Evenlode Income Investment View

July 2024 – Interim results

EVENLODE
INCOME FUND

Market data is from Bloomberg, FactSet and FE Analytics.

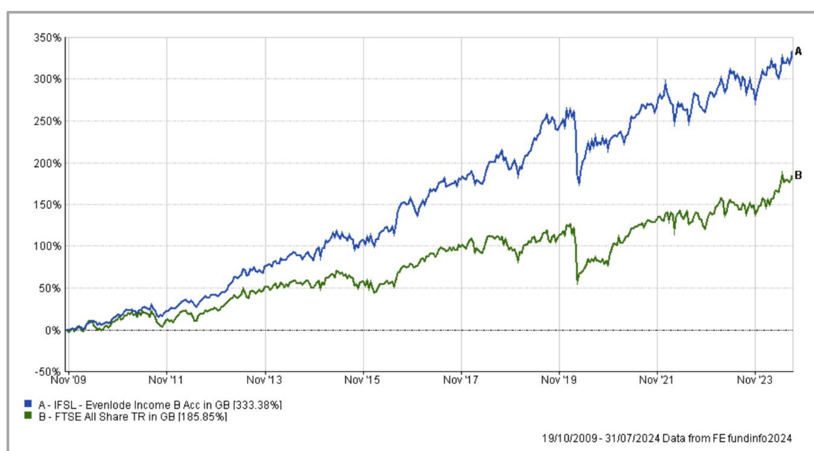
July has been an interesting and complicated month for global investors on all levels – geopolitical, economic, stock market and corporate. The outcome of the US election remains uncertain, and tensions in the Middle East have risen again. Meanwhile, recent data has shown signs that the US economy is cooling, and inflation has also fallen back. The Federal Reserve is now expected to make its first interest rate cut of the cycle in September. Closer to home, the Bank of England made its first cut at the start of August.

Global stock market volatility picked up in July, with US technology shares – 'the only game in town' since January 2023 – showing signs of fatigue. A backcloth of anxiety over post-Covid induced inflation, geopolitical risk, rapidly rising interest rates and a cooling global economy has led investors to bid-up a select few large US companies over the last few years, at the expense of most other areas of the global market. This has led investor positioning to become extreme, which was well summed up – anecdotally - by the Barclays strategy team on return from a client trip to the US in early July:

"Stocks related to popular themes like AI, weight loss drugs, data centres or electrification are core holdings in many funds. So, clients run very concentrated portfolios in very consensual stocks, but don't seem too worried about it, as performance has benefited from it."

The Nasdaq Composite fell in July, whereas most other areas of equity markets rose, including the UK stock market. Evenlode Income rose +3.2% over the month compared to +3.1% for the FTSE All-Share Index. This brings the year-to-date return for the fund to +5.1% compared to +10.8% for the FTSE All-Share Index[i]. As discussed in recent investment views, the fund's underperformance occurred in March and April, as more cyclical and asset-intensive sectors drove the market higher, leaving the Evenlode Income portfolio behind.

Though our 'get rich slowly' strategy has lagged so far this year, we continue to plough our usual furrow and have faith in its through-cycle delivery. As highlighted in the chart below, the strategy has returned +333% after fees since launch, versus +186% for the FTSE All-Share Index, over a period of a little under fifteen years. This represents an average annual return of +10.5% per annum after fees, versus +7.6% for the FTSE All-Share Index[ii]. The market has broadened out since the end of April, with Evenlode Income returning +5.4% compared to +4.4% for the FTSE All-Share Index[iii].



Interim results

In the last two weeks of July, interim results season has been in full swing. Results across the market are mixed. Plenty of companies are performing strongly, but there are also pockets of the global economy that remain weak. This includes certain industrial end-markets and others – such as life sciences and spirits – that are suffering from weak demand following a Covid-era demand surge, which has then been accentuated by destocking trends. Global consumers have also been tightening their belts a little, in reaction to three years of rising prices and interest rates.

Within the Evenlode Income portfolio, over 85% of holdings have reported results since the start of July – a barrage of summer news! Though a few holdings are posting negative revenue growth – including Hays, Page, Spectris, Diageo and Burberry – most others are growing well. So good aggregate progress is being made, with mid-single-digit organic revenue growth[iv] and high-single digit operating profit growth on average[v]. Cash generation remains healthy, and valuations look good relative to history. The free cash flow yield[vi] for the portfolio is 5.1% for this year and forecast to grow to 5.8% next year, supporting the fund's current dividend yield[vii] of 2.9%.

Below is a discussion of some key trends and recent developments that we have seen across the fund's holdings.

Niche market leaders

"I'm smart in spots, and I stay around those spots"
Thomas Watson

In a meeting with Howden Joinery Group last week, management described themselves as 'obsessive kitchen nerds'. Howden builds strong relationships with its trade builder customers through a hyper-local depot network. The company then listens closely to these builders and invests relentlessly to improve the product range and service offering. It's a simple approach and a very powerful one.

The fruits of this strategy can be seen in the steady market share gains that Howden has made over recent years. The company now accounts for one quarter of the UK kitchen market and think they could steadily get to a 30% share, and above, over time. The UK kitchen market is currently at a cyclical trough, with volumes well down from pre-Covid highs and back to levels last seen in 2009. The cost-of-living crisis, high interest rates and low housing transaction rates have all played a part. But despite these challenging conditions, Howden's revenues are now +48% higher than they were in 2019. This has been achieved though market share gains (the strong growing stronger), expanding into adjacent categories (premium kitchens, flooring, bedrooms, doors, accessories, hand tools etc) and international expansion in France and Ireland. When Howden's end markets begin to pick up, the company is very well placed to benefit. Many of its competitors have been closing stores, making staff redundant, or going out of business. As management put it to us, *"our competition is in a poor place and won't be ready to take business when the market turns – so we are likely to take even more share"*.

Talking of nerds, Games Workshop – discussed in last month's investment view – sells fantasy miniature models to a loyal and growing hobbyist customer base. Like Howden – and Tom Watson – it is good in its spots and sticks closely to them:

"Our ambitions remain clear: 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".

Games Workshop released full year results in July and announced organic revenue growth and operating profit growth of +15% and +26% respectively.

Elsewhere in the portfolio, a broad range of niche global leaders continue to quietly plough their furrow, and are investing for the long-term, to strengthen their relationships with customers and competitive advantages:

- **Compass** - The global market-leader in food catering with a reputation for quality and operational know-how. The company continues to take market share both from both competitors and in-house offerings.
- **Bunzl** - The global market leader in the distribution of not-for-resale products to a wide range of sectors. Also, the 'Berkshire Hathaway' of its sector with a reputation for being a good owner. Founders in the industry, that care about their business and their team, want to sell their business to Bunzl when they are ready to retire.
- **Informa** – The global market leader in trade shows. Informa operate a diverse portfolio of shows that build enviable and impossible to replicate local and regional network effects, within the niche communities that attend them. In an increasingly digital world, the opportunity to meet the whole of your industry in person once a year, has become even more valued.
- **Diploma** - A specialist value-adding industrial distributor, focused on delivering a Halma-like compounding model (as discussed in last month's view) for the long-term.
- **Intertek and SGS** – Global market leaders in test and inspection markets. Helping corporates navigate health and safety regulations, reconfigured supply chains (re-shoring, friend-shoring, dual sourcing etc), supply chain sustainability audits and more.
- **Savills** – A global leader in real estate services. Well-invested and beginning to emerge from a deep interest-rate driven downturn in global property markets.
- **Page and Hays** – Global market leaders in specialist recruitment. Currently navigating a difficult post-Covid recruitment market but in good shape to capture the upturn when conditions improve.
- **Speciality engineers** – Selling mission-critical products into niche markets with very interesting compounding runways, as the industrial system reconfigures itself around energy security, decarbonisation and electrification. We have discussed holdings such as **Halma, Spectris, Spirax, Smiths** and **Rotork** in recent investment views.

Data and software analytics

Evenlode's data and software analytics holdings represent c.18% of the portfolio. These companies are seeing steady demand growth as their clients continue to prioritise investment in digital tools to improve productivity, adaptability and the quality of their own products and services. The digital tools these companies sell become highly embedded in client workflows, driving high levels of recurring revenue and attractive economics. Recent revenue growth rates bear witness to these trends: RELX +7%, Experian +7%, LSEG +7%, Sage +9%, Wolters Kluwer +6% and Microsoft +16%. These companies continue to invest steadily and meaningfully to drive future growth. RELX management sum-up this focused investment approach well:

"Our improving long-term growth trajectory continues to be driven by the ongoing shift in business mix towards higher growth analytics and decision tools that deliver enhanced value to our customers across market segments. We develop and deploy these tools across the company by leveraging deep customer understanding to combine leading content and data sets with powerful artificial intelligence and other technologies. This has been a key driver of the evolution of our business for well over a decade, and will remain a key driver of customer value and growth in our business for many years to come".

After very strong share price performance since January 2023, we have nudged down our exposure to some of these holdings for valuation reasons, over recent months ie RELX, Microsoft, Sage and Wolters Kluwer. We do, though, continue to see a great combination of quality and compounding free cash flow for these companies, and remain very open to increasing exposure if relative valuations and dividend yields start improving.

Consumer branded goods

The portfolio's exposure to Consumer Staples is approximately 20%, with the bulk of this in three holdings – Unilever, Diageo and Reckitt Benckiser. Unilever delivered a solid first half, with revenue and profit growth of +4% and +17% respectively. The company is taking a more focused approach and accelerating its investments in innovation and marketing spend behind the company's 30 power brands, such as Dove and Vaseline. These power brands generate more than 75% of Unilever's sales and enjoy strong market leadership, scale and more attractive economics than the company's other brands. In the first half, the power brand portfolio continued to outperform with revenue growth of +6%, of which two-thirds was driven by volume.

Reckitt's share price has been affected this year by US litigation risk in its infant formula business, Mead Johnson. Though we are factoring in this risk, we would note that the c.£8bn that has been removed from the value of the company since March, compares to a potential settlement of up to £2bn if conservative assumptions are made. Reckitt refutes any liability and has received supportive comments from the American Association of Paediatricians. Outside of Mead Johnson, the other 85% of the company is a portfolio of global market-leading health and hygiene brands (Mucinex, Strepsils, Gaviscon, Lysol, Dettol, Finish, Vanish, Durex etc), which generate attractive 60% gross margins and have good potential to compound free cash flow over the longer-term.

Diageo continues to face a challenging industry backdrop due to softer consumer demand and post-Covid destocking. The company released full year results in July, posting a fall in revenue and profit of -0.6% and -4.8% respectively. For the long-term investor though, Diageo remains a well-invested global market leader with good growth prospects and an impossible-to-replicate brand portfolio and global footprint. The valuation hasn't looked this good for a decade. When industry dynamics begin to normalise and recover, we believe Diageo will be well placed to benefit.

More generally, the consumer branded goods sector has not been fashionable over the last four years – the market has been more interested in faster growing technology companies on the one hand, and more cyclical business models such as commodity producers and banks on the other. The sector has also produced less predictable results each quarter than investors are used to, due to both Covid-induced demand volatility and an extreme post-Covid input cost spike. Their strong brand portfolios, diversification and repeat-purchase cash flows provide welcome qualities though, in the context of our through-cycle investment approach.

Luxury goods

Evenlode Income has two small holdings in the luxury sector - LVMH and Burberry - each of which make up approximately 1% of the fund. Like the spirits industry, the luxury market has weakened significantly over recent months. For some luxury consumers this is a cost-of-living challenge, but for other wealthier consumers it is more of a confidence issue, driven by economic and political uncertainty and volatility.

Within the global downturn in luxury there has also been a flight to brand 'certainty'. LVMH has benefited from this trend and has traded relatively resiliently through the downturn, with first half revenue growing at +2%. Brands in transition though, such as Gucci and Burberry, are underperforming. Our conversations with both industry experts and Burberry over recent months, suggest there have been significant – though addressable – executional missteps with the latest collections. The Burberry brand is strong with more than a century of heritage, particularly in outerwear and accessories. With the right adjustments we expect the company to come through this rough patch and benefit from recovery and growth in the luxury goods industry over the medium term. From a valuation perspective, Burberry has historically traded on a price/sales multiple of approximately 3x; it is currently trading on a price/sales multiple of less than 1x its currently depressed sales. This frames the potential upside when sales begin to stabilise and recover.

Health Care

Evenlode Income's three holdings in the Health Care sector – Smith & Nephew, GSK and Roche – make up c.10% of the fund. Mr Market hasn't been very interested in most health care stocks of late – they have been stuck in the doldrums from a share price perspective. But we like their defensive cash flows, their valuations look interesting, and they have been quietly making progress. At recent results these three holdings grew their revenue by +4%, +13% and +5% respectively.

Smith & Nephew, for instance, is a high-quality business trading on a very modest valuation (not an unusual situation in the UK market currently). The company has a strong position in each of its three

divisions – Sports Medicine, Advanced Wound Care, and Orthopaedics. All are structurally growing markets, driven by ageing populations and rising health care spending. Smith and Nephew is number one or two globally in most of the categories it operates in within Sports Medicine and Advanced Wound Care. These divisions have been growing well and generate approximately 60% of revenue. Its recent issue has been operational challenges in Orthopaedics – the other 40% of the company – where it is number four in a global market dominated by four players. The current management team is focused on improving operational performance, whilst also investing for growth at attractive returns on capital. Investment in research and development has stepped up to 6-7% of sales, relative to c.5% in the pre-Covid era. The company released upbeat results just after the month end, with signs that management's strategic plan is beginning to bear fruit.

That's all for now. With all the usual caveats, we see an interesting combination of valuation appeal and under-appreciated quality within the Evenlode Income portfolio, for the long-term, through-cycle investor.

Wishing you a great summer, and we look forward to updating you further over coming months.

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

31 July 2024

Evenlode has developed a glossary to assist investors to better understand commonly used terms – please see https://evenlodeinvestment.com/resources/evenlode-fund-assets/Key-Investor-Information/Evenlode-Glossary.pdf

Please note, these views represent the opinions of the Evenlode Team as of 31 July 2024 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 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. Current forecasts provided for transparency purposes, are subject to change and are not guaranteed. Source: Evenlode Investment Management Limited, authorised and regulated by the Financial Conduct Authority, No. 767844.

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[i] *IFSL Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return. Swing-price adjusted NAV Performance from 31 December 2023 to 31 July 2024. Year-to-date performance based on published (swung) prices is +4.7%.*

[ii] *IFSL Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return. From 19 October 2009 to 31 July 2024.*

[iii] *IFSL Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return. From 30 April 2024 to 31 July 2024.*

[iv] *Organic revenue growth - excludes growth attributable to mergers and acquisitions and foreign exchange.*

[v] *Source: Evenlode, company reports.*

[vi] *Free cash flow (FCF) - A measure of how much cash a company can generate over and above normal operating expenses and capital expenditure. The more FCF a company has, the more it can allocate to dividend payments and growth opportunities. FCF yield is FCF per share divided by the current share price. A higher FCF yield implies a company is generating more cash that could be paid out as dividends and to reinvest into growth of the business.*

[vii] *Dividend yield - A measure of income from an investment over a period of time. A dividend yield is calculated by dividing the dividend per share by the current share price.*