Dear Shareholder,

This was a challenging quarter for global stock markets, particularly in America where the S&P 500 lost -4.3% and the Nasdaq fell -10.3%.

As we have highlighted for some time, the market suffers from a combination of extreme risks which have been masked by the momentum of the past couple of years. These risks are **overconcentration**, **overvaluation** and **over earning**. The current level of market concentration, valuation and profit margin have rarely been seen in the past hundred years and it's likely that some, or all, are set to reverse. All these risks are wrapped up in the AI enthusiasm, although they are also prevalent in a wider set of securities too; our generation's "nifty fifty", rebranded this time as "quality growth".

We're optimists and see great opportunities ahead. The obsession with this small collection of stocks and the circular feedback of their concentration through passive fund flows has led to their overvaluation. At the same time, the inverse has happened for many other high-quality businesses which are trading at a fraction of the valuation despite delivering strong and durable growth.

It's moments like these when active managers earn their stripes against the passive funds, not for rapid action when the market changes, but for sticking to a process *throughout* market cycles which ultimately comes out on top. Trying to time these regime changes is a fool's game, although we believe that this rotation may just be getting started.

This quarter we're diving deep into one of our long-held stocks, **Tesco**. The shares delivered 13% annualised total return over the past five years, despite dropping 15% recently on news that a competitor was lowering prices. At 11x PE with strong, cash supported growth ahead, this is one of many examples of stocks we find attractive today.

Tesco History

Please skip this section if you are familiar with the history of the business, a once towering success story, which is now emerging from fifteen years of mis execution.

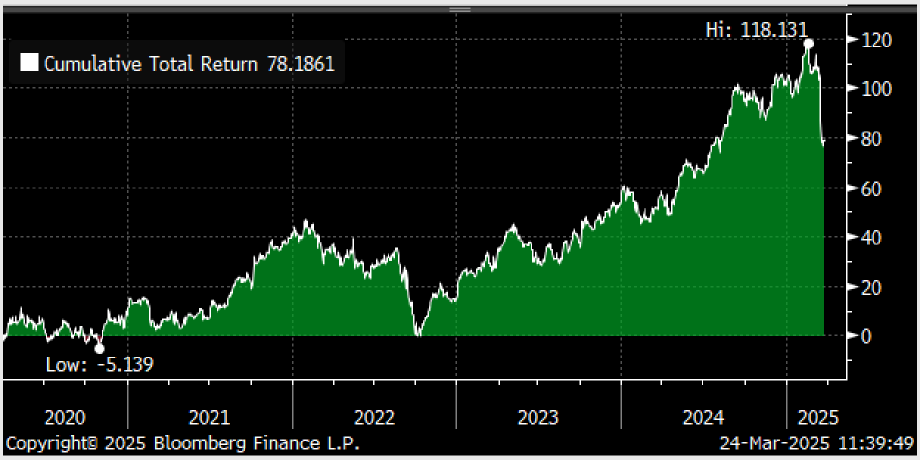
Tesco is the largest UK food retailer with revenues of £70bn and a dominant market share of 28.5%.

Tesco's long history dates back to 1919 when it was founded by Jack Cohen in Hackney, London. It floated on the London Stock Exchange in 1947 growing through acquisition and expanded to become the largest food retailer in the UK in 1996, when it overtook Sainsbury's. Around the same time in the 1990s, Tesco established its value credentials positioning itself with its iconic low-cost "Tesco Value" range in 1993, followed by a premium range "Tesco Finest" in 1998 and has been a full-line grocer ever since. Over the next 20 years Tesco expanded internationally into 11 countries across Asia, Europe and North America. Its domestic success was never truly repeated overseas, with these expansions ultimately proving costly, adding significant complexity and were dilutive to returns. Ultimately, this expansion has been steadily unwound, exiting markets in France (2010), Japan (2012), North America (2013), South Korea (2015), Turkey (2016), Poland (2020), Malaysia and Thailand (2021). Today Tesco has c.4300 stores in the UK and Ireland and a few hundred across its Eastern European business in the Czech Republic, Hungary and Slovakia, representing 6% of group sales.

The reason for recounting the history of Tesco's international expansion is because these ultimately detracted and distracted from the UK business. Food retail is a highly competitive and 'slender' margin business and the investment behind these operations naturally placed pressure on the UK business – which was required to deliver profitability and cashflow to meet the needs of the rest of the group (the US alone ended up costing £2bn). This left the UK vulnerable to newer competitors: the German discounters, Aldi and Lidl, who entered the UK in the late 1990s and amassed 11% market share by 2016. Perhaps the darkest hour in Tesco's history was a major accounting scandal revealed in 2014 which cost the business £260m. This coincided with the appointment of a new CEO, Dave Lewis, who significantly reset the business, simplifying, investing and sharpening operational execution. The current CEO, Ken Murphy, took the reins in 2020 and oversaw the final significant step of the transformation with the sale of Tesco's Asian businesses ("Tesco Lotus") for £8bn, which coincided with a significant return of capital to shareholders via a 65 pence special dividend (over 20% of market capitalisation of the business at the time).

Drivers of Growth

The important conclusions to draw from this whistlestop tour of Tesco's history is that **(1)** Tesco has always had a strong UK business, albeit substantially encumbered by its international operations and **(2)** much is potentially missed in a superficial glance at an uninspiring long-term share price chart. Indeed, although the nominal price return over the last five years has been 2% p.a., even with the 15% drawdown over the last few weeks Tesco's *total return* over the same time frame has been 13% p.a.



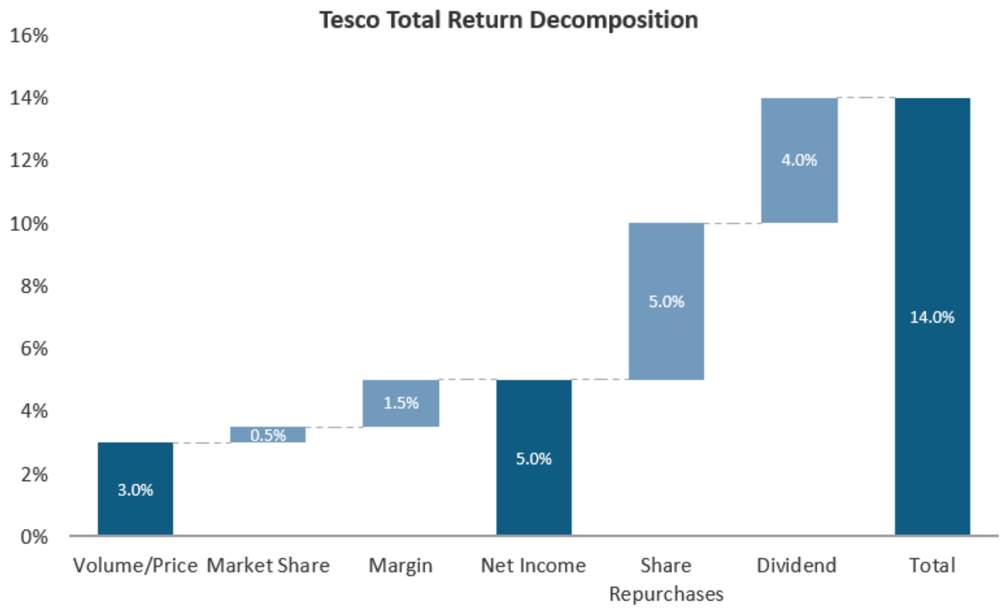
We believe that Tesco is well placed to continue to deliver double digit returns for the foreseeable future. Readers who aren't close followers of food retailers might be puzzled by the prospect of double digit returns from a relatively mature sector like food retail.

This is possible in a low growth sector due to two levers:

1. Market share gains due to their dominant position and strategy

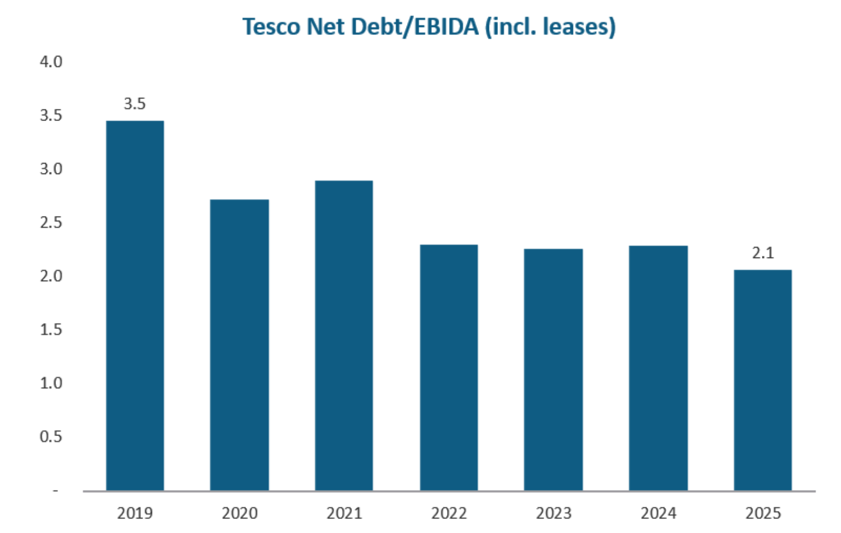
2. Their extraordinary cash flow which, given the maturity of the industry, is almost all returned to shareholders.

Indeed, our forecasts are based on net income growth of 5%, derived from market growth (reflecting stickier food inflation than the last decade), incremental market share gains and modest operating leverage. The three are intrinsically linked with Tesco choosing to reinvest operating leverage into prices to drive top-line growth and incremental market share gains. Augmenting healthy net income growth, the real torque comes from disciplined capital allocation through the return of capital to shareholders via share repurchases and dividends.



Source: Latitude estimates

In recent years, Tesco has substantially deleveraged – a function of the aforementioned disposal of Tesco Lotus and the fact that Tesco retail is strongly cash generative. This deleveraging has reduced interest costs, further improving conversion of operating profits to free cash flow. After capital expenditures (in line with depreciation and amortisation), Tesco coverts over three quarters of operating profits to free cash flow meaning that Tesco generates a circa 11-12% free cash flow yield. Being below management's 2.3-2.8x target range, this is substantially all available for shareholder distributions. High cash availability and low valuation is a recipe for significant share count reduction – a common feature amongst Latitude portfolio holdings.



Source: Latitude, Company

In common with all our investments, our hurdle returns are not predicated on a re-rating of the shares. Tesco trades well below its long-term earnings multiple (illustrated in the chart below). While we bake nothing in, we do acknowledge that a re-rating of the shares could mark an acceleration of returns. Equally, this low level of valuation implies very low downside risk. If the business dynamics play out as we expect it wouldn't surprise us to see the shares trading between 15-18x PE again in the future, a 40-70% additional upside on top of the growth in the business.

Having laid out the attractive prospective returns upfront, we need to add some meat to the bones of why we believe these returns are not only probable but also durable.

The Competitive Advantages

As we noted in our 2024 Annual Report, food retailer economics are highly sensitive to volume growth. Small, almost imperceptible market share shifts are powerful drivers of incremental economics. To see this, consider the incremental drop-through margins for a food retailer. Tesco's grocery gross margins are c.26%, with the *majority* of costs below this line *approximately* fixed. We calculate that the incremental contribution margins of retail sales growth are close to 20%, which is four times higher than current operating margins of 4.5%. Tesco can either choose to reinvest in price competitiveness to drive further topline volume growth, or it can allow some of it to drop through to drive operating margin expansion. Tesco has used volume share gains in recent times to reinvest in price making it now the lowest cost full line grocer in the market. Given the importance of volume growth, relative competitive positioning and market share gains are the key driver of returns.

Tesco presently enjoys its **strongest competitive position** in years. Tesco has circa twice the market share of any other retailer at 28.3%, Sainsbury's is the next largest at 15.7%.[1] The chart below illustrates the stark change over the last five years with Tesco, Aldi and Lidl gaining a cumulative 4% market share, and Asda and Morrisons being the donors. Tesco's scale conveys several powerful advantages, most obviously with purchasing terms with suppliers, but also with distribution and logistics. Tesco operates a Clubcard scheme which boasts 23 million households in the UK, providing valuable data which is leveraged to drive the highest promotional participation of any retailer, over 10% ahead of the market average.[2] Tesco can provide the most granular data to suppliers who, being more confident in their return on investment in promotional support, can lean in to offer lower prices, confident they will recover their investment through higher volumes. This has been the key to Tesco and Sainsbury's competitive response to the German discounters who offer an 'everyday low prices' (EDLP) strategy, but across a much narrower range of stock keeping units (SKUs) (typically 3,000 vs a full line grocer's 30,000). It has enabled Tesco to respond with price matching the discounters, while offering customers the choice of a differentiated private label offering.

The market share donors have been **Asda** and **Morrisons**, both of which were subject to ill-timed, debt-fuelled private equity take overs in 2021; Asda by TDR and the Issa Brothers and Morrisons by CD&R. Ill-timed because equity markets, buoyed by stimulus and liquidity, meant the prices paid were 'full', and also because the cost of debt was low – a trend which dramatically turned in 2022. With bondholder coupons to pay, both businesses became less price competitive as the bow wave of inflation hit. Price perception takes time to register with consumers, as is illustrated by the gentle but steady market share attrition in the chart below. Food retail is therefore a market with trading momentum and inertia, it takes time for such trends to become established, and a very significant and sustained investment to arrest them.

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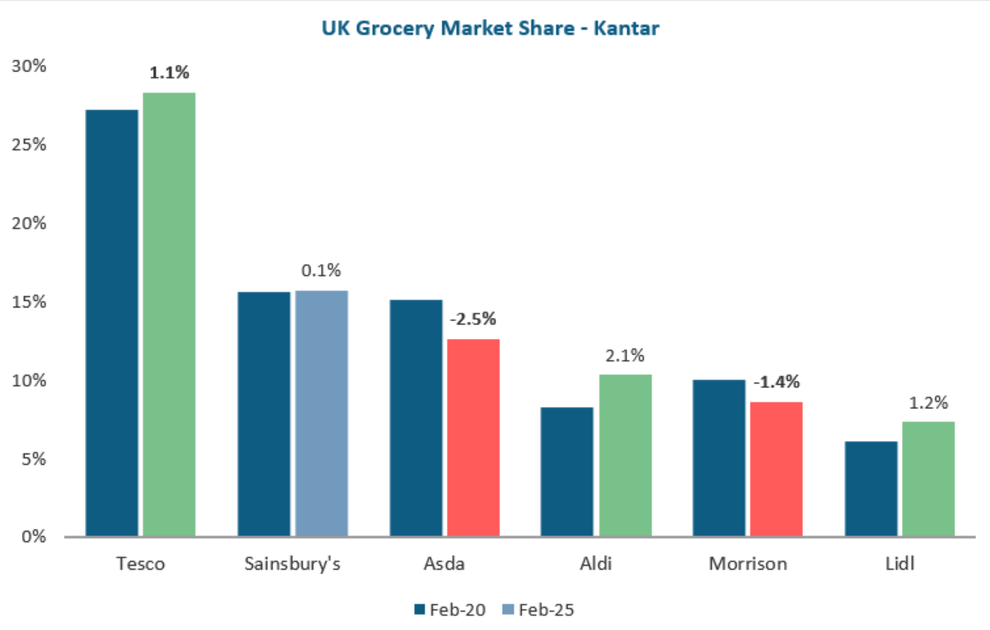
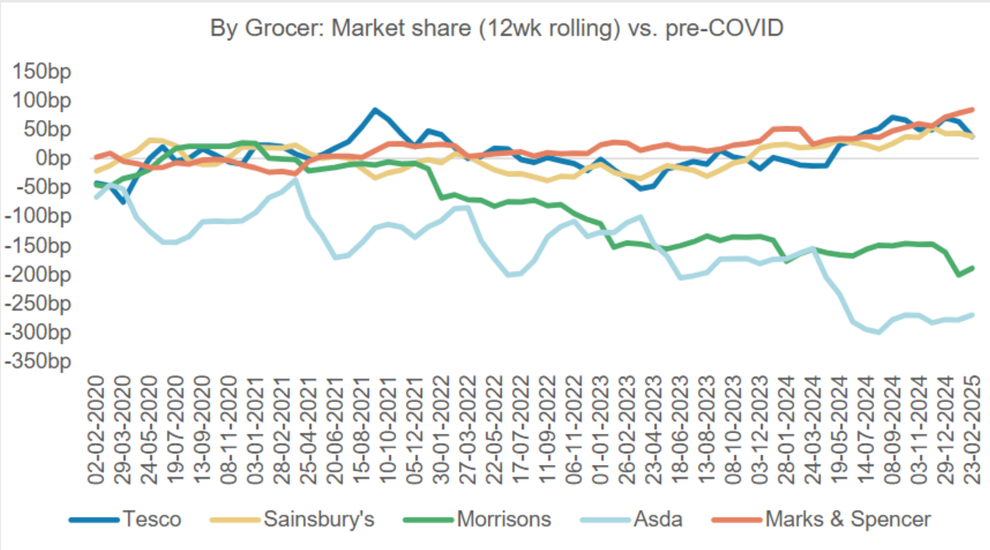
[1] Grocery Market Share - Kantar
[2] Kantar: Kantar reported 39% of sales were sold on promotion at Tesco vs a market average of 28.3%.





Source: Kantar, Morgan Stanley

The Asda Rollback

This brings us to the share price volatility experienced during the month, ostensibly due to Asda's announced price investment. Having ceded so much market share, some competitive response was always to be expected – in fact we're somewhat surprised it didn't come earlier – something we partially attribute to the nearly *four year* gap since Asda last had a CEO[3]. Asda has experienced something of a revolving door of executive leadership, with the new Executive Chair, Allan Leighton, replacing Lord Stuart Rose at the end of 2024.

In the year to December 2024, Asda reported like-for-like sales down -3.4%[4] in contrast to Tesco's +4%[5]. The virtuous cycle of volume growth at Tesco discussed above has been working in reverse at Asda. The loss of volume comes with painful incremental economics driving operational deleveraging and under recovery of fixed costs. We estimate a 4% decline in sales creates a c.£150-200m profit hit, compared to a net income of c.£300-350m last year.

Asda responded to this by cutting in-store costs which came at the cost of availability, shelf presentation and in-store experience. It was the British retail entrepreneur, James Gulliver, who famously coined the dictum "retail is detail" and we think that applies here. Price alone is not the only determinant of success, so it's no surprise to see Asda have to reverse gear and invest £80m into in-store colleague hours.

Asda is belatedly doing the right thing but is it enough and can they afford it? We don't think so and, indeed, Asda has indicated it will take a significant profit hit this year. They intend to reduce the prices of 25% of SKUs aiming to be 5-10% cheaper that competitors, a price investment of £250-500m over the next 12 months or so. Asda's pro forma leverage, including leases, is set to breach 7x ND/EBITDA, compared to Tesco at 2.1x. While Asda has a window of opportunity before the next wave of major debt refinancings, it's clear it faced two choices **(a)** do nothing and cede market share, enduring painful operating deleveraging and pressuring debt metrics **(b)** take a profit hit upfront through a strategic investment in prices, hoping it will recoup enough sales and market share to offset the investment. We've illustrated how the 'do nothing' approach was not really an option, but neither is option (b) a guaranteed success. With a c.26% gross margin, Asda will need to recover sales of £1-2bn just to cover the investment each year, equivalent to reporting 5-10% like-for-like sales.

It's also easy to forget that Asda's problems don't have quick fixes: it's over-leveraged, it has too many superstores and too few smaller format convenience stores[6], it has underinvested in private label and lacks the

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[3] Asda's last permanent CEO was Roger Burnley who abruptly left in August 2021 following a disagreement with TDR Capital.
[4] Asda updates on FY24 results and Rollback to Asda Price strategy
[5] Tesco UK like-for-like sales tesco-plc-interim-results-2425-press-release.pdf
[6] Asda operates c. 1100 stores with 500 recently acquired convenience sites. Tesco operates c. 3000 stores of which over 2000 are the Tesco Express format.

invaluable granular data asset collected from millions of households that Tesco and Sainsbury's have accrued from their respective Clubcard and Nectar membership programs. This latter point matters because in food retail, volume elasticity is low – it takes time for consumer price perceptions to change.

We think the share price reactions of Tesco, Sainsbury's and M&S give Asda too much credit. Asda's panoply of problems spans high leverage declining sales, negative volumes, weak range, price and availability. Meanwhile, it doesn't account for Tesco's ability to invest its incremental operating leverage in a targeted fashion to neuter Asda's price investments in a targeted way *if* required.

We remain confident in the strength of Tesco's market position, one reinforced in recent years by the simplification of the business through the disposal of international operations, deleveraging of the balance sheet and disciplined reinvestment of operating leverage in lower prices for customers. As shareholders, we can be agnostic about the share price over recent weeks, as it will only give Tesco's share buyback greater torque, boosting earnings and cashflow *per share.*