had a rough few years from 2015 to 2018 and this volatility allowed us to enter a position in a market leading business at a very attractive price. The stock had traded sideways over these three years, despite a 58% growth in EPS. The two key concerns were Chinese exposure and the saturation of the brand in its existing developed markets, especially the US. The exposure to the growing middle class in China is one of the key reasons we want to own the shares, and is another example of how shorter-term market concerns can distract from long-term structural opportunities, to the longer-term investor's benefit. Starbucks refer to China as their “second home market”. They have been active for more than twenty five years and the country is still incredibly under penetrated despite their high growth.

The average American drinks 300 cups of coffee per year, the average person in China drinks 1. The middle class is expected by Mckinsey to double to 600m over the next five years. Within the non-China business, deals such as the recent payment from Nestle of $7.5bn for rights to use the Starbucks logo on their products is further endorsement of the enduring power of the brand. The structural growth in China, combined with premiumisation and the secular trend of consumers to prefer experiences such as visiting restaurants, over material goods, will pay dividends over the years. Finally, investors need to remember that, due to the incredibly quick payback period (1.5 years globally, 1.2 years in China) Starbucks has the highest ROIC on incremental capital of any retail or restaurant business we have seen. Assuming a 15x EBITDA multiple, each $1 invested is worth $10-$13 within a year of investment, and spending and growth is rightly accelerating from here despite shorter term over-saturation fears.

When the supermarket model evolved to replace grocers and corner stores the customer base for **Unilever** and other consumer goods companies contracted dramatically. This is classically a bad sign for suppliers. However, it is clear that pricing power in the long-term was not negatively affected, quite the opposite in fact as margins across the group remained resilient and high. What became clear was that the value of stocking #1 and #2 brands to distributors is a high price worth paying. Fast forward to today and we have two similar threats to contend with. The first, online and mobile shopping, where the analogue world concept of enormous shelf space is being replaced by a digital shelf no larger than one screen. These choices are often algorithmically chosen to match a consumer's preferences, and are also heavily influenced by increasingly high advertising spends on these platforms. What is clear is that, in order to thrive in this ecosystem, you need to be at the top of the screen, and a key reason why we like Unilever is that 90% of its products occupy #1 or #2 market positions. The second threat is private label, and the increasing push by supermarkets to cut out the middle man. In essence a private label offering is still branded, where the supermarket becomes the brand. This is a defensive move from incumbent supermarkets and is thus a mainly developed market phenomenon. In the Emerging Markets small scale grocery stores are being replaced immediately with online offerings, where brands continue to dominate sales. This is therefore likely to be a stage in the industry life cycle where choice contracts, and mega brands continue to thrive. Unilever and other well placed consumer goods giants can continue to win in this environment, as the market trends towards further concentration.

We invested in **Tesco** four years ago when the stars aligned for what we believed would be an extremely attractive multiyear turnaround opportunity. Since 2015 operating performance has gone from strength to strength with operating profits rising from £400m to £1.7bn and net debt down from c.£8bn to c.£3bn. For 25 years Tesco was a textbook example of growth and reinvestment, and putting the customer first. It was the Amazon of its day, taking each year's increase in margin and spending it on improved facilities, service and better pricing for customers.

A return to this virtuous circle, which began to unwind in 2010, is now firmly part of management's strategy. In 2014 when Dave Lewis arrived from Unilever, he set about a rejuvenation plan which is having dramatic results. In particular, the business employee, customer and supplier KPIs have improved dramatically, and the business is making use of its dominant market position to secure its financial future. Aldi and Lidl's growth is slowing, and their planning applications for new stores is down by more than half. Asda and Sainsbury's have been forced to consider merging in order to contend with the rejuvenated Tesco, but have recently been disallowed by the CMA. Given that historically the business enjoyed 5% margins when it was supporting a growth-biased cost base, we see no reason why in the future the business couldn't achieve similar levels to this again or even exceed it. This would imply a share price of between 400-500p, which compares favourably to its 230p price tag today. The acquisition of Booker adds further scale to their offering, achieving better terms with suppliers as well as providing options for bulk discounts and a Costco style membership model in the future.

Nokia remains a contentious and contrarian investment, however, the recent green shoots of a 5G cycle have helped sentiment around the business enormously. As one of three main providers of network equipment they operate in a wonderfully concentrated market, with low threats from new entrants and, to some degree, certain future demand patterns as consumers and corporates require ever-increasing levels of data traffic, which all runs through Nokia supplied pipes. We are now at the beginning of the 5G cycle which we believe will be far longer and larger than currently expected as evolving use cases come forward over the next few years. Moreover, Nokia's patent portfolio is still the envy of the mobile industry – with Apple and Samsung both needing to pay between $3-5 per handset for Nokia radio content. Beyond this, growth optionality from hyperscale technology players, secure government networks and private networks for industry gives Nokia great optionality over the coming years. At 12x our estimate of earnings next year, we believe the market is missing the longer-term opportunity.

Benefits from digitalisation come in many forms. In **Orange's** case they roughly split into two opportunity sets; incremental sources of revenue from new customer products and cost cutting through more efficient digital tools. Mobile network operators such as Orange provide the backbone for innumerable mobile services available to businesses and consumers. Finding new ways to monetise this platform is part of the challenge, which will become simpler in the world of edge computing powered by 5G. Digitalisation also works behind the scenes, replacing costly labour forces and reducing friction within the processing and maintenance areas of the industry. The marginal contribution of technology investment at Orange is a 20% opex saving – a huge benefit to a business where growth is scarce. Critically this saving comes not at the expense of customer experience, but while improving customer service and retention rates. Servicing a customer using an app as opposed to a call centre costs one tenth as much, for example.

We know that from 2000 to 2014 returns across the European Telecom sector fell from around twice their cost of capital to a level roughly equal to their cost of capital, and that the industry has taken a long time to recover from the slump. The 4G cycle was more muted than anticipated and did little to help lift the value of the sector which today, when including both equity and debt, is roughly equal to the total investment capital, which tells you that investors believe the industry will never grow again. Orange generates a 5% dividend yield and a 9% free cash flow yield. Even without growth this is an ample return for little risk. Moreover, with many possible ways to create value, and nothing "in the price" for this uninteresting sector, we believe Orange is a great source of defensive value which further diversifies our portfolio.

Since first investing in 2009 into the auto parts retailers (of which our holdings in **Autozone** and **Advance Auto Parts** are two out of three large players) the sector has been an incredibly attractive investment. Our largest holding, Autozone, has delivered a 100% growth in net income, using cash flow to buy back 50% of its shares outstanding resulting in nearly a 400% increase in EPS. In 2017 the stock price fell dramatically as we saw the businesses enter two bear traps: namely disruption from Amazon and from increasing penetration of electric and autonomous cars. As is often the case shorter term headlines prove exaggerated and, in 2018, both of the shares recovered strongly. For context, over the past ten years, including the recession, earnings have consistently grown at 15% per year, and we believe they will continue to grow at c.5-10% per year in the near future.

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