Evenlode Income Investment View

March 2024 – Company specifics

During March, global stock markets continued to move higher. At the end of October last year, investors were downbeat on the economic outlook, and, other than the US technology sector which has been on its own unique and spellbinding ascent since the start of 2022, stock markets were languishing as the economic outlook was viewed as very challenging. Since then, animal spirits have soared as investors have become increasingly confident in the trajectory of the global (and most importantly US) economy, with 'soft landing' or 'no landing' scenarios increasingly consensual.

Though risks from more elevated interest rate levels and geopolitical uncertainty remain, these concerns weren't a focal point for investors during the month.

Performance

For three months ended 31 March 2024, Evenlode Income has risen +0.7% compared to a rise of +2.9% for the IA UK All Companies sector and +3.6% for the FTSE All-Share Index[i].

Having returned +9.3% versus +7.9% for the FTSE All-Share in 2023, Evenlode Income was also ahead of the UK market for the 2024 year to date as at the end of February, so its relative performance was disappointing in March, posting a flat return in a strong month for the index. There were two main reasons for this underperformance. First, and most significant, was the 'risk on' flavour of the market. The fund's lack of exposure to more asset-intensive business models was a drag. These areas of the market (energy, mining, banks etc.) make up a large part of the FTSE All-Share and led the market higher. Conversely more stable, repeat-purchase business models – which always make up the bedrock of the Evenlode Income portfolio – generally posted more pedestrian or negative returns, as investor sentiment on the global economy remained upbeat. The second factor was the -10% fall in Reckitt Benckiser shares during March (which subtracted -0.6% from the fund's performance) as fears emerged around US litigation involving its infant nutrition business Mead Johnson. We are happy to discuss the details of this news flow with interested readers, but in summary we think the lost market value, though understandable, significantly outweighs a realistic worse-case value to settle the cases. Reckitt's free cash flow generation and balance sheet strength are strong, and the stock's valuation is currently deeply discounted compared to peers and historical levels, trading on 13x forward earnings at the time of writing, compared to a 10-year average of 20x.

Fundamentals

We would of course rather be reporting on outperformance than underperformance for the first quarter of 2024. As discussed in last month's investment view, though, the aggregate fundamentals for the portfolio have continued to progress in a reassuring manner. Organic revenue growth for portfolio companies for 2023 averaged +6%, with organic operating profit growth a little above this rate[ii]. Looking ahead, the outlook for profitability continues to improve as input cost inflation falls back to more normal levels. Free cash flow growth is also healthy, helped by the normalisation of supply chains and inventory levels. The fund's free cash flow yield is 4.9% for this year and forecast to be 5.5% for next year, providing healthy cover on the 2.9% dividend yield[iii].

Company specifics

In last month's investment view, we discussed some of the key themes we are seeing across the portfolio. This month we discuss four companies in a little more detail that have had recent news flow, to give some more colour on operational trends.

Unilever

Unilever recently announced plans to separate their ice cream business, most likely through a demerger or sale. This follows decisive actions under the new management team over the past year - divesting Elida Beauty, a portfolio of slower growing European and US mass market personal care brands, completing the move to a simpler and more dynamic category focused organisation structure, aligning staff compensation structures more closely to performance, and increasing investment behind their 30 leading brands, which represent 75% of group revenue and have higher growth and margins than the rest of the portfolio. Unilever's ice cream business represents slightly less than 10% of group profit and is the global market leader, with three particularly strong brands in Magnum, Ben & Jerry's and Wall's. However, operationally it is distinct to the rest of the group, seasonal and more capital intensive, with a different route to market focused on managing over 3 million freezer cabinets located at customers' food service outlets, such as cafes and restaurants. Profit margins are around 6 percentage points below group average, and it is more reliant on developed markets, where the business faces stiff competition in the mass retail channel, leading to organic sales growing below the group's average in recent years. Management expects the actions they have taken to drive stronger growth and margins and have increased their organic sales target to a mid-single digit range from 2026 onwards, following the ice cream separation. We are supportive of management's actions and, given the high return on assets Unilever generates, we view the increased focus on driving organic growth as the optimal strategy for delivering value for shareholders. Unilever's shares are currently trading on a forward free cash flow yield of 6.1%, the most attractive level for most of the past 10 years[iv].

Intertek

Intertek released full year 2023 results in March, with continued steady progress, increasing organic revenue +6%, profit +11% and the dividend +6%. It is a global leader in the testing, inspection and certification (TIC) industry, serving a range of industries, from testing food and pharmaceutical products for the presence of dangerous chemicals, to inspecting the safety of buildings and infrastructure. These services are mission critical for customers to ensure compliance with regulatory and safety standards but represent a tiny proportion of a customer's final product cost, driving economic resilience and strong pricing power. Intertek is one of three truly global businesses in the TIC industry, with a network of laboratories and accreditations in key trading and manufacturing hubs, allowing it to effectively service multinational customers. This has become increasingly important as global corporations look to diversify supply chains and establish dual supply arrangements following disruption during the pandemic. New reporting and disclosure requirements are also driving strong growth in ESG assurance and corporate sustainability certifications. Management expects to deliver further progress in 2024, guiding to mid-single digit organic revenue growth, margin progression and strong cash flow. The shares trade on an attractive 5.2% free cash flow yield, with good prospects for steady cash flow compounding[iv].

Diploma

Diploma is a specialist distribution business with a portfolio ranging from electrical connectors to medical equipment to industrial seals. It operates a decentralised model with around 25 operating subsidiaries that add value for customers through technical support, customised product solutions and in-stock next day delivery capabilities for a broad range of specialist products. It has also driven significant growth and shareholder value through bolt-on acquisitions. It focuses on small to medium sized market leading distribution businesses within its existing markets. At the end of March, it announced the acquisition of US-based speciality fasteners business, Peerless Aerospace Fastener LLC, for £236m. Peerless is a leading value-added distributor of aerospace fasteners with a strong reputation for customer service, product breadth and quality. It's a business Diploma has tracked for some time and broadens and strengthens their existing position in fasteners in the US and Europe. It has an impressive track record with revenue growing at 9% historically and strong operating margins of 30%, reflecting the value-add customer proposition. The acquisition price implies a first-year return on capital employed of 15%, well in excess of Diploma's cost of capital. Diploma has compounded revenue and earnings at 14% and 15%, respectively, over the past 15 years. The forward free cash flow yield of 3.5% represents a reasonable starting point for strong cash compounding, both through organic development and bolt-on acquisitions[iv].

Savills

Savills reported full year 2023 results in March, which reflected a very challenging year for global real estate, with profit falling -42%. For context, global investment volumes in the commercial real estate market fell -44% in 2023, as economic and geopolitical uncertainties and rapidly rising interest rates drove down valuations and led to a stand-off between buyers and sellers. While best known in the UK for its network of high-end estate agents, Savills is a globally diversified real estate services business, with strong positions in commercial and residential transaction advisory, property management and consulting. This broad service offering is increasingly important as global real estate owners and corporate occupiers look to outsource non-core activities. The property management and consulting businesses, which account for around 60% of group revenue, also improve Savills' resilience, with embedded customer relationships, multi-year contracts and high renewal rates, and both businesses grew revenue in 2023. Management also maintains a strong net cash balance to ensure the business can survive and invest through downturns in the property market. They did this in 2023, broadly maintaining headcount, while many competitors made cuts, hurting profitability but driving market share gains and strengthening customer relationships for the eventual upturn in the market. This strategy has paid off historically as Savills has grown ahead of the global real estate services market, with revenue compounding at c10% over the past 10 years. Encouragingly, management highlighted a pick-up in activity at the end of 2023, particularly in the UK and Southern European countries, and they expect a broader global recovery from the second half of 2024. With potential for a significant earnings recovery in the coming years, the shares are trading at an attractive valuation, with a forward free cash yield of 6.2%[iv].

Quality and value

Our approach at Evenlode is to balance quality and valuation appeal with the aim of delivering attractive, through-cycle compound returns over time, whilst managing fundamental and valuation risk along the way. This is the furrow we will continue to steadily plough. As always, we expect the bulk of total returns to come from fundamentals – via a combination of dividends and per share free cash flow growth.

It is worth reiterating, though, the attractiveness of valuations at present. Within Evenlode Income's investable universe, the aggregate valuation opportunity is at the top end of the range it has been in over the last decade, other than during the Covid sell-off in 2020. This provides both a reassuring margin of safety for the long-term investor, and also potential upside (over and above dividends and per share free cash flow growth) if sentiment towards UK-listed quality compounders improves from its currently depressed level.

Hugh, Chris M., Ben P., Charlotte, Leon and the Evenlode team

4 April 2024

[i] *IFSL Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return, bid-to-bid, GBP terms. Performance from 31 December 2023 to 31 March 2024.*

[ii] *Source: Evenlode, Visible Alpha. Organic revenue growth excludes FX and M & A impact.*

[iii] *Source: Evenlode, FactSet. Free Cash Flow Yield as at 31 March 2024, based on FactSet estimates for the current year. Dividend yield is historic yield as at 31 March 2024.*

[iv] *Source: FactSet.*