Evenlode Income Investment View

June 2024 – Under the bonnet

EVENLODE
INCOME FUND

Market data is from Bloomberg, FactSet and FE Analytics.

In a quiet month for company news flow, investors were focused more on electoral than corporate developments. The shift towards populism in the French parliamentary elections, and the growing possibility of another Trump presidency, were both reflected in the performance of a range of financial assets. In the US, data continues to suggest inflation is moderating, but political considerations – such as potential tariff increases under Trump - meant inflation expectations and US government bond yields rose again. In France, the stock market fell more than -6%. In contrast, with the outcome of our domestic election more predictable, the UK stock market had a quieter month.

Evenlode Income rose +0.2% in June compared to a fall of -1.2% for both the FTSE All-Share and the IA UK All Companies sector. This brought Evenlode Income's year-to-date return to +2.0%, compared to a rise of +6.8% for the IA UK All Companies sector and +7.4% for the FTSE All-Share[i].

The share prices of many of the portfolio's cash compounding companies significantly lagged the UK market in March and April, as other areas such as financial and commodity stocks drove the index higher. Within the portfolio, there are also (as discussed in recent investment views) some individual companies that are posting negative revenue growth: notably Hays and PageGroup (recruitment), Victrex and Spectris (industrial production/engineering), and Diageo and Burberry (spirits/global luxury). Many others, though, are growing strongly, and healthy aggregate progress continues to be made. Forecasts for 2024 fundamental performance are in-line with expectations at the start of the year - organic revenue growth[ii] for the portfolio is expected to grow at +5%, operating profit at high-single-digits, and free cash-flow[iii] at low double-digits[iv]. Valuations also remain unusually good relative to history. The current free cash flow yield[v] for the portfolio is 5.0% and forecast to grow to 5.7% next year[vi].

Since launch, Evenlode Income has returned +320% after fees compared to +177% for the FTSE All-Share and 167% for the IA UK All Companies Sector. This return represents an annualised return of +10.3% net of fees, compared to +7.2% for the FTSE All-Share and +6.9% for the IA UK All Companies sector[vii]. Looking ahead over the long-term – and with all the usual caveats - we continue to aim for similar levels of 'get rich slowly' compounding total returns, driven by a combination of dividends and annualised free cash flow per share, in tandem with the valuation management over time.

Compelling UK valuations

In addition to our usual focus on valuation, the portfolio's current valuation appeal also reflects the unfashionable situation that the UK stock market has found itself in. Relative to the global stock market – and particularly relative to the US market, which has come to dominate the global index in recent years - the UK's valuation discount is significant, on both a headline and sector-adjusted level.

The river of outflows from the UK stock market has been eyewatering since at least 2016 but has accelerated more recently; net flows out of UK equity funds have been negative every month for three years now. This has left the main buyer of UK shares, over recent months, as the companies themselves. Another emerging buyer of the UK market has been foreign investors, including activist-minded entities in companies such as Unilever (Trian Partners) and, more recently, Smith & Nephew (Cevian). Foreign takeovers have also been a theme over recent months, both from private equity consortiums and trade buyers.

The following statement is not particularly scientific, it is rather a gut feeling based on more than twenty years in and around investment markets and might prove to be wrong, but with those caveats out the way *it feels like the entrenched negative sentiment towards the UK equity market has begun to run out of steam.* UK institutional and wealth management investors have significantly reduced their exposure to UK equities over the last twenty years, so the wick of that candle is beginning to burn out. On the other side of the trade, buy- backs continue and overseas investors warm up to the UK as they consider the interesting valuation discount, and political uncertainty in other regions.

Under the bonnet

Recent weeks have been quiet for company news-flow, with second quarter results commencing in July. But a trickle of results has continued, and below we cover four companies that have released updates in recent weeks, which give some colour on what we are hearing from companies under the bonnet of the stock market.

Halma – Capital allocation machine (2.1% position)

'At Halma we choose the long-term view, aiming from the start to build slowly and carefully, very much with an eye to the future.

The analogy I have often used with analysts in discussing Halma is that it is like a centipede with very many little legs, but each leg moving a tiny step in the right direction. If every small move is positive and if every negative move is eliminated, then it is surprising how quickly one can move towards a defined objective. That is the long-term route.'
David Barber, co-founder

We met with Halma management at their headquarters in Amersham last month, following the release of full year results. We added back a holding in Halma to the Evenlode Income portfolio in autumn 2022. Headquartered in a pleasant old building next to the church – where they have been since the 1970s - the company employs more than 8,000 people worldwide. Halma is a group of technology and engineering businesses with leading positions in niche, growing sectors across safety, environmental and health end markets. Examples include fire detection, water analysis and food safety. Products tend to perform important, value-adding functions but cost a low amount relative to the customer's overall cost base.

Halma is a hidden champion. Stop a passer-by and ask if they have heard of the company, and you might get a blank look, but its steady compounding growth has been exceptional. At Halma's most recent full year results, the company reported its 21st year of consecutive record profit and 45th year of consecutive dividend increases of +5% or more. Today, Halma is valued at over £10bn, making it a constituent of the FTSE 100. Long-term performance of this calibre requires a clear, consistent approach. The foundations of Halma's cultural DNA were put in place over 50 years ago, in 1972, when David Barber became CEO (the quote above is from a speech he gave in 1997 – *Delivering Shareholder Value*).

Halma operates a decentralised model, with clear guardrails and minimal financial targets set at the centre, and then significant autonomy given to the management of the fifty operating companies within the group to execute within these parameters. Current management see this bottom-up ownership of decision-making as key:

'You've got to be really clear on the rules of the game, and then you allow each company to get there in their own way.'

Halma targets at least +3-5% organic revenue growth[ii] from their operating companies, combined with a similar level of contribution from bolt-on acquisitions. This algorithm has driven double-digit adjusted revenue and profit over the last decade, and management expect similar growth over coming years. The acquisition-related part of the algorithm echoes David Barber's centipede comments, with over 600 potential companies in the pipeline that are sourced via relationship building with owners over time. In the last eight years none of Halma's acquisitions have been sourced from investment banks:

'We're always keen to understand what the company's primary driver for selling is - that is really key for us. If it's to maximise money today, then we are not the right acquirer. If it's to grow the business by ten times over the long-term then Halma is the right place for them.'

End markets are generally strong for Halma, but as for many companies, demand from China - which is 5% of group sales - has been weak over the last year. Halma's measured attitude to its Chinese exposure is representative of the tone that most multinationals we speak to now take toward China, if they do business in the region:

'On the one hand, we think about the scale of opportunity and growth potential. Wrapped around all of that, we have the geopolitical consideration. Our approach isn't to come out of China completely and it isn't to double-down. Instead, we are focused on how we can grow in a sensible and self-funded way, so we're not missing an opportunity but we're also not putting fresh capital at risk.'

Spectris – Unappreciated quality (2.4% position)

Spectris is a global market-leading supplier of precision measurement and instrumentation equipment. The company has been a great long-term compounding business and entered the Evenlode Income portfolio ten years ago. Current trading has been tough, and the company said in June that profit will be at the bottom end of expectations this year, forecast to fall by about -9%. This is largely driven by weaker-than-expected sales in China, and subdued demand in the life sciences sector due to a post-Covid destocking hangover. As recent trading demonstrates, Spectris does have some sensitivity to economic conditions. But longer-term, end demand from sectors such as semiconductors, life sciences, clean energy and infrastructure are set to drive good structural growth, with management targeting a through-cycle organic revenue growth[ii] rate of +6-7% and gently rising profit margins. In our view the company is also a more resilient, less capital-intensive business than it was several years ago, thanks to a more focused strategy. It also has a strong, net cash balance sheet.

Spectris's valuation looks compelling, given the above considerations - trading on 15x this year's earnings and a dividend yield[viii] of about 3%. For the company's discount to its global peer group - of similar test and instrumentation companies - to close, its shares would need to rise by +70%.

Games Workshop – A universe of content (2.7% position)

Nottingham-based Games Workshop sells fantasy miniature models to a loyal and growing hobbyist customer base. We added the holding to Evenlode Income in summer 2022. The company thinks long-term, and for many years has ploughed back investment into both developing its universe of content and new product development. As the company invests in 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. Games Workshop released a full year trading update in June, and, despite a muted backdrop for the global consumer, revenue grew at +11% over the year, helped by the launch of a significant number of new products. Profit grew +17%. The company has a net cash balance sheet and trades on a dividend yield[viii] of 4%.

IntegraFin – Client-centric approach (1.8% position)

IntegraFin provides a leading investment platform, Transact, to UK financial advisers, generating sticky recurring revenue. We introduced the holding in summer 2022 and caught up with management last month after their interim results. Listening carefully to clients is a key part of IntegraFin's business model and is backed up by a consistent commitment to invest in customer service and technology enhancements over time. The recent backdrop for the sector has been difficult, with net inflows onto both direct-to-consumer and business-to-business investment platforms slowing considerably (as we discussed in relation to Hargreaves Lansdown in last month's view). IntegraFin's management have done detailed work on this dynamic, with rising interest rates and cost-of-living accounting for the bulk of money leaving the platform: '*most clients withdrawing money have been paying down debt. In particularly, parents and grandparents repaying debt for children as interest rates have risen - particularly for mortgages. We think we are at the peak of this, though the trend may continue to some extent if interest rates remain high.*'

Despite this backdrop, IntegraFin released strong results in May, growing revenue +6% and profit by +14% in the last six months, as share gains continued and net inflows remained positive. The company's market share of the UK financial adviser platform market is approximately 10%, but its share of new inflows into the business-to-business platform sector is running at more than 20%. 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.

IntegraFin is a well invested business, has coped well through a difficult period for the industry, and is well placed to take advantage when conditions improve again in its end markets, the early signs of which management are beginning to see. The company has a net cash balance sheet and trades on a dividend yield[viii] of 3%.

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

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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 8 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

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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 30 June 2024. Year to date performance based on published (swung) prices is +1.4%.*

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

[iii] *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.*

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

[v] *Free cash flow yield - Free Cash Flow (FCF) per share divided by the current share price. A higher free cash flow yield implies a company is generating more cash that could be paid out as dividends and to reinvest into growth of the business.*

[vi] *Source: Evenlode, FactSet.*

[vii] *IFSL Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return. 19 October 2009 to 30 June 2024.*

[viii] *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.*