Evenlode Investment View

August 2018 – Themes From Results

The second half of August has been quiet for company news, with the UK market drifting slightly lower as thoughts turned to macro-economic concerns such as US trade tariffs and Brexit uncertainty. As I write, the FTSE All-Share has risen +2.3% year-to-date, compared to +9.5% for the Evenlode Income fund[1].

Most companies in the Evenlode Income portfolio released updates during July and early August, and this month I'd like to briefly discuss some of the themes we have been observing and thinking about, across the portfolio.

Consumer Brands and Emerging Markets

Our preference in the consumer branded goods sector continues to be towards those companies that enjoy the following characteristics:

1) A very strong brand portfolio
2) Exposure to product categories with attractive economics and long-term growth potential
3) A good emerging market footprint
4) Scale and diversification
5) The willingness and capacity to invest meaningfully and adapt to changing industry conditions

Recent results were a reminder of the ability of companies that possess these characteristics (Unilever, Diageo, Reckitt, Pepsi etc.) to grind out an attractive combination of steady sales growth, gradually expanding margins and compounding free cash flow and dividends. Dividend yields and latest dividend increases for the fund's largest exposure to this sector are shown below, all of which are backed by very healthy ongoing cash generation[2]:

	Dividend Yield	Most Recent Dividend Increase
Unilever	3.1%	+8%
Diageo	2.5%	+5%
Reckitt	2.5%	+6%
Pepsi	3.2%	+15%

"No one likes an unclean toilet"

Rakesh Kapoor, CEO Reckitt Benckiser.

All of these businesses have a very strong, embedded presence in emerging markets. Though the region as a whole has had a difficult few years the long-term growth potential from these geographies remains very interesting. Take Reckitt Benckiser: as management pointed out at recent results only 2% of households in China have a dishwasher, with penetration levels gradually rising. In India, 75 million toilets have been built in the last three years and millions more are set to be built in coming years. With a strong distribution footprint in these regions and trusted health and hygiene brands such as Finish, Harpic and Dettol, a company like Reckitt is well placed to take advantage of this structural growth.

The sector's market-leaders are also busily responding to a shifting industry landscape (more digital sales, changing consumer preferences, competition from smaller and more regional players etc.) by investing in innovation and increasing agility. Unilever has reorganised its management structure to balance the benefits of its global scale with the flexibility to launch products tailor-made to local markets. Innovation timescales have halved and 30% of Unilever's product launches are now specifically aimed at particular geographic markets to respond to local consumer needs and tastes. Meanwhile, digital sales are growing and it remains reassuring to note that attractive economics are retained as more sales move online (the most extreme example we have come across is Reckitt's existing Chinese business, where more than 50% of sales are now made through the digital channel[3]).

Pepsi management summed up the need to keep investing and adapting when they released results this month - it's not a one-off push that's required but a persistent, steady, relentless drive to improve and adapt as industry conditions change over time[4].

All that we're doing is investing as we go along. We've been doing that deliberately and carefully over the years. And we're going to do this deliberately and carefully over coming years.

Software, Information and Digitalisation

The continued drive towards deeper and more embedded digitalisation - across the economy - is perhaps the most universal theme across the sectors we look at. All businesses are investing heavily in IT infrastructure, software and data analytics, and businesses that provide these products and services are seeing good growth (Latest results from US-listed technology holdings Microsoft and Cisco exemplified this trend, as did those from business-to-business media companies such as Relx and Informa as demand for digital analytics continues to grow).

Within the software sector a quick word on Sage is warranted, given the company's shares have been a notable laggard year-to-date (in fact, the holding has been the most significant negative contributor to Evenlode Income's performance this year). The market has become concerned that Sage will struggle to meet its medium-term revenue goal (of growing organically by at least +10% per annum), particularly in light of a changed competitive environment in the world of cloud-computing. Perhaps this medium-term target is, indeed, an unnecessarily high bar for management to set the company. However, even if this growth rate isn't achieved, the transition to cloud-based products should not only be manageable but also provide a higher quality free cash flow steam over coming years. 78% of Sage's revenue is already recurring, and this percentage is likely to increase towards 85-90% as customers steadily shift to the cloud. A predictable, highly cash generative business model combined with prospects for reasonable (even if single digit) organic growth and gentle margin expansion remains attractive in my view. This month Sage reported a reassuring quarter with organic sales +6.5% year-to-date.

Engineering, Industrial Production and the Capacity to Suffer

I have discussed before the concept of businesses with 'the capacity to suffer': companies with the cultural and financial strength to continue investing in more difficult times (i.e industry downturns, economic recessions etc.). Though this comes at a financial cost in the short-term, the benefits that accrue to long-term shareholders can be very significant, particularly if a company's competitors fail to make similarly forward-thinking investments in leaner years - *the strong grow stronger.*

Several of the fund's holdings with exposure to industrial production end markets have fitted into this category over recent years (Victrex, Aveva, Rotork, Smiths Group, Spectris, Kone etc), as they have continued to invest through a rather austere market backdrop. Recent results, however, demonstrate a stabilisation and improvement in these end markets, with the fruits of these investments beginning to show up in financial results. Share price performance, though, has been by no means uniform in recent months and we have made some changes as a result - in particular adding to Smiths Group and Spectris whilst trimming exposure to Aveva and Rotork.

Healthcare

Healthcare companies are in some ways very different to these niche industrial businesses. However, the need for continual, heavy investment in R & D and innovation is a shared pre-requisite for long-term success. We have been encouraged by the commitment demonstrated to this investment amongst Evenlode Income holdings, particularly in light of the not-entirely-straightforward time that several of them have had over recent years (Smith & Nephew's issues with commercial execution, Glaxo's challenges from pricing pressure in its US respiratory business and Astrazeneca's lost sales from off-patent products Crestor and Nexium). Medical technology is advancing rapidly and the companies in the portfolio are well placed to harness these trends, which include immuno-therapies, advanced wound treatment, surgical robotics and personalised medicine (as demonstrated, for instance, by Glaxo's 23andme partnership announced this month).

Another healthcare theme we have been keeping an eye on is been free cash flow generation As I have mentioned in previous investment views, GSK and Astrazeneca have been two of the only stocks of note in the portfolio that have not consistently covered their dividends over the last 2-3 years, as cash has been spent on restructuring and new product investment. This led us to reduce exposure to both companies in the 201617 period. Encouragingly, Glaxo's new management team have increased focus on free cash flow, including the introduction of cash metrics to management's incentives, and it has been good to see cash generation improve in recent quarters. As Astrazeneca returns to growth over the next year or two, we expect a similar improvement. However, we will continue to monitor developments carefully for these two stocks and manage risk accordingly.

Cash Generation and Excess Returns

Elsewhere in the portfolio there is a large diversity of businesses that have been posting generally reassuring updates. In particular, it is nice to see many businesses generating meaningful amounts of excess cash flow after both properly investing in the future and growing the ordinary dividend. Page Group, Howden, Victrex, Moneysupermarket and Aveva are all good examples of businesses whose cash positions continue to build and for which the prospects of special returns to shareholders remain very possible. The 'big four' holdings in the portfolio - Unilever, Diageo, Relx and Compass - are in a similar position, with significant levels of cash having been returned to shareholders over recent years[5], and excellent prospects for similar returns in the future thanks to healthy ongoing cash generation.

Hugh Yarrow
Fund Manager
28th August 2018

Please note, these views represent the opinions of Hugh Yarrow as at 28th August 2018 and do not constitute investment advice.

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[1] Source: Financial Express (Total return: 31st December 2017 to 28th August 2018)
[2] Source: Canaccord Quest, Evenlode: yields are current financial year forecasts.
[3] i.e. excluding the acquired Mead Johnson business.
[4] Pepsi's CEO Indra Nooyi announced her very successful twelve year term at the helm will end in October. We do not expect Pepsi's long-term incremental investment approach to change materially as a result of this CEO succession.
[5] In the form of share buy-backs for Unilever, Diageo and Relx, and in the form of special dividends for Compass