

Evenlode Investment View

December 2018 – The Pendulum Swings



“Investment is most intelligent when it is most business-like”

Benjamin Graham

It feels like a long time ago, but this time last year, sentiment was very buoyant towards both the stock market and the outlook for the global economy. Mr Market was afraid of missing out, with economically exposed shares driving returns and speculative assets such as Bitcoin soaring. Since then, the pendulum of sentiment has swung quite significantly. The key catalyst has been increasing concern over the global economy’s outlook, spurred in particular by US trade tariffs and the effect they are beginning to have on both current global trade flows and leading indicators for future global trade. At the same time, the Federal Reserve has continued to crank US interest rates higher with another hike or two still expected in 2019. Closer to home, as I discussed last month, the fog of Brexit continues to hang in the air.

When viewed in the round, 2018 has therefore presented a rather tricky, volatile backcloth for investors, with most asset classes producing a negative return. The FTSE All-Share’s year-to-date decline now stands at -9.8%, compared to a small positive return of +1.5% for the Evenlode Income fundⁱ.

More Interesting Valuations

As I wrote in my investment view at the beginning of this year, more positive sentiment towards the economy and investment markets may ostensibly be a ‘good’ thing, but as the saying goes, ‘you can pay a high price for a cheerful consensus’ - positive sentiment can result in higher valuations and therefore less potential for future return.

Now, conversely, this cheery consensus has dissipated. As a result, valuations are improving for many companies. In particular, I have been pleased that, despite producing a small positive total return so far this year, the free cash flow yield on the Evenlode Income portfolio has improved (i.e. the valuation has become more attractive)ⁱⁱ. This has been down to both good growth in the portfolio’s underlying cash generation, and the changes we have made to the portfolio during the year (which I will summarise in more detail in next month’s investment view).

Avoiding Debt

Managing balance sheet risk remains a key focus. We always prefer the safety and the optionality that a strong balance sheet provides, but this is a particularly important risk to manage at the moment, given that overall corporate debt levels have been ticking up, whilst interest rates (and therefore borrowing costs) are also now rising. When strong balance sheets combine with high and healthy free cash flow generation, a company can pay sustainable dividends whilst also investing in long-term growth: even in more difficult economic times. This state of affairs represents the holy grail, in my view, for the long-term dividend investor. Companies with weak balance sheets and poor cash generation are far less enjoyable to own.

Of the 39 holdings in the portfolio, 18 have no debt at all (i.e. 46% of holdings), and almost all of the

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companies we have been adding to over recent weeks have net cash balance sheets (including Moneysupermarket, Howden Joinery, Schroders, Savills, Hays, DMGT, Euromoney and Rotork). The portfolio's aggregate balance sheet is also significantly stronger than the market averageⁱⁱⁱ.

Long-Term Strategy

December has been a quieter month for results, though those holdings in the Evenlode Income portfolio that have given updates have reassured us (e.g. Victrex). Some companies take a quiet December as an opportunity to hold investor days to update shareholders on longer-term strategy, and I'd like to briefly discuss two Evenlode holdings that have done this in the last couple of weeks: WPP and Unilever. I think both updates highlighted some of the key themes that businesses must grapple with and adapt to in today's global economy.

WPP: Technology and Industry Change

"Technology is our growth engine. Any company that is not investing deeply in technology will not be successful five or ten years from now."

Mark Read, WPP

WPP has had a difficult couple of years and has been the second most negative contributor to Evenlode Income's return during 2018 (the most negative contributor has been Sage, which I discussed in last month's view). With recent management change, December's update was an opportunity for new management to discuss plans for the next few years.

We agree with management's basic view: that the advertising and marketing industry's long-term growth prospects remain quite good: the industry is going through structural change, not structural decline. Marketing spend has remained stable as a percentage of corporate revenues over recent years, but it has changed in nature with increasing fragmentation and digitalisation: it is this change which has presented challenges for the industry. WPP need to move with the times, but it is interesting to note that 17 of Silicon Valley's 20 biggest public companies are already clients (including Google, who are a top five client). This fact is a reminder that WPP's combination of creative skills, industry expertise and sector-specific technology/data know-how remain valuable, even to the most digital-savvy businesses. One of the key tasks for WPP over the next few years will be to develop its technology and data assets further and integrate them as tightly as possible with the company's creative proposition. On this note, it is encouraging that the company has committed an extra £20m a year on technology investment from 2019.

The company has a lot to do over the next couple of years, which comes with some execution risk. However, we are encouraged by new management's focus on organic investment, client satisfaction, portfolio simplification, and a strengthening balance sheet (which will likely be strengthened further by a partial sale of its Kantar business in the first half of 2019). Meanwhile, free cash flow generation remains very strong and provides healthy cover for the dividend stream.

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Unilever: Evolution, Emerging Markets and Digitalisation

“I firmly believe it’s not about hitting the ball out of the park every year, or dancing to the tunes of anybody who wants a quick return. What we are trying to do is run this company year-in, year-out consistently”

Paul Polman, Unilever

There have been many changing dynamics in Unilever’s markets over the last decade, including strong emerging market growth, changing consumer preferences towards healthier/natural products, the growing shift to digital channels, and the threat from private label and start-up brands. Unilever’s strategy update was a reminder of how much consistent investment and incremental progress the business has made over the last few years, but also how much the business plans to evolve over coming years: both to cope with these industry changes, but also to take advantage of them.

Unilever has invested heavily in its brand portfolio. This has included innovation in its existing brands (with time-to-market for new launches halved over recent years), the launch of 28 new brands since the beginning of 2017 (compared to only three new brand launches in the preceding decade) and several bolt-on acquisitions. This has led to a gradual evolution of the company’s product portfolio with higher exposure, for instance, to the attractive Beauty and Personal Care category (which have grown from 28% of Unilever’s sales to 40% over the last decade).

Emerging markets also remain a huge opportunity for the company, and thanks to +9% average underlying sales growth over the last ten years (the 25-year average growth rate is also +9%) this region now represents 58% of sales, compared to 45% ten years ago. The runway for future growth remains clear, with 1.7 billion people in these regions expected to enter the middle-income bracket over the next ten years. This is particularly the case for Unilever, with its enviably entrenched position in many of these countries. It has been in India, for instance, since the 1880s, and its Indian Beauty and Personal Care business enjoys a market position four times larger than its next biggest peer. Interestingly, emerging markets are also now accretive to Unilever’s margins, so as the percentage of Unilever’s sales from these regions continues to increase, there should be a positive impact on the overall company’s profitability.

Finally, the business is digitalising rapidly, and Unilever see this trend as much as an opportunity as a threat (the company’s e-commerce business has grown by +53% over the past year.) Unilever will have 1 billion (!) direct-to-consumer digital relationships by the end of this year and continue to invest in a digital platform and data analytics capacity that can help automate processes, maximise efficiency, communicate effectively with retailers and individual customers, help predict consumer trends and even crowd-source product innovation ideas. The company will be recruiting 10,000 people with digital expertise over the next two years, which will take Unilever’s digital workforce to 20% of the company.

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Happy Christmas

As we peer ahead into 2019 the outlook is as ever unclear. However, taking the long-term view, I am reassured by the fund's dividend yield of 3.4% which is very well covered by the portfolio's cash generation, and I continue to think that the prospects for modest real dividend growth remain good over coming years.

I look forward to updating you on Evenlode Income's progress during 2019. In the meantime I'd like to thank all co-investors for their interest and support this year, and wish you an enjoyable, peaceful Christmas on behalf of all of us at Evenlode.

Hugh and the Evenlode Team
20th December 2018

Please note, these views represent the opinions of Hugh Yarrow as at 20th December 2018 and do not constitute investment advice.

ⁱ Source: Evenlode, Financial Express, total return, bid-to-bid, 31/12/2017 to 20/12/2018.

ⁱⁱ Source: Evenlode/Factset. Evenlode Income's free cash flow yield is 5.2% for this year, 5.9% for next year.

ⁱⁱⁱ Source: Evenlode/Factset/FTSE: Evenlode's net debt is 1.0x this year, 0.9x next year, compared to 1.6x for the FTSE Allshare ex financials.