Evenlode Investment View

May 2019 – Eye on the long-term prize

The UK market has moved slightly lower in May. Trade negotiations between the US and China failed to reach a compromise, leading to further tariff announcements from both sides and the threat of more to come. This led to some concern over the global economic outlook and the underperformance of many economically sensitive shares. The other main theme this month for UK investors has been a renewed drop in the pound. A lack of clarity on both Brexit and the UK political situation have not helped, with a new prime minister now expected to be announced in July. This theme was helpful for many UK-listed multi-nationals (benefiting as they do from sterling weakness) but less helpful for domestically focused shares.

Despite a slightly weaker May, year-to-date returns for the UK market remain strong. As I write the FTSE All-Share has risen +10.5% since the start of January compared to +16.3% for the Evenlode Income fund[i].

Share Prices Still Wobbling Up and Down

Though overall returns have been positive, individual share prices have been deviating just as much as usual from the market average. This is providing us with opportunities to nudge the portfolio to areas of better value and we have had a relatively active start to the year as a result. In May we added a holding in Bunzl to the fund, following a disappointing trading statement that led to quite a significant fall in the company's share price. Bunzl's business model is ostensibly rather dull but, on closer inspection, the company enjoys significant competitive strengths and good diversification both by geography and by end market. Bunzl provides its business customers with not-for-resale products such as napkins, plates, foil and safety glasses ('nuisance' products) and is the only global operator in a fragmented market with good long-term growth prospects. These products represent a low share of customer's overall spend but if not delivered on time and in full can cause significant operational issues. Bunzl becomes a trusted partner, taking ownership of this element of the customer's supply chain through long-term relationships. The predictable, repeat-purchase nature of its business and consistently high cash generation have led to a 26-year track record of dividend growth, with the most recent dividend increase +9%. Bunzl's 2.5% current dividend yield is well covered by a free cash flow yield of 6.2%.[ii]

This month, we have also exited the fund's remaining position in engineering software group Aveva. Aveva is a high-quality business with good growth prospects, which we hope to return to again in the future. However, the share price has risen +44% so far this year and has more than trebled since we built the fund's holding up in early 2016[iii]. This has left the free cash flow valuation and dividend yield less compelling relative to other opportunities.

Eye On The Long-Term Prize

For a company to be a truly worthwhile investment, it must not only be able to sell its products, but also be able to appraise the changing needs and desires of its customers
Philip Fisher

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In the remainder of this month's investment view I'd like to update our thoughts on two holdings that updated the market this month. Both are busy adapting their business models to ensure they continue to provide customers with helpful, relevant and innovative products over coming years.

Sage

Sage's share price performance was disappointing last year, after lowering expectations of sales growth and changing chief executive. As I discussed in my investment view last November, we like new management's subtle shift in strategy to emphasise pleasing and retaining existing customers rather than driving new sales. As Steve Hare, Sage's new chief executive points out, a software company's best sales person is a satisfied existing customer. So keep your current customers happy and you will enjoy a healthy franchise with new customers gravitating to your product based on positive recommendations. Recent interim results were reassuring (with sales +6.2% driven by +10.2% recurring revenue growth) and management provided more information on the extra investments being made in customer service and innovation. A single software system has been implemented to manage customer service (more than 20 were being used previously) whilst processes and incentive structures have been changed across the organisation to focus more on customer satisfaction, customer feedback and revenue from existing customers. Sage is also investing in improving product quality and developing its 'next generation' suite of cloud-based products to which existing customers will migrate over coming years.

Sage's earnings quality is already high, thanks to a high level of customer embeddedness. 83% of revenue is recurring (a little more than 60% of which is generated from software subscription, with the rest from maintenance and support contracts). Renewal rates on this recurring revenue are above 90% on average, providing a high level of visibility. In time, however, earnings quality should increase further with a long-term aspiration to generate more than 90% of group sales from software subscriptions at even higher renewal rates than those currently enjoyed.

Informa

Informa is a business-to-business media company that we added to the Evenlode Income fund in 2014. The company is a global leader in trade exhibitions, academic publishing and digital information markets. Back in 2014, we were encouraged by the investment culture that management had begun engendering with the aim of improving product quality and customer service. This came at the expense of operating margin expansion in the short-term but looked sensible from the perspective of both long-term customers and shareholders. At Informa's recent investor day, management gave an update on their strategy and product portfolio. As management pointed out, market growth prospects are good as long as they can ensure the products they develop help customers make sense of the world and make better decisions:

Everyone experiences the effect of being surrounded by more and more data in both our private and professional lives. I'm sure everyone also feels that sense of being somewhat overwhelmed at times. With too much information, making sense of it quickly and accurately becomes increasingly difficult. In that *context anything that helps cut through that noise to what matters, to convert data into actionable information, is increasingly valuable.*

In Informa's Taylor and Francis publishing division for instance, its eBooks platform has been created internally. An AI-facilitated analysis of meaning and function is being developed, which will help to search for more abstract terms and thus aid navigation of the exploding number of chapters and articles being written. In the exhibition business, a digital platform has also been developed, which illustrates the application of digitalisation to the face-to-face world of events. This platform holds information on more than 100,000 products, helping visitors to find what it is they're looking for at these vast trade shows. More generally, we think Informa remains an interesting proposition. Growth prospects look good, recurring revenue is high and the current valuation (a 3% dividend yield supported by a 6.7% free cash flow yield) remains attractive.

Hugh and the Evenlode Team
24th May 2019

Please note, these views represent the opinions of Hugh Yarrow as at 24th May 2019 and do not constitute investment advice.

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[i] Source: Evenlode, Financial Express, total return, bid-to-bid, 31/12/2018 to 25/05/2019.
[ii] For dividend yields and free cash flow yields quoted this view: Source: Evenlode, Factset, Current Year
[iii] Source: Evenlode, Factset, total return. From initialisation of position in February 2016.