

Evenlode Investment View

July 2020 – Snippets from Results



Markets have been range-bound during July, easing off towards the end of the month. Positive news on vaccine development has been offset by an increase in Covid-19 cases in several geographies, and localised lockdown measures. More generally, concerns remain that the pandemic will cast a shadow over several parts of the global economy for at least another year or two, even if good progress is made on vaccines and antiviral treatments.

As I write, the Evenlode Income fund has fallen -9.2% since the start of the year, compared to a fall of -17.7% for the FTSE All-Share.ⁱ

Cash Generation and Dividends

Investors have been absorbing the second quarter results season, with companies reporting on the very challenging March-to-June quarter.

We have been reassured that the overall free cash flow generation for the portfolio, whilst clearly impacted, has remained quite healthy and continues to provide good cover on the dividend stream. The following table demonstrates this dynamic. It shows Evenlode Income's free cash flow yield and dividend yield statistics, based on data for each holding's last financial year (FY0 – for most companies calendar year 2019), as well as estimates for the current financial year (FY1 - 2020) and next year (FY2 - 2021)ⁱⁱ:

	FY0	FY1	FY2
Free Cash Flow Yield	5.2%	4.6%	5.2%
Dividend Yield	3.4%	2.6%	3.0%

These statistics highlight the crisis-effect on dividends. With a large number of companies deciding to pass their payments during lockdown, the impact has been significant. When I updated on the dividend stream in May we expected a fall in dividends of between -20% and -25% for the fund's current financial year (to February 2021). Some uncertainty remains, but based on current forecasts we would expect the end result to be towards the bottom end of this range. Though estimates for the UK market suggest a much greater fall in dividends (of nearly -50%ⁱⁱⁱ) it is still clearly disappointing to report this impact. Looking ahead, we think the portfolio's dividend stream should recover relatively strongly next year (albeit not immediately to pre-crisis levels). Longer-term, we think the prospects for free cash flow and dividend growth remain good, given the collection of cash generative, market-leading companies held in the portfolio.

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Since the beginning of July, nearly 70% of the Evenlode fund has updated the market and we've been busy absorbing these results and speaking to company management. In the remainder of this investment view, I'd like to give some flavour of these results and discussions.

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Polarised Performance by Category and Geography

Perhaps the most obvious trend has been the vastly divergent performance of companies operating in different sectors and geographies. Some companies (particularly those in the consumer branded goods, digital and healthcare sectors) have actually seen strong sales growth during lockdown. Reckitt, Microsoft and AstraZeneca grew revenues, for instance, by +19%, +15% and +11%. Others, of course, such as Howden and Compass, were far more impacted (with revenue falls of -56% and -44% respectively) as large portions of their operations were required to close. This divergence is not just evident between companies, but also between divisions within companies (both by sector and geography). Unilever revenues were broadly flat but the company posted +7.3% growth in North America, benefiting from a portfolio biased towards the stay-at-home trend. In contrast, emerging market sales fell -1.9% with the severity of the Indian lockdown impacting performance, but offset by strong growth in China as it returned to some sense of normality after its first quarter lockdown. For Pepsico, people stayed at home eating savoury snacks (Doritos, Walkers, Lays etc.) on their sofas, leading to good growth in this division, whereas its beverages division saw revenue fall as people consumed less on-the-go drinks.

Health & Hygiene

The twin themes of health and hygiene have of course been centre stage over the last few months. Healthcare companies themselves have by no means been entirely unaffected by lockdown. For biopharmaceutical companies, prescription activities have dropped for some therapies as patients have been unable to access hospitals. For medical devices companies such as Smith & Nephew, volumes were impacted by the decline in elective surgeries as hospitals cleared their wards for COVID sufferers.

However, the overall picture is of resilience. Roche last week announced sales +1% and operating profit +2% for the first half of 2020 and expected steady growth for the full year. Management noted that despite the tick up in new COVID cases in the US over recent weeks, things are beginning to function more normally, suggesting that healthcare systems are adapting and patients suffering from non-COVID diseases are resuming treatment. Smith & Nephew have reported sequential trends in the recovery of elective surgeries and growth in China in the second quarter. People who needed a hip or a knee implant before the crisis are likely to still need it now, and have generally delayed rather than cancelled their surgery. Smith & Nephew's management are looking past lockdown and are continuing with pre-crisis R & D investment plans.

Thinking longer-term, there will always be risks to healthcare companies (product innovation cycles, regulatory change etc.). However, investments in diagnostics, vaccines, healthcare therapies and improved hygiene are likely to provide a useful tailwind for this sector over coming years. The crisis has also served as a reminder to governments of the role that health and hygiene companies can play in taking the strain off healthcare systems and mobilising innovation to help solve public health problems.

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On the subject of hygiene specifically, Reckitt are well placed to benefit from hygiene trends as the world's market leader in surface disinfectants with the Lysol and Dettol brands representing c.20% of their portfolio. Lysol and Dettol grew +70% and +60% in the first half this year. Whilst this extreme level of growth will ease back, management are expecting the change in consumer behaviour to last years rather than months or quarters. Their research suggests that when consumers change their behaviour for more than 60 days new habits stick, and that 85% of individuals have changed their hygiene habits during the lockdown period.

Digitalisation

This Reckitt example highlights a broader point. There will be many ways in which the world will return to normal once this public health crisis subsides, but it will also leave some permanent imprints on our habits and preferences.

Along with hygiene habits, the working-from-home trend and accelerated digitalisation are perhaps the clearest. Digitalisation is perhaps the most ubiquitous trend we see across all the companies in the fund, with the proportion of the global economy that is digital expected to double over the next decade. Both consumers and businesses are increasingly digitalising their day-to-day habits and workflows. Unilever's e-commerce sales grew +49% during the first half of 2020 and now represents 8% of group sales. Management mentioned to us this week that they are considering a world in which more than 30% of their sales may ultimately be generated through the digital channel.

Companies that are helping other businesses to digitise have traded quite resiliently over the last few months. Microsoft is in a sweet spot, with Teams users spending more than 5 billion minutes on video conferences on a single day in the second quarter, and Microsoft 365 revenues growing +50% over the last 12 months. Several other holdings in the fund (including Relx, Sage, EMIS, IBM, Intel and Cisco) are aligned to these trends.

Resilience

“The last five months have made it very clear that digital tech intensity is key to business resilience. Organizations that build their own digital capability will recover faster and emerge from this crisis stronger. We are seeing businesses accelerate the digitization of every part of their operations, from manufacturing to sales and customer service.”

Satya Nadella, Microsoft

Pre-crisis, the emphasis when companies talked about digital investment was perhaps more on increasing efficiency and improving product quality. But, as the above quote highlights, the crisis underlines how digital investment helps improve operational flexibility and resilience, both qualities that companies have craved in the recent trading environment.

There are other non-digital ways in which companies would like to make themselves more robust to the crises of the future. These include financial robustness. Buy-backs have suddenly become deeply unfashionable and some companies are revisiting their policies on what counts as an appropriately

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strong balance sheet. Supply chain resilience has also come up in recent conversations. Changes to supply chains tend to be incremental, but at the margin companies are looking to ensure that more localised (or vertically integrated) supply chains are available where required, that depend less on one supplier or far-away region. Unilever mentioned to us this week that the early stage of the crisis reminded the company of their dependence on China for several raw ingredients. Howden Joinery already have quite a vertically integrated supply chain with many of their kitchen components manufactured in the UK. This has been a key source of competitive advantage (leading up to the crisis, but particularly during the last few months where many competitors suffered from big stock availability problems and had to hike prices for much of their product range). Howden are now considering investing to bring more of their product range in-house over the medium-term.

Long-Termism versus Short-Termism

This brings me to finish on what is, I believe, a positive note. *From the perspective of the business world, might anything good come from this crisis?* I think it will help to catalyse a shift away from the short-term efficiency mind-set, which was to already happening to some degree pre-crisis. The current tone from companies reflects a willingness to increase resilience to shocks in order to thrive over the longer-term (whether these shocks come from public health crises, environmental impacts, ‘normal’ recessions or anything else). This requires more emphasis on long-termism, flexibility, balance sheet strength, healthy levels of investment and running a multi-stakeholder business. It requires less emphasis on exactly what the profit number (to the nearest decimal point) is each month or each quarter.

Any shift in this direction represents a positive step for patient, long-term shareholders.

Hugh and the Evenlode team

30th July 2020

Please note, these views represent the opinions of Hugh Yarrow as at 30th July 2020 and do not constitute investment advice.

ⁱ Source: Evenlode, Financial Express. TB Evenlode Income B Inc shares. All figures total return, bid-to-bid, GBP terms - 31/12/2019 to 30/07/2020. Past performance is not a reliable indicator of future performance.

ⁱⁱ Source: Evenlode, Factset, 30th July 2020

ⁱⁱⁱ See, for instance, Link’s latest dividend monitor: <https://www.linkassetservices.com/our-thinking/uk-dividend-monitor-q2-2020>