Evenlode Income Investment View

February 2024 – Themes from results

February was a mixed month for investor sentiment. On the positive side, corporate earnings were reasonable and the global economy, led by the US, has been holding up better than expected. On the other hand, this more optimistic economic picture meant that market expectations for interest rate cuts lessened somewhat. Since the start of the year, Evenlode Income has risen +0.9% compared to rises of +0.3% for the FTSE All-Share and +0.2% for the IA UK All Companies sector[i].

Results

More than 90% of the portfolio companies have updated the market since the start of the year, and we have met with many management teams. The economic backdrop has not been easy, but the aggregate portfolio is making reassuring progress, with organic revenue growth for 2023 averaging +6%[ii]. The outlook for profitability is improving as input cost inflation falls back to more normal levels and global wage inflation is easing back. Free cash flow growth is also healthy, helped by the normalisation of supply chains and inventory levels.

In the rest of this investment view, we'll discuss some key themes emerging from these results, and more generally from the current investment environment.

Supply chains and input costs

A consistent message from management teams is how much better the supply chain situation is now relative to even a few months ago, but particularly when compared to the height of the Covid-related bottlenecks in 2022. As management of Spectris, the test and measurement company put it to us this week, '*overall we are back to a more normal environment, like 2018 or 2019*' Even the tightest markets of all, such as semiconductors, are back to functioning more normally.

In addition to these shorter-term developments, there are structural undercurrents shifting under the surface. Pockets of supply chain vulnerability and fragility were revealed during the chaotic Covid period, which management teams have since been quietly addressing.

Most companies, for instance, are now looking to ensure that as close to 100% of components as possible are dual-sourced. Geopolitical risk is also now given a high weighting in decisions, with 'near-shoring' and 'friend-shoring' both noticeable trends in terms of where incremental investments are made. To return to Spectris, for instance, the percentage of its global cost-of-goods-sold sourced from China has reduced from more than 25% in 2019 to around 10% today, with only half of this 10% used in Spectris equipment that is sold outside China, the rest is used to meet Chinese demand.

Test, inspection and certification companies Intertek and SGS are also seeing these supply chain trends develop across their client base. As Intertek management said this week, '*COVID-19 has been a catalyst for many corporations to strengthen the resilience of their supply chain. We are seeing important changes within our clients. There is a high appetite for more data to understand what's happening in all parts of the supply chain, and there is definitely tighter scrutiny of business continuity plans. Companies are trying to diversify their Tier 1, Tier 2, Tier 3 suppliers, creating opportunities for more audit and inspections*'. Helped by this demand, Intertek and SGS grew their organic revenues in 2023 by +7% and +8% respectively.

Consumer staples

The consumer staples companies have been buffeted around, more than most, by the input cost inflation and demand volatility that the pandemic created. The sector experienced a violent pick-up in input cost inflation in 2022, with most businesses facing around +20% year-on-year cost inflation. Though their repeat-purchase business models, pricing power, high gross margins and asset-light economics have all helped insulate performance through the period, it is hard to understate how unusually volatile the backdrop has been.

Four years on from the onset of the pandemic, these trends are finally beginning to normalise. Unilever, for instance, had to raise prices by +13% in the fourth quarter of 2022 as input costs surged. This led to a -4% fall in volumes. By the fourth quarter of 2023, though, the need for price increases lessened as input cost inflation slowed materially. For this latest quarter, prices rose +2.8% and volume growth recovered to +1.8%, leading to organic revenue growth of +4.7%. Looking ahead, Unilever management expects to generate organic growth rate of +3-5% per annum, with a more familiar pre-pandemic balance between volume and price growth, and gradual margin expansion over time driven by operating leverage.

As well as pandemic volatility, Evenlode Income's key holdings in this sector - Unilever, Reckitt and Diageo - have also suffered from some internal issues over recent years. With Unilever and Reckitt, we would have liked them to invest more consistently in future growth. Diageo, on the other hand, has faced a specific inventory management issue in Latin America over recent months, which was magnified by post Covid-volatility.

All these companies, though, continue to generate very healthy cash flows. And looking ahead, Covid dynamics are normalising and these internal issues, as with any fundamentally good business, are fixable with the right people in place, making the right strategic decisions and the right investments. Diageo noted at recent results that a full global review and audit of inventory management has been completed, and its South American business has a new senior management team. Meanwhile, Reckitt and Unilever both significantly increased investments in advertising, innovation, and manufacturing/distribution capacity during 2023, and committed to continue stepping up these investments in coming years.

We think the prospects for mid-to-high single digit growth in free cash flow per share are good for these three companies. In the meantime, their valuations are at or near multi-year valuation lows, and they all contribute healthy and resilient free cash flow and dividend streams to the overall portfolio.

Strong grow stronger

We discussed the 'strong grow stronger' theme in our November view. Many sectors have seen demand fall over the last eighteen months as the global economy has slowed, whilst interest rates have risen very sharply. Though it's hard to see in the financial results for 2023 due to tough end market conditions, we see many well-managed businesses with strong financial positions quietly strengthening their competitive positions. When conditions improve, they will emerge in very good health.

Howden, Savills, PageGroup, Hays and Integrafin are all good examples. Financial technology provider Integrafin, for instance, has stepped up investment in its systems and customer support over the last two years, despite difficult end markets. In 2023, the company's market share of the UK financial adviser platform market grew to 10%, with its share of new inflows into the sector running at 21%. These figures are testament to the strength of the company's proposition, as is the 95% client retention rate. Over the last five years, through a very difficult period, the company has grown its client numbers by +7% per annum and funds under direction by +11% per annum.

Howden Joinery is a very different business to Integrafin, but the themes are similar. 2023 was a difficult year for Howden, but the company continued to take market share. The UK kitchen and joinery market decreased by more than -10% in volume terms. Howden significantly outperformed with a decrease in volumes of -5%. The company is benefitting from continued investments in its depot network, upgrading existing depots, and improving digital tools so builders can now check inventories and place orders through the app.

We've already seen this dynamic play out at Compass and Informa through the pandemic and back out the other side. Their competitive positions strengthened through very difficult Covid-impacted markets, and they are now reaping the rewards as demand rebounds strongly. Compass, the global market leader in outsourced catering services, has continued to improve its offering in recent years, developing new brands, and investing in digital tools and standalone kitchens to serve smaller businesses. This has driven new contract wins over the past few years to roughly double the pre-pandemic level. Helped by these trends, organic revenue for Compass grew +12% over the company's most recent quarter.

The 'strong grow stronger' theme is just as relevant when there is no clear competitor for your offering as is the case for Games Workshop. Management, though, do not rest on their laurels: '*we aim to make the best fantasy miniatures in the world, to engage and inspire our customers, and to sell our products globally at a profit. We intend to do this forever. Our decisions are focused on long-term success, not short-term gains*'. As the company invests in this focused expansion, the Warhammer hobby continues to spread globally, with 70% of sales now international. Its licencing division also offers interesting growth prospects - an agreement has recently been signed with Amazon to produce films and television series that will use the company's rich array of intellectual property. Despite a muted backdrop for the global consumer, revenue for Games Workshop grew at +12% over the last six months, helped by the launch of a significant number of new products. As management put it, '*morale is good at Games Workshop and our hobbyists are having fun too*'.

Software eating the world

Corporate investment in technology remains a ubiquitous trend across the global economy, as companies of all shapes and sizes invest in digital tools to improve their performance, adaptability, and efficiency. At recent results, Sage noted that '*small and mid-sized businesses are continuing to digitalise despite the ongoing macroeconomic uncertainty, and through our trusted cloud solutions and innovative, AI-powered services we are well positioned to support them*'.

Revenue and earnings growth for these software and data analytics holdings continues at a very healthy rate. Organic revenue growth for RELX, Sage, Microsoft, Experian, LSE and Wolters Kluwer were +8%, +10%, +16%, +7%, +7% and +6% respectively, for their most recent reporting period.

These businesses have been steadily investing in digital information and cutting-edge data analytics technology for many years, and growth opportunities remain significant. It is worth noting, though, that Mr Market has taken a fancy to digital business models over the last year, and the share prices of many have been very strong. Reflecting this trend, we have been trimming back some of these holdings (RELX, Sage, Microsoft and Wolters Kluwer) over recent weeks, recycling the proceeds into other holdings where the valuation and dividends look more attractive.

Speciality engineers

The portfolio's engineering and industrial holdings - Rotork, Spectris, Spirax, Smiths Group, Halma and Diploma – sell mission critical products to loyal customers and generate attractive economics and healthy cash flow. They are all well placed to benefit from another long-term shift in the global economy: the upgrading and decarbonising of the global industrial system over coming years.

As Rotork said this week, '*our divisions are extremely well placed to benefit from the industrial megatrends of automation, electrification and digitalization, which are accelerating.*' Spectris are seeing similar long-term potential in their end markets from investments being made in sustainability, electrification, batteries, advanced materials and life sciences.

We added a small position in Spirax to the portfolio a few months ago after a difficult year for its end markets led to share price underperformance. Spirax is the global leader in steam and electric systems essential for the transfer of heat and energy into industrial processes. Despite a difficult year, Spirax has continued to invest for the long term. As management put it at recent results, '*our decision to maintain investment in critical strategic initiatives, such as further developing our digital and decarbonisation capabilities, will support the delivery of compounding growth at attractive margins for many years to come*'.

Compounding free cash flow at attractive valuations

There are, then, plenty of high-quality UK-listed businesses quietly getting on with things. Current trading conditions are very positive for some, and more challenging for others, but aggregate growth remains robust and the foundation stones for future compound growth are being laid across the portfolio. There is also no shortage of valuation and dividend appeal on offer – within Evenlode Income's investable universe, the aggregate valuation opportunity is looking about as good as it has at any time over the last decade, other than during the Covid sell-off in 2020. Whilst we, as always, would expect the bulk of future returns from the fund to be driven by a combination of compound free cash flow growth and dividends, this valuation starting point provides a very reassuring margin of safety for the long-term investor.

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

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[i] *WS Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return, bid-to-bid, GBP terms. Performance from 31 December 2023 to 7 March 2024.*

[ii] *Source: Evenlode, Visible Alpha.*