Evenlode Investment View

February 2018 - Real Free Cash Flow Growth

Focus on the companies, not on the stocks.

Peter Lynch

In January's view I discussed the buoyancy that had steadily crept into investment markets over recent months. Right on cue, global stock markets fell sharply in early February and levels of volatility surged. At one point the UK market had fallen -8.6% from its recent January high, before recovering somewhat in the second half of February. Year-to-date, the UK market has returned -4.9% compared to a return of -2.6% for the Evenlode Income fund*.

Economic growth is generally considered to be a good thing for equity investments, but the proximate cause of the recent sell-off was attributed to a growing sense that rising economic growth and inflation may cause interest rates to increase at a faster rate than previously expected, particularly in the US.

Real Free Cash Flow Growth

As I have noted several times over the last few years, there is no perfect way of insulating one's savings from an environment in which both inflation and interest rates are rising: particularly if the rise were to be rapid. However, there are some qualities that we believe provide a company with some very important safety buffers to such a scenario:

1) **Strong balance sheet**: helps insulate a company from the rising cost of debt. A strong balance sheet can also provide protection if rising interest rates ultimately tip the economy into recession.
2) **Market-leading competitive position**: helps provide a business with pricing power and therefore inflation protection.
3) **Asset-light business model**: for asset-heavy business models, rising asset replacement requirements can eat into the spare cash available to shareholders, potentially leading to dividend cuts and rights issues in highly inflationary periods, as was seen in the 1970s. Asset-light businesses are better placed as capital expenditure requirements remain low relative to cash generation even when the price level is rising. Warren Buffett's investment approach was heavily influenced by the 1970s experience, in which these dynamics were clearly demonstrated. As he put it in the early 1980s, *for years the traditional wisdom – long on tradition, short on wisdom – held that inflation protection was best provided by businesses laden with natural resources, plants and machinery, or other tangible assets ("In Goods We Trust"). It doesn't work that way. Asset-heavy businesses generally earn low rates of return – rates that often barely provide enough capital to fund the inflationary needs of the existing business, with nothing left over for real growth, for distribution to owners, or for acquisition of new businesses***.
4) **High free cash flow yield**: attractively valued shares offer better protection if higher rates and bond yields provide a headwind to valuations.

Whether interest rates in the developed world *do* rise by any significant degree in the next few years remains to be seen. Various structural deflationary factors are unlikely to dissipate in the medium term including a high stock of global debt (for which even a small rise in rates may create problems and tip the world into a deflationary environment), demographic trends and innovation. And either way, companies benefiting from the above four factors should remain good friends to shareholders. They equip a business well to produce an attractive, inflation-protected free cash flow stream through a wide range of economic conditions (the holy grail for long-term dividend growth investors).

Results Season

Whilst share prices have been wobbling around in January and February, companies have been busy releasing results – in fact, more than 85% of the Evenlode Income portfolio has updated the market since the start of January.

Overall progress for the portfolio has been encouraging, particularly in relation to free cash flow generation. The tone from management teams has also been quite upbeat, perhaps not surprisingly given the more benign economic backdrop mentioned above. Pepsi management's outlook comment is quite representative of the trends that many global leaders are seeing in the world today:

The global economy is growing, with developed markets stable and a number of developing and emerging economies showing signs of acceleration. In most of our key markets, the picture is relatively positive, with strong employment, consumer spending, and consumer sentiment data. And in the United States, our largest market, we expect the recently enacted tax reform to have a positive impact on many sectors and businesses and on the economy overall.

However, along with this improved economic picture, the competitive environment and disruptive trends remain quite dynamic in many industries. 'The Amazon Effect' is alive and well, a topic that Pepsi and many others discussed at length at recent results. We continue to favour businesses such as Pepsi that are in a good place to defend against these threats and harness opportunities. Investment, agility, innovation, brand strength, scale and regional diversification are all important factors. In Pepsi's case these characteristics have allowed the company to grow sales and earnings at a decent clip (+4% and +9% per annum respectively over the last five years) despite these headwinds having been in place for some time. The company also announced a +15% dividend increase for 2018, its 46th consecutive annual dividend increase.***

Efficiency and digitalisation

Meanwhile, for those companies best placed to harness the biggest trends in the business world today (efficiency, big data, software analytics, machine learning etc.) opportunities continue to abound. We are seeing this most prominently in the fund's software and business-to-business media holdings, though the trend is relevant to many other holdings including engineering companies such as Spectris.

Relx are as well placed as any in this regard, using information and analytics to help their customers make better decisions, and therefore also help improve their efficiency and product quality. Relx's CEO Erik Engstrom summed up the opportunity well at this month's results presentation:

We are spending most of our time focusing on how we can take existing content sets and additional datasets and leverage these with predictive analytics where we can measure and increase the value we provide to the customer at each decision point. And the closer we get to each decision point and the more we can quantify the increased value from that decision, the higher value we're providing to them. And if we focus on the increased value to the customer, it shouldn't be a surprise that that they will want more of that service and use more of it.

The evolution of Relx's product offering, as described above, should not just drive growth opportunities. It should also augment the level of customer 'stickiness' given the embeddedness that comes with these increasingly sophisticated decision analytics tools.

Acquisition Activity

The value of digital franchises with deeply embedded customers and recurring cash flows is not always fully recognised in the publicly traded markets. This value has not, however, escaped the attention of industry peers over recent months for two Evenlode holdings that fall into this category. Aveva recieved a reverse takeover from French peer Schneider Software last autumn and this month Fidessa announced a recommended takeover approach from Swiss software company Temenos. Fidessa's share price rose significantly, with the shares now up by more than +50% since the start of the year. As I have discussed before, the incredible commitment to organic investment that Fidessa has made over the years would be a difficult one to appreciate if you were to limit yourself solely to 'analysis by spreadsheet'.**** Even today, we estimate Fidessa's current earnings and free cash flow are depressed by c40% due to investments being made in the company's new derivatives platform. But this culture has led over time to the creation of a unique, impossible-to-replicate franchise with 88% of the company's revenues coming from a subscription base that enjoys a renewal rate not far from 100%. Though these characteristics are being appreciated today, over the last few years they have often been forgotten as markets focused on more 'exciting' opportunities.

There's Always Something To Do

Quite a few shares in the portfolio have performed well recently, not least Fidessa. However, as is normally the case, others have not. As the great Canadian value investor Peter Cundill would put it, *there is always something to do*. In the last couple of weeks we have begun gently nudging the portfolio towards certain holdings where we are seeing the most interesting combination of quality and free cash flow appeal. As always this has been stock specific - we added to the fund's position in Moneysupermarket for instance after shares fell following results last week. However, a broader trend worth highlighting is that several of the more consistent, stable franchises in the portfolio have seen their share prices fall over recent weeks, in some cases by quite a lot. We have begun to gently 'nudge up' some of these positions for the first time in a while. Examples include Unilever, Sage, Pepsi, Johnson and Johnson, Relx, Smith & Nephew and Reckitt Benckiser. All of these companies are trading on attractive free cash flow yields that very comfortably cover current dividend payments. Moreover - returning to the discussion at the start of this piece - they possess many of the most important characteristics for delivering real free cash flow growth over time through a wide range of economic conditions.

Hugh Yarrow
Fund Manager
26th February 2018

Please note, these views represent the opinions of Hugh Yarrow as at 26th February 2018 and do not constitute investment advice.

*Source: Financial Express, total return, bid-to-bid. To 23rd February 2018.
**Appendix to 1983 Berkshire Hathaway shareholder letter (http://www.berkshirehathaway.com/letters/1983.html).
***Source: PepsiCo. Sales definition used is organic revenue, earnings definition is core constant currency earnings per share (EPS).
****E.g. *Evenlode Investment View November 2015 - Earnings Will Jiggle* (https://evenlodeinvestment.com/news/evenlode-investment-view-november-2015)