

Evenlode Investment View

March 2021 – Opportunities for Growth



Global stock markets have been a bit mixed during March, though both Evenlode Income and the UK market have posted a positive return. Reopening optimism continues, somewhat tempered by the announcement of further lockdowns in Europe following a rise in cases, and a less positive trend in economic leading indicators versus expectations. Commodity and energy prices also fell in the second half of the month.

So far this year, the Evenlode Income fund has risen +0.8%, compared with a rise of +4.5% for the FTSE All-Shareⁱ. As discussed in February's investment view, the fund has lagged the recent market rally as investors have looked to take on more risk within their portfolios. The shares of more asset-intensive, financially leveraged and economically-sensitive companies have significantly outperformed over the last five months.

It is important to note that our view on the fundamentals of Evenlode Income's underlying holdings hasn't changed materially over recent weeks. It remains a portfolio of good quality businesses with strong competitive positions, cash generative economics and interesting long-term growth prospects. On our estimates these companies remain attractively valued. From a dividend perspective, our forecasts suggest the forward-looking dividend yield is also approximately 3%ⁱⁱ. We think there are then good prospects for further real (i.e. inflation-protected) long-term dividend growth from there.

Themes from Results

More than 90% of the portfolio has released results since January, and we've spoken to wide variety of company management teams.

The overall picture is one of reassuring resilience and interesting opportunities for the future. As I mentioned last month, aggregate revenues and earnings for the portfolio fell approximately -3% and -12% respectively during 2020ⁱⁱⁱ. Forecasts then suggest a healthy cumulative earnings recovery of more than +20% during 2021 and 2022.

The portfolio can be, very crudely, split into three categories in the context of trading through and beyond the pandemic. Category 1 is those companies significantly impacted by the crisis and accounts for just under 10% of portfolio value. Category 2 comprises companies that have experienced an impact from the pandemic, but a milder one, and accounts for about two thirds of the portfolio. The third category is companies that have seen no material impact, or in some cases have benefitted from the crisis. This last category represents around a quarter of the portfolio by value.

Below we give an update on six holdings to give a flavour of how portfolio holdings have navigated the pandemic and the growth opportunities they are seeing as the crisis begins to abate. We have aimed to give a representative sample with two companies chosen from each of these three categories.

Evenlode Investment View

March 2021 – Opportunities for Growth



Category 1: Significantly Impacted Companies

Companies in the significantly impacted category are currently entering an interesting phase as their industries emerge from the disruption of recent months. The broad theme is that market leaders are emerging with improved competitive positions. *The strong grow stronger* in a downturn, as the old saying goes.

Compass

Compass is the global leader in outsourced catering. Though normally quite resilient to economic downturns, Compass has been hit by the pandemic due to lockdown measures and the forced closure of many schools, offices and sports and leisure facilities.

However, Compass's differentiation versus smaller regional peers and in-house catering teams has been quietly strengthening. The company was, for example, able to quickly release apps for order and queue management during the pandemic, thanks to the technology acquisitions they made before and during the initial phase of the crisis, and more generally has quickly adapted to the complexities of delivering catering services in a post-Covid world, whilst fully complying with health and safety regulations.

Clients are also concerned about the financial viability of smaller, more indebted and less diversified competitors, which has led to a 'flight to quality' in the industry, with Compass a clear beneficiary. This is starting to show in the company's key performance indicators, with an improvement in the contract retention rate in 2020 to over 96%, record new business wins in the US (its largest market), and a step-up in first time outsourcing enquiries, particularly in healthcare.

Looking longer-term, this structural growth opportunity from first-time outsourcing remains compelling, a trend that is likely to continue and accelerate over coming years (around 50% of the global market is still in-house). We think this dynamic, along with Compass's steady market share gains, will more than offset the increased working-from-home trend. The business is therefore well-placed to recovery strongly as the world emerges from the pandemic, and return to its usual highly-cash-generative and dividend-paying ways.

Page Group

The global specialist recruitment company Page Group has seen some similar trends, with a flight to quality evident for both clients and people. Page's revenue dropped in 2020, but the company grew market share and management are finding that clients are increasingly willing to engage with the large recruitment providers where they have confidence in their financial viability. This is particularly important in temporary recruitment: in many markets Page are responsible for paying temporary staff their wages. Page has also been able to attract key experienced hires to drive future growth. Whilst

Evenlode Investment View

March 2021 – Opportunities for Growth



the company did reduce headcount in 2020 overall, they made 400 new experienced hires, which represents 8% of their front office staff, to drive the opportunity in growth areas such as big corporate accounts, technology, health care, and in structurally under-penetrated markets such as Germany and China. Page is undoubtedly an economically sensitive business, but structural growth opportunities remain compelling in newer markets such as Germany, Asia and Latin America, as an increasing number of companies and workers transition to a more flexible working culture. The company currently sits with more than £150m of cash on its balance sheet and, after a pause in 2020, intends to resume dividends and special dividends in the summer.

Category 2: Moderately Impacted Companies

There are a range of companies in this category including consumer branded goods stocks with some out-of-home exposure, and several of the portfolio's industrial-focused and engineering holdings.

Diageo

Diageo returned to year-on-year revenue growth in the second half of the calendar year 2020. That is an impressive performance, given that in a normal year around 30% of Diageo's business is generated from the 'on-trade' channel (i.e. bars and restaurants). The company was helped by strong growth in at-home consumption, particularly in the US. A strong brand portfolio and global scale also helped the company gain market share in 70% of its markets.

We met with Diageo management this month, and they are optimistic on the outlook, anticipating a full recovery in the on-trade channel over time. Key structural growth drivers such as increasing demand for premium products, and a shift in drinking habits from wine and beer to spirits, remain in place and are in some cases accelerating. The opportunity in emerging markets also remains compelling. Forecasts currently suggest that Diageo will return to pre-pandemic revenue and profit levels by next year. Over the longer-term, the company expects to grow annual organic revenue at approximately +4-6%, along with steady operating margin expansion and strong cash generation. The company has continued to grow its dividend through the crisis.

Spectris

Another example of a moderately impacted company is Spectris, a market leader in measurement technologies and software, with its portfolio including, for instance, equipment for assessing food and drug compositions, and sensors for monitoring industrial processes. Some of its end markets, such as automotive and aerospace, faced disruption last year, leading to an organic revenue decline of -11%. Spectris management were, though, able to broadly maintain investments in research and development whilst also increasing free cash flow generation. The company has more than £100m of net cash on its balance sheet, so it is well positioned to take advantage of any acquisition opportunities, whilst also returning any surplus cash to shareholders as it builds up on the balance

Evenlode Investment View

March 2021 – Opportunities for Growth



sheet. Longer-term, the company has very attractive exposures to structurally growing sectors, such as life sciences, semi-conductors and factory automation. They are well placed, for instance, to provide customers with increasingly sophisticated analytics relating to the data that their equipment produces, helping to save customers costs, reduce waste and improve efficiency. The company increased its dividend by +5% for 2020.

Category 3: Beneficiaries or Minimal/ No Impact Companies

This third category includes some of the fund's technology holdings, consumer businesses more focused on the health and hygiene sectors, and certain healthcare holdings.

Bunzl

It also includes Bunzl, the global distribution business selling not-for-resale consumables, such as packaging items for the food service sector and PPE for industrial and healthcare sectors.

Bunzl had a strong year driven by demand for hygiene and PPE products related to the pandemic, leading to organic revenue growth of +9%. While the company is expecting some drop off in Covid orders this year, their market has enlarged versus pre-pandemic levels, and management see additional positive dynamics. Firstly, their main competition tends to be smaller distribution businesses which have struggled through the pandemic. This has created opportunities for Bunzl to both strengthen its competitive position and make attractive acquisitions. Bunzl spent £400m on acquisitions in 2020 which is the second biggest year in the company's history. Management's track record of integrating and driving strong returns on capital on those companies is very good. Secondly, in hygiene and in sustainability, they have introduced new own brand products and services, including environmental impact scoring. This is driving growth, and increasing the stickiness of their customer relationships. The company increased its dividend by +7% in 2020, representing the twenty-eighth year of consecutive growth.

Reckitt Benckiser

In the case of Reckitt Benckiser, the company saw a mixed performance across its portfolio of health and hygiene brands, in 2020. Flu-related healthcare products were weak, for instance, due to lockdowns. However, overall growth was strong, driven by demand for disinfectants, detergents and health products such as vitamins. Consumers trended towards well-known trusted brands like Dettol and Lysol, and have started to adopt new habits. Though the pandemic-related surge in demand will moderate this year and next, Reckitt do expect many of the crisis-induced hygiene habits to stick now, given that the two-month threshold for new routines to become habits is long-passed (surveys suggest around 80% of people have improved their hygiene habits as a result of the pandemic). We have also been encouraged by new management at Reckitt. They ensured supply during the crisis, have invested heavily in the long-term health of the business through the pandemic, and are taking

Evenlode Investment View

March 2021 – Opportunities for Growth



advantage of new opportunities emerging. This includes, for instance, the set-up of a new business-to-business division for their hygiene products in sectors such as hospitality and airlines.

Despite growing organic revenue by +12% for 2020, Reckitt expects to grow sales year-on-year in 2021 thanks to these trends and the rebound in other product areas such as over-the-counter flu products (and Durex condoms!). Over the longer-term, Reckitt's management team expects the company to grow organic revenues at a mid-single digit rate, and earnings at a high-single digit rate, backed by strong cash generation.

A Word on Inflation

Before signing off, it's worth mentioning the topic of inflation, which has become quite a talking point among market participants over recent weeks. As with the recovery from the 2008-9 downturn, many strategists are forecasting higher inflation over coming years, and market-implied inflation expectations have ticked up over recent weeks. Thus far, on the ground, companies have seen a rise in certain input costs, but they have generally been related to specific Covid-related supply constraints (freight rates, for instance) and/or the recovery in commodity markets from its lows last year. However, there are few signs of a meaningful pick-up in broad inflation levels at this point.

Time will tell with this debate. At Evenlode we prefer not to make big predictions on economic outcomes; instead, we aim to invest in a collection of companies that we think are well placed to operate through and adapt to a wide range of conditions over time.

There is, of course, no perfect financial asset to insulate an investor from inflation (or deflation for that matter). However, market-leading companies that have embedded relationships with their customers do tend to have an ability to raise prices over time, which is extremely helpful. In particular, companies that sell products and services representing a small part of a customer's expenditure, but which are highly valued by these customers (thanks to quality/safety assurance, reduced hassle, improved operations, greater efficiencies etc.) tend to be particularly well placed.

To return to the six companies discussed above, they each have some helpful characteristics when it comes to dealing with inflation over time, as confirmed by recent management conversations. Bunzl and Compass provide services representing a low portion of their customers' overall cost base, but where the value (and reduction in hassle) that their services can deliver is highly appreciated by the customer. For both companies, many of their contracts also include automatic inflationary pass-throughs. As Bunzl management put it this month, 'inflation in general is good for Bunzl'. Both recruitment companies held in the portfolio (Page Group and Hays) would be well placed to benefit from global wage inflation if it were ever to accelerate from its currently muted levels. Their revenues are, to oversimplify, an *ad valorem* fee based on the wages that clients pay the temporary and

Evenlode Investment View

March 2021 – Opportunities for Growth



permanent staff that Page and Hays find for clients. Despite the crisis, Page Group management noted that their fee-rates have held up, a reminder that customers continue to value their service, even in more difficult markets. For Diageo and Reckitt, a balance of volume and pricing growth is part of their economic algorithms, as demonstrated by the composition of long-term revenue growth for both companies. More generally, many consumer branded goods companies have grown successfully over recent decades in markets such as Indonesia or Latin America, where annualised inflation rates have been running at consistently high levels. Brand strength, distribution strength and innovation are particularly key enablers of pricing power for these business models. Finally, Spectris management noted this month that the company has a good track record of dealing with input cost inflation thanks to the pricing power enjoyed by the differentiated, mission-critical franchises that make up the overall Spectris portfolio.

To sum up, no one quite knows what the economic environment will look like over coming years. However, we are reassured by the strong economics, cash generation and growth prospects of the underlying portfolio and will continue to focus the portfolio on the shares of companies that enjoy these characteristics.

Hugh and the Evenlode team
26th March 2021

Please note, these views represent the opinions of Hugh Yarrow and the Evenlode Team as of 26th March 2021 and do not constitute investment advice.

Past performance is not a reliable indicator of future results. The value of investments can go down as well as up, and investors may not get back the money they invested.

ⁱ Source: Evenlode, Financial Express. B Inc Shares, Total return, GBP bid-to-bid, 31/12/2020 to 25/03/2021.

ⁱⁱ Source: Evenlode EDDIE Database.

ⁱⁱⁱ Source: Evenlode, Visible Alpha.