

# Evenlode Investment View

March 2020 – Navigating through and beyond this crisis



Following sharp falls in the last week of February, markets fell significantly further in the first half of March as the highly contagious nature of Covid-19 has become increasingly apparent, as has the need for governments and societies across the world to take extreme measures to help contain and manage the subsequent public health crisis.

It feels like we are collectively, as a species, having a bad dream that we have yet to wake up from. Hospital wards are filling up and large parts of the global economy have come to an abrupt halt or at least a significant slowdown. Thoughts are now turning to the possibility of vaccine and antiviral drug development, as well as the timescale and nature of containment measures in different regions of the world (ironically several Asian countries including China, which were at the epicentre of the epidemic three weeks ago, have returned to a semblance of normality over recent days). Central banks have slashed rates (the Federal Reserve cutting by 1.5% in less than two weeks) and are also in the process of launching a range of measures to help with liquidity and funding in money markets. Global governments are beginning to release huge stimulus packages to help support individuals and companies through their periods of lockdown and self-isolation.

Stock markets have not only fallen, but volatility has also picked up significantly and rapidly, returning to levels last seen in the Great Financial Crisis of 2008/9. Whilst coronavirus has been the proximate catalyst for these trends, the collapse in the oil price over the last two weeks (following the failure of Saudi Arabia and Russia to reach a supply agreement) has not helped, and the combination of these two events has combined to have a significant impact on corporate credit markets as well as equity markets. Meanwhile, government bonds in many parts of the world are now trading on negative yields.

As I write (Wednesday 17<sup>th</sup> March), the Evenlode Income fund has fallen -25.5% since the start of the year, compared to -33.5% for the FTSE All-Share (since launch in October 2009, the Evenlode Income fund has now returned +166% compared to +56% for the FTSE All-Share)<sup>i</sup>.

## The Nature of This Crisis

All financial crises have echoes of previous ones, but also tend to be different in certain ways. With coronavirus thus far, several analogies can be drawn. For instance, there are parallels with the 1987 stock market crash in terms of the rapidity at which global stock markets have corrected from erstwhile buoyant conditions. There are also parallels with 9/11 given the impact the disease has had on global travel and in the way it has led us to look at the world in a new way. Or with the collapse of Lehman in 2008 in terms of the sudden shock it has rendered on the global economy, and the recession it is now causing. However, it is also different to any of these events: it is a public health crisis that has caused a financial crisis. And it has not just put a stop to most international travel, but also to many events and social gatherings within individual nations.

## What We Have Been Doing

We have completed a very significant amount of analysis over the last two weeks, revisiting all the companies in the fund in the light of the new world we are living in, running downside-scenarios and analysing debt and liquidity where relevant (in terms of debt, the portfolio is helped by the fact that 18 of the 39 holdings have a net cash position). Most of the holdings that have debt are relatively resilient businesses, but it is important for us to have a clear, up-to-date picture of the debt profile and liquidity

# Evenlode Investment View

March 2020 – Navigating through and beyond this crisis



situation of each company in the fund, particularly those that will see some pressure on their cash generation over coming weeks.

We have not made any major changes to the portfolio. However, we have used cash to top-up some existing positions with a focus on more repeat-purchase business models and have also added a new position in Swiss pharmaceutical company Roche. The holding offers a 3.3% dividend yield backed by resilient free cash flow yield and a net cash balance sheet. More generally cash flow resilience, balance sheet strength and liquidity will all be important characteristics for companies over coming weeks. With the initial sell-off in the market relatively undiscerning, it has been interesting in the last few days to see that these qualities are beginning to be recognised somewhat by Mr Market, as he slowly sifts through the rubble of what has been a dramatic correction.

## The Shape of The Portfolio in a World Turned Upside Down

In this new parallel universe of viral contagion it is worth revisiting the portfolio to discuss how different holdings are likely to fare operationally in the short-term. There will be very few companies unaffected by the virus but some will be more resilient than others, in my view. In particular these categories stand out:

### Consumer Staples (c. 29% of the fund):

Most of the fund's largest holdings in this sector (Unilever, Reckitt Benckiser, Procter & Gamble and Pepsi) sell the majority of their products through supermarkets, convenience stores and online channels which is helpful in the current environment. Nearly 80% of Unilever's sales, for instance, are small-ticket stocking-up items such as shampoo, Dove soap, Vaseline, Persil, Domestos, Cif, Hellman's and Marmite<sup>ii</sup>. Reckitt has attractive category exposure for the current environment with health and hygiene brands such as Lysol, Dettol and, dare I say it, Durex! For several of Reckitt's product lines (12% of sales are disinfectants), the issue will be trying to get enough stock onto shelves. Pepsi is the market-leader globally in savoury snacks, which are likely to see relatively robust demand (people may well eat some Frito-Lays and Doritos whilst sitting on their sofas over coming weeks!). P & G's brands include Pampers, Fairy washing-up liquid, various feminine care products, Gillette razor blades and also household cleaning products such as Ariel.

Diageo will be more impacted than these companies as footfall globally reduces in restaurants, bars etc. (though more consumption of Guinness, Johnnie Walker etc. is likely to switch to the home setting). Some geographies, such as China and other parts of Asia, are in the process of returning to more normal conditions with bars and restaurants beginning to fill up again.

### Healthcare (c. 10% of the fund):

Biopharmaceutical companies (Glaxosmithkline, Astrazeneca, Roche) should be relatively well insulated from current events given the nature of their business (essential cancer therapies, respiratory therapies etc.), and may in some instances be able to contribute to solving this crisis (Glaxosmithkline has a market leading vaccine subsidiary, for instance, and Roche had a diagnostic testing kit for Covid-19 approved by the FDA this week). However, Smith & Nephew (c.1.7% holding) will not be as immune in the short-term as it would be in a 'normal' recession given its hips and knees portfolio will see an impact due to delays in elective surgeries over coming weeks.

# Evenlode Investment View

March 2020 – Navigating through and beyond this crisis



## Technology (c. 17% of the fund):

Software companies such as Sage (5.1% of fund), Microsoft (1.7%) and EMIS (0.9%) should be relatively resilient given their recurring revenues and in the case of Microsoft, for instance, they are able to enable people to work at home via Microsoft teams etc. We also think that this period is likely to accelerate the digitalisation of the global economy as more people work remotely and utilise the global IT infrastructure system, and use devices at the 'edge' of the internet (laptops have flown off the shelves over the last two weeks). Though businesses such as Intel (2.4%) and Cisco (2.9%) will see some pressure from businesses cutting costs during the current economic slowdown, we think demand trends will be positive in the medium/long term and the work-from-home trend, combined with pressure on global server capacity etc., may help in coming weeks and months too. Though not specifically in the technology sector, other businesses such as Relx (6.3% of the fund), should be *relatively* resilient (the company generates 10% of its sales from trade exhibitions but most of the rest of its revenues are embedded digital subscriptions to academics, doctors, lawyer and other professionals, with a high level of renewal).

Holdings that face tough trading conditions over coming months include Informa (2.2% of fund), Compass (2.1%) and Bunzl (2.7%). These are all diversified global businesses that would typically be quite resilient in a 'common or garden' recession, but the coronavirus lockdown will make the next few weeks difficult. Each has some resilient revenues (35% of Informa's revenue is from subscription-like revenues, a significant amount of Bunzl's revenue is generated from grocery retail and healthcare, and Compass provides food catering to the healthcare sector). However, more than half of Informa's revenues are generated from trade exhibitions, Bunzl provides its not-for-resale goods into the foodservice and retail sectors, and Compass provides food catering services to businesses and schools. We very much acknowledge their current trading difficulties. This year will be a challenge and pressure will be put on cash generation and potentially dividends in the short-term. However, they are all market-leading businesses with good long-term growth potential in our view.

Other than these holdings, it will mostly be those companies in the portfolio with more 'normal' economic sensitivity that will see most pressure on their cash flows, such as the engineering and recruitment holdings. These more economically sensitive holdings generally have strong balance sheets (many of them have no debt at all), which we think puts them in a good position to hunker down during this difficult period and emerge on the other side in good shape. As the management teams of many of these companies point out, a downturn is often a good opportunity to strengthen a company's competitive position, even though you won't see this progress in the financial results at the time. As the value investor Shelby Davis once put it, *you make most of your money in a bear market, you just don't realise it at the time.*

## Dividends

Several companies across the UK and globally have already cancelled dividends to preserve liquidity and it is likely that many more reductions and cancellations will occur over coming weeks given the global economic shock that has just occurred. The UK market's aggregate dividend stream is therefore likely to fall significantly over coming months.

The Evenlode Income fund's historic yield is currently 4.1%. Though a resilient portfolio, I think it's important to manage expectations on the short-term dividend stream for the fund (i.e. over the next year). The portfolio has entered this crisis with a healthy level of free cash flow cover relative to dividends, some

# Evenlode Investment View

March 2020 – Navigating through and beyond this crisis



very strong balance sheets across the portfolio and a bedrock of repeat-purchase business models. This should provide a strong underpin over coming months. It is also worth noting that the pound has weakened over the last two weeks against other major currencies, which for multinational holdings will help earnings in sterling terms (16% of the portfolio's revenue is generated in the UK, with the rest quite broadly spread globally).

However, the Evenlode Income portfolio won't be entirely immune from pressure on cash flow and dividends given the extremity of the current situation, as discussed above in respect of certain holdings. As a result, it may well be (unless this crisis begins to resolve itself relatively quickly in the next few weeks) that the fund's dividend stream falls somewhat over the coming year (i.e. to February 2021).

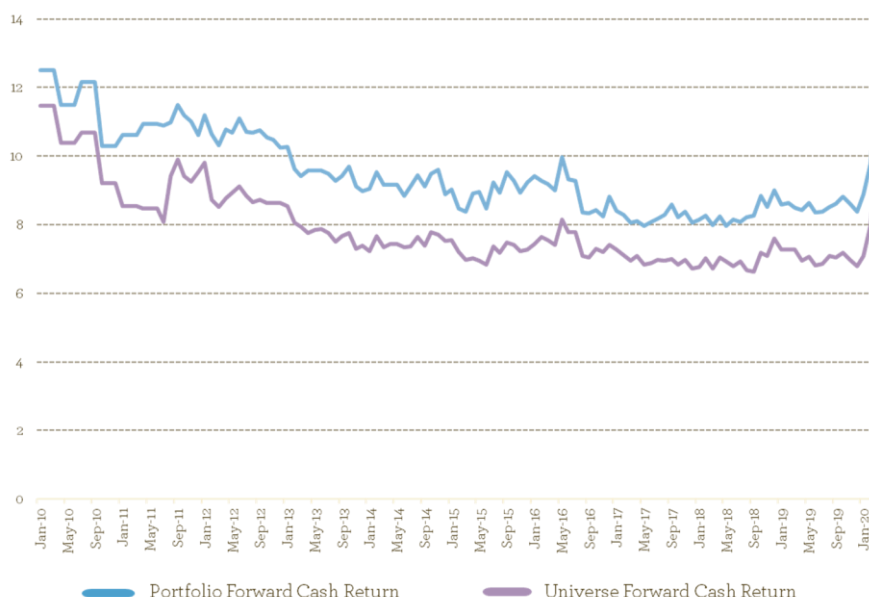
On a medium to long-term view, our objective of growing the dividend at a real rate remains very much in place. Looking past the current crisis, we continue to feel positive about the long-term prospects for the portfolio's free cash flow and dividend stream.

## Longer Term Thoughts

It may feel a little too early to begin looking past this crisis from a long-term investment perspective. However, given equity investment should, in my view, always be a genuinely long-term pursuit (i.e. pursued with a time horizon of 5-7 years or more), I lay out some brief initial thoughts here.

### Part 1: Valuations

I have used this chart in past investment views to attempt to give a rough feel as to how the valuation environment looks to us:



It shows our 'forward cash return' valuation measure and how it has varied for both the portfolio and the investable universe since the early days of the fund. It is based on our company-by-company estimates of free cash flow generation over 10-15 years and more, so is very much a long-term measure and as such

# Evenlode Investment View

March 2020 – Navigating through and beyond this crisis



looks beyond the current crisis. It will tell you nothing about what the shares of these companies might do over the next few weeks or months. However, very crudely, we think of it as a back-of-the-envelope proxy for the annualised total return potential you might expect over the genuinely long-term (i.e. 5-7 years or more) from our estimates of fundamental cash generation. Having been in a less attractive environment over the last few years, the rapid market correction of the last month has ‘ripped the sticking plaster’ off the valuation environment. It feels to us like we are back at levels last seen in the early days of the fund.

## Longer Term Thoughts Part 2: The Aftermath

In many ways the world will return to normal once this current public health crisis has passed. However, in some subtle ways I believe it will catalyse and/or accelerate some societal and economic trends, many of which were already very much underway. Perhaps not least both the digitalisation of the global economy and the trend towards a more sustainable economy: the stark reality that pollution levels plummeted and air quality shot up when Chinese manufacturing shut down in February is hard to ignore, for instance. I also believe that businesses will increasingly look to match local supply with demand, a trend which was already emerging, partly due to the introduction of trade tariffs over recent years. The coronavirus crisis will also likely lead to a reappraisal and greater focus on healthcare systems and healthcare innovation in coming years.

## Non-Investment Thoughts

Since Tuesday 17<sup>th</sup> March, the Evenlode team have been working from home. We feel it is important to stick together through this period, looking after each other and working collaboratively on the significant amount of analysis that is required. We have been enjoying the power of our proprietary research software system EDDIE, and other collaborative tools such as Microsoft Teams and Slack. We continue to hold our regular investment meetings, now have daily team and one-to-one catch-ups by video conference, and continue to speak to representatives of the companies held in the portfolios.

We also feel it is even more important than normal to keep in close contact with our co-investors during this very dynamic and uncertain period. We will continue to communicate regularly, and as always, please do let us know if you have any questions or feedback.

Finally, I’d like to mention that we have decided to contribute a significant part of Evenlode’s charitable budget this year to help fight Covid-19 and assist those most affected by the epidemic. This has included support for Oxford University’s Coronavirus Research Fund.

<http://www.ox.ac.uk/coronavirus-research#>.

I look forward to keeping you in touch with our thoughts.

Best wishes

Hugh and the Evenlode Team

***Please note, these views represent the opinions of Hugh Yarrow as at 19th March 2020 and do not constitute investment advice.***

<sup>i</sup> Source: Evenlode, Financial Express, total return, bid-to-bid, 31/12/2019 to 17/03/2020

<sup>ii</sup> Source: Investec Research