Evenlode Investment View

March 2016 - Field Notes

The newswires have been filled with a barrage of 'macro' over the last few weeks. There has been plenty to talk about: China's economic slowdown; the risk of Brexit; Europe's refugee crisis; the rise of Donald Trump; a hugely volatile oil price; negative interest rates and more.

On the 'micro' front it has been busy too, with company results season in full swing. Since December we have had results from most Evenlode holdings, giving us a snapshot on how these businesses are coping in a global economy which one might charitably describe as *mixed*. Overall, we have been very reassured by the resilient performance and dividend growth produced by the aggregate portfolio.

Below is a brief update - some 'field notes' - on the Evenlode portfolio by sector:

Consumer Branded Goods (30% of portfolio)

The emerging market slowdown was the big theme for these companies again in 2015, just as it was in 2014. But as Reckitt CEO Rakesh Kapoor put it recently, it feels like conditions have gone from 'worse to bad'. Tough operating conditions are the new normal, businesses have made adjustments and management teams are not planning for an improvement any time soon. In the meantime repeat-purchase products keep the cash flow coming. The recent sales resilience in Indonesia for Cussons baby care products (nappie cream, baby wipes etc.) is a great example - babies aren't aware of maco-economics!

We reduced our exposure to this sector at the start of the year, but it still represents an important contributor to Evenlode's dividend stream. The table below is a reminder of why, as dividend growth investors, we have a structural bias towards these business models:

	Latest Dividend Increase	5 Year Div Growth (p.a.)	Dividend Yield
Unilever	+6%	+8%	3.2%
Diageo	+5%	+8%	3.2%
Procter & Gamble	+3%	+8%	3.5%
Imperial Brands	+10%	+11%	4.2%
BATs	+4%	+6%	3.8%

Software (14% of portfolio)

Software companies now represent Evenlode's second biggest sector exposure, with new holdings added in Fidessa and Aveva over the last few months. As with consumer branded goods, customer loyalty makes for attractive economics and high recurring revenues. Even for Aveva (whose software is used by engineers to design and maintain facilities such as oil refineries and power plants), the mission-critical nature of its products continues to provide pricing protection and good contract renewals. As management put it to us recently, *the software component as a proportion of total project costs is tiny and you just can't spec it out.*

These companies are also enjoying a good tailwind of structural growth as companies increasingly utilise software to drive up productivity. This is how Sage see it:

Today there are millions of SMEs that don't use accountancy software – they are losing 2 hours a day to spreadsheets – keeping a manual scorecard of the business. The future is real-time accounting and we are very well placed to take advantage of this trend.

Media (10% of portfolio)

These companies are predominately business-to-business information companies (Informa, DMGT, Relx, Euromoney) with a high level of digital content. They enjoy micro-economics not dissimilar to the fund's software companies (i.e. a low capital intensity and repeat-purchase cash-flows). They also have plenty of growth potential as customers look to

utilise information and data analytics to improve their own products and increase efficiency.

My favourite quote from the recent results season was from Eric Engstrom, Relx CEO, when asked by an analyst why Relx aren't spending more on acquisitions. His relentless mantra on organic development was as impressive as usual:

We could buy lots of businesses in adjacent areas at high valuations. But does that add much value to the customer or to shareholders? We think the real value is taking the platforms and content we have today and developing them into increasingly more sophisticated analytics and decision-making tool. This creates more value for clients, and has a far higher return on capital in the longer-term.

One of the key attractions of both media and software companies is how dominant they can become in small (sometimes esoteric) niches over time thanks to this process of incrementally embedding themselves into their customers' daily lives. As Stephen Carter, Informa's CEO put it last month, *one of the great strengths of Informa is that we are a super-specialist business - the god of small things. This gives us a lot of resilience.* We have been encouraged by Informa's progress over the last year, as the company's investment programme begins to gain traction.

Pearson, on the other hand, was Evenlode's problem child during 2015, as discussed in recent investment views. I thought new Chairman Sidney Taurel summed up the company's current position well at their recent results (perhaps taking a leaf out of Mr Engstrom's book):

I have found an organisation that is too large and too complex, I think it's the result of history, this company has grown a lot through acquisitions. The recent move from a conglomerate to an operating company approach has not completely streamlined the organisation to the degree it can and there is significant potential for efficiencies. There are also opportunities to simplify the portfolio and to make sure we concentrate on products and platforms that can be leveraged globally. My advice has been to go as deep and quick as possible on the restructuring and to stay away from acquisitions in order to add no more complexity to the business. Our objective for the next few months is to focus on execution and to be a 'boring' company – no surprises.

Healthcare (12% of portfolio)

As with the consumer branded goods sector, we cut back the fund's healthcare exposure in January and February as other opportunities began to emerge. However, we continue to like the healthcare industry's high barriers to entry, economic insensitivity and the potential for growth thanks to innovation and demographics. We also like the sector's asset-light nature (these are companies for which intangible assets such as research expertise are key).

In terms of recent results, Johnson and Johnson clearly demonstrated these qualities, generating strong free cash flow and a dividend increase of +7%. GlaxoSmithKline and Astrazeneca had a more difficult year. Their businesses were impacted by falling sales in some key legacy products. We continue to view the long-term prospects for both businesses as good, but the impact of restructuring costs on current free cash flow means these companies are (quite rightly) not growing their dividends.

Elsewhere In The Portfolio

Three other Evenlode holdings that have been 'up against it' over the last year are Rotork, Smiths Group and IMI - all speciality engineering companies with exposure to oil and gas end markets. But like Aveva, they sell mission-critical products that customers can't abandon, even in a downturn. Here is how a Smiths customer from a petrochemical plant explained why they always repurchase the company's market-leading mechanical seals, rather than risking cheaper alternatives:

Mechanical seals are mission critical. If they break we need to shut down the plant at a cost of $1,000 per minute. We would not hold the plant hostage to a faulty seal.

All three of these companies edged their dividends higher at recent results, reflecting free cash flow resilience despite tough end markets.

Elsewhere, we have been encouraged by recent updates from various holdings. Dividend growth has been healthy for many stocks in the fund with highlights including Jardine Lloyd Thomson (+6%), Spectris (+6%), Compass Group (+11%), RWS Holdings (+7%), Paypoint (+15%) and RPS Group (+15%), .

Dividends

Looking across the portfolio as a whole, average dividend growth is currently running at approximately +6%**. This is a slower rate of growth than the underlying portfolio has managed over the longer-term, but very respectable in light of the broader dividend backdrop.

Looking ahead, we remain focused on retaining a portfolio of reliable businesses that, in aggregate, provide both an attractive initial yield and the potential for good dividend growth over time. This might sound like a rather dull, dry ambition, and is one that regular readers will have certainly heard before. But I'll leave the last word to Buffett and Munger:

To the extent we have been successful, it is because we concentrated on identifying one-foot hurdles that we could step over rather than because we acquired any ability to clear seven-footers.

Hugh Yarrow
Investment Director
March 2016

Please note, these views represent the personal opinions of Hugh Yarrow as at 17th March 2016 and do not constitute investment advice.

*Aveva began life as a Cambridge University spin-off in the 1960s. Since then it has built its market-leading sector position without ever borrowing money. This ability to steadily self-fund organic expansion over time is the mark of a business with uniquely attractive economics. It has done so whilst also growing dividends at an annual rate of +20% over the last fifteen years.
**Based on the latest announcement for each stock. This compares with an average annualised dividend growth rate for the current portfolio in the high single digits over the last ten and fifteen years.