Evenlode Investment View

July 2021 – Themes from Results

During July, the UK stock market has been range-bound with investors contemplating a mixed backdrop. The coronavirus situation continues to improve in many regions, with vaccination programmes progressing well. Disruption from the virus, however, has by no means ended: global case rates are high and rising in certain regions (the US, South East Asia etc.) and some restrictions have been re-imposed over recent weeks. On the economic front, there are positives: monetary and fiscal stimulus remains very accommodative, and the post-lockdown global recovery has been rapid. On the other hand, the phased withdrawal of fiscal stimulus programmes (furlough etc.) may present economic headwinds over coming months, and leading economic indicators suggest a slowing rate of global growth, led by China.

So far this year, Evenlode Income has risen by +9.7% compared to a rise of +11.7% for the FTSE All-Share[i].

Themes from Results

July has been a busy month for company results, with the bulk of the first-half reporting season now over. More than 80% of Evenlode Income holdings have released results this month, and we have been busy analysing them and talking to company management teams. The remainder of this view gives a flavour of some key themes from the corporate world.

The Shape of The Recovery

For those companies most impacted by the pandemic, it is interesting to note the shape of financial recovery. Most impacted companies are seeing a rapid recovery with sales close to or above pre-pandemic levels:

- Diageo's revenue for the past year was +6% ahead of its 2019 performance, impressive given how many bars and restaurants have been closed during this period due to lockdown measures. Strong cash generation through the crisis has allowed the company to raise its dividend by +4%, the 20th consecutive annual increase in its dividend payment.
- Specialist recruiter Page Group announced that fee revenue last month was +11% higher than the same month in 2019. For an economically sensitive company like Page, this represents an unimaginably sharp recovery trajectory relative to anything that management or analysts would have hoped for back in March or April last year. Page has generated strong cash flow through the crisis and will return to dividend payments this summer.
- Howden Joinery's first half revenue (which included the winter lockdown period) was +20% higher than 2019 levels. With people now spending more time at home, they are prioritising investment in their living environments. Howden has a huge cash pile and upped its dividend at the latest results.

- Smith & Nephew's first half revenue was -1% below 2019 levels. Orthopaedic surgery volumes were significantly impacted by the crisis last year as hospitals were cleared out to make way for Covid patients. Surgeons around the world are now working hard to catch up on delays and deferrals as hospitals gradually return to normal. The company has held dividends through the crisis, with plenty of potential for growth over coming years.

Other companies, still burdened by travel and social distancing restrictions, are recovering less rapidly. The two companies that most clearly fit into this category within the Evenlode Income portfolio are Compass and Informa:

- Compass Group's financials are recovering as social restrictions begin to lift and food catering demand correspondingly rebounds. Revenues, however, were still -24% lower than 2019 in the latest quarter, with the gap expected to close to -15% for the current quarter.
- Informa's trade exhibitions division remains impacted by travel restrictions. Chinese exhibitions have recovered most quickly, with revenues expected to be close to 2019 levels in 2022. Management note that the recovery trajectory of trade exhibitions in other regions is running about a year behind China.

The Strong Grow Stronger

Market leaders have generally been particularly well placed to cope with the crisis, and for many this has led to a strengthening of competitive position. This trend is notable across many portfolio companies. Returning to Compass Group, for example, management note a 'flight to trust' since the onset of the crisis, as customers have looked to the most financially strong, trusted provider in their sector. Possessing the scale and expertise, as Compass do, to cope with operational complexities such as Covid restrictions, health and safety precautions and input cost inflation represents a significant competitive advantage. Compass management report they have been consistently taking market share in all regions and sectors since the crisis began.

Flexible Working

Flexible working is another theme that comes up regularly in conversations with management, and is undoubtedly here to stay. The office will remain an important space, but it will be used in a different way: for meetings, collaboration and training, as much as desk work. As Savills pointed out recently, this is likely to mean that prime, flexible office space will remain in high demand, whereas out-of-date tertiary facilities will become surplus to requirements. Many companies we have spoken to are rationalising their office footprints to reflect these changes. Combined with less business travel, this is helping to reduce ancillary costs. On the other side of this trend, the home has become more important. Pepsi talk of the concept of 'the home as the hub', with more time now being spent at home, and more meals being eaten there, both of which have an impact on spending patterns.

Inflation and Pricing Power

The recent spike in raw material prices has needed careful management over the last few months, with everything from freight costs, timber, steel, soap noodles and plastics having risen sharply in price, with Covid-related supply constraints playing a major part in this dynamic. Input cost inflation can create some short-term pressure on margins (more on which below), but overall we are very reassured by the excellent economics (high profitability, low capital intensity etc.) and pricing power that companies across the portfolio enjoy. This is helpful for insulating cash generation through such a period. Company examples include the speciality engineers in the portfolio. Input costs for products such as valves, actuators and spectrometers have seen a short-term upward spike. But as our conversation with Smiths Group confirmed this month, the company is able to use pricing as a tool to drive revenue growth through these periods, given the mission critical nature of its products, and the low proportion of a customer's overall cost-base that these products represent. Test and measurement company Spectris also noted this ability to take price at recent results, in which they reported revenue growth of +14% combined with significant margin expansion.

Consumer Branded Goods

Within the consumer branded goods sector, input cost inflation has been particularly high over the first half. The sector enjoys high gross margins and has a strong track record of taking price over time where necessary. PepsiCo and Diageo for instance, confirmed they are taking actions which will offset the effect of input cost inflation this year. To give a sense of this dynamic at work, PepsiCo's second quarter revenue increased by +12%, +7% of which was driven by volume growth, with the other +5% coming from price and mix.

Some consumer branded goods companies however, including Unilever and Reckitt, have noted they won't completely offset input cost rises within the current financial year, and have trimmed operating margin guidance relative to expectations set at the start of 2021. This was not taken well by the market, with Unilever and Reckitt's share prices having fallen -3% and -13% respectively this month[ii].

Taking a step back, our fundamental views on these companies remain positive. Unilever is growing revenue at a healthy rate and is generating significant free cash flow. Though we are in a volatile period, Unilever has the advantage of generating strong 40%+ gross margins, and a record of managing successfully through inflationary periods (most recently in Latin America), generating growth and protecting margins through efficiencies and pricing. We continue to think the strength and breadth of the brand portfolio, and high exposure to structurally growing emerging markets (60% of sales) positions Unilever well for the medium and long-term.

For Reckitt, the Covid period has created an unusual amount of volatility in the company's quarter-by-quarter financial performance, compared to more normal times. However, it is worth noting that group organic sales have grown by more than +17% versus 2019, and new management has invested significantly in the business for the long-term during this period. Reckitt's R & D investment, for instance, has increased by +30% as a result, whilst E-commerce sales have also grown by +95% and now represent 12% of group sales. Looking ahead, Reckitt has a strong portfolio of brands in attractive categories, with particularly interesting growth in emerging markets which represent nearly 40% of group sales. Management's medium-term guidance (of mid-single-digit organic sales growth and profit margins in the mid-20s) was reiterated at recent results.

Consumer branded goods companies such as Unilever and Reckitt are rare, precious companies for the patient income and growth investor. They are global market leaders with repeat-purchase business models and steady long-term cash-compounding economics. As discussed in several recent investment views though, Mr Market has been more interested recently in deep recovery stocks on the one hand, and very high-growth and highly-rated businesses on the other. On our estimates, this has left long-term forward return potential looking very attractive for several of the more stable, repeat-purchase business models within the Evenlode Income universe.

Digitalisation, Operational Resilience and Adaptability

Another common theme we see across companies is the desire to invest properly in operational resilience and flexibility. Well-invested companies have been far better positioned to cope with, adapt to, and emerge stronger from the recent crisis.

One of the most effective ways to improve resilience is to invest in digitalising your business. Many companies in the fund (Relx, Wolters Kluwers, Microsoft, Sage, EMIS etc.) are enabling their customers, through the provision of software and data analytics products, to work more effectively and flexibly. Relx management noted this week that the data analytics trends within its end markets (medicine, science, risk analytics, cyber-security, law etc.) enjoy a compelling, multi-year runway as both penetration rates and demand for these services steadily increase.

For specialist outsourcers such as Bunzl, Page Group, Hays, SGS, Compass and Savills, demand for greater flexibility is also creating structural tailwinds in their markets. Their business customers are looking to focus on their core operations, leading to structural growth in the outsourcing of ancillary services to trusted specialists, and often improving services and lowering costs in the process.

Evenlode Investment View

July 2021 – Themes from Results

Through and Beyond the Crisis

To sum up, the operational environment has not been without complexity over the last eighteen months, and share prices (at both the market and individual company level) have been very volatile due to the noisy short-term news flow and swings in investor sentiment. In terms of fundamentals through, underlying portfolio companies have coped well through the crisis and have generated strong cash flows along the way (with the fund's free cash flow yield currently standing at 5%[iii]).

Looking ahead, we think these companies enjoy strong competitive positions in attractive markets and are, in aggregate, well placed to steadily compound free cash flow and dividends over coming years.

Hugh and the Evenlode team
30th July 2021

Please note, these views represent the opinions of Hugh Yarrow and the Evenlode Team as of 30th July 2021 and do not constitute investment advice.

Where opinions are expressed they are based on current market conditions, they may differ from those of other investment professionals and are subject to change without notice. This document is not intended as a recommendation to invest in any particular asset class, security or strategy. The information provided is for illustrative purposes only and should not be relied upon as a recommendation to buy or sell securities.

For full information on fund risks and costs and charges, please refer to the Key Investor Information Documents, Annual & Interim Reports and the Prospectus, which are available on the Evenlode Investment Management website (https://evenlodeinvestment.com). Recent performance information is also shown on factsheets, also available on the website.

Past performance is not a guide to future returns. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Fund performance figures are shown in Pound Sterling, inclusive of reinvested income and net of the ongoing charges and portfolio transaction costs unless otherwise stated. The figures do not reflect any entry charge paid by individual investors.

[i] *Source: Evenlode, Financial Express. Evenlode Income B Income, total return, bid-to-bid, 31/12/2020 to 30/07/2021*
[ii] *Source: Evenlode, Financial Express, total return, bid-to-bid, 28/02/2021 to 29/07/2021*
[iii] *Source: Evenlode, Factset, 30/07/2021, forecast for next financial year*