

# Evenlode Income Investment View

May 2023 – How to compound a business

After a strong start to the year, the UK stock market gave back some of its gains in May. The impact of higher interest rates on a slowing economy remains at the top of the worry list for investors and this month negotiations between US law makers on the Treasury's debt ceiling added to uneasiness. More positively, the global economy's slowdown has thus far been orderly, and inflationary pressures are easing gradually.

## Results

Since the start of the year, Evenlode Income has returned +5.6% compared to +1.6% for the FTSE All-Share and +2.4% for the IA UK All Companies sector<sup>i</sup>.

We continue to be impressed with the resilience of the portfolio holdings. Some companies have seen demand slow over recent months (most notably for more economically sensitive holdings such as Savills, PageGroup and Hays), but aggregate growth remains healthy. More than three quarters of the portfolio reported results to the end of March, with average organic revenue growth +9.3% year-on-year<sup>ii</sup>. Management teams are also noting a calmer situation on the input cost inflation and supply chain front, after three very challenging years.

## Best of British

The unfashionable UK stock market has been a talking point over recent months and years. The FTSE All-Share is skewed towards some big, asset-intensive and cyclical companies - oil, industrial metals and financial companies alone, for instance, make up about 40% of the index. This has led the index to be seen as something of a dinosaur, particularly when compared to the US stock market. But when we look under the bonnet of the UK market, we see plenty of opportunities to invest in a broad range of British-based global leaders with attractive compounding economics. This is particularly the case following 2022, when the share prices of many high-quality UK-listed companies fell quite materially - both within the FTSE 100 and the FTSE 250.

## Halma

One example is Halma, which we added back to the Evenlode Income portfolio during 2022, following a share price fall of about -40%. Headquartered in Amersham and employing more than 7,000 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 - characteristics that lead to attractive economics.

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 19<sup>th</sup> year of consecutive record profit and 43<sup>rd</sup> year of consecutive dividend increases of more than +5%. Today, Halma is valued at over £9bn, making it a constituent of the FTSE 100.



### How To Compound a Business

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. Along with his colleague Mike Arthur, he began transforming a small mechanical and electronic holding company into a focused group of technology companies. Barber was CEO for over twenty years, and Chairman until his retirement in 2003. In 1997 he gave a speech at a conference, entitled 'Delivering Shareholder Value'<sup>iii</sup>. At this point, Halma had delivered +22.5% per annum compound growth in earnings over the prior twenty years. In his speech, Barber noted several factors that he saw as foundational to the company's success. These factors for long-term compounding are summarised below:

#### Ingredient 1 – A long-term approach

There is a saying used in both investment and other areas of life: that the long-term is just the aggregation of many short-term periods. Though clearly true in a certain way, from a business management perspective the idea can be misleading. In fact, the short-term approach to value creation is fundamentally different to the long-term approach. Crudely characterised, the short-term approach requires big short-term steps on a regular basis - for instance making large transformative acquisitions and disposals or launching big cost-cutting programmes to boost short-term earnings.

Though both approaches can lead to success, the short-term approach carries a higher level of risk, can lead to more volatility and uncertainty, and is more difficult to sustain over longer periods of time. As Barber puts it:

*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.*

#### Ingredient 2 – Building leadership in niche markets

The difference in strategic approach that this long-term, incremental approach will lead to is well summed up by Barber:

*If you are in a niche market and you are already a dominant player, your position then either looks very good or very bad according to how you perceive it. The short-term operator immediately sees that he has very little to work on except cost reductions. He sees that he already has 60%-70% of the market. This means to him that the market is saturated and that he has nowhere to go. A real niche market is going to be unattractive to most short-term operators. The long-term manager, however, can see it very differently. He will observe that if he can find ways to increase the size of the whole market, he can also increase the size of this already very profitable business.*



Our experience with the culture of high-quality compounding businesses resonates very closely with these observations. Consider the approach RELX has taken for instance, over the last decade, as it listens very closely to its customers and consistently ploughs back investment to develop new value-added products and services.

Within this process, discussions of market share gains or losses are not particularly meaningful or helpful. The important perspective is that the customer is provided with new useful products that save money and improve operations. Thus, the pie is grown.

### **Ingredient 3 - A self-funding business model**

Another advantage of the incremental ‘centipede’ approach is that internally generated cash flow tends to be sufficient to provide funding for any required organic investments and bolt-on acquisitions. This is helpful as a self-funding strategy is not dependant on a favourable external environment and the kindness of strangers to work:

*Halma's own long-term planning and its financial modelling were radically shaped by our having to live through the events of the mid-1970s. I know that to many people here today that must almost count as pre-history. There was a kind of economic blizzard which lasted about four years from 1973 to 1977. The Stock Market was in shock. We were producing a string of sensationally good results at Halma but at one stage our price-to-earnings ratio was less than four. Inflation was running at 17% per annum and the banks couldn't or didn't want to lend money.*

Barber then goes on to make a couple of really interesting distinctions relating to acquisitions. The first is that, when funded by internally generated cash-flow, he considers acquisitions more similar to organic investment than to large, transformational acquisitions:

*Our total shares in issue over the 24 years from 1973 to 1997 increased by only 46%. Over that same period, our pre-tax profit increased by 22,000%. So, the first distinction I would draw is that growth by internally funded cash is more akin to organic growth than it is to growth by acquisition.*

His second point on acquisitions is that it is sensible to stick close to your circles of competence:

*The risk in acquisitions can be hugely reduced if you are already highly expert in the field. If you buy a business which is a replica of one you already own and manage successfully, then you are in a good position to check whether or not you have a good deal. Where we do move into a newish field, we do so very cautiously and, wherever we can, we will buy small so as to reduce the scale of the risk.*

Again, these points chime closely with our experience of businesses, such as Compass and Bunzl, that have combined self-funded organic investment over the years with a steady stream of sensible tuck-in acquisitions. The returns on capital and shareholder value creation that accrue from this incremental approach can be very substantial.



### Ingredient 4 – A clear, common sense financial framework

The last ingredient is a clear financial framework for shareholder value creation. One of the key metrics that Halma has used over the years is Return on Total Invested Capital (or ROTIC), a measure that is integral to the both the way in which Halma measures its performance, and how management are incentivised.

Myopia however, when applied to any form of number-crunching can be dangerous, and a multi-perspective approach combined with a dose of common sense is always advisable:

*Be suspicious of any measurement system which is so complex or difficult to apply that you need to use a consultant.*

*Don't use these measurements in isolation, as a means to decide specific management action, and certainly don't take action from them if that action seems contrary to plain common sense.*

### British compounders today

Interestingly, when David Barber gave his talk in 1997, Halma was valued at £500m and, with Barber soon to retire, one might have concluded that the company's best days were over. The business has continued to operate successfully over the subsequent twenty-five years though, in line with the principles that Barber established. The company today is worth more than 18x its value in 1997 and has produced a total return of +3,208% since the day that Barber gave his speech, compared to a return of +290% for the FTSE All-Share<sup>iv</sup>.

The primary message we are interested in extracting from this case study isn't Halma's specific success, impressive though it has been. It is that there are some key approaches to business management that, if practiced within a good business for a long period of time, can produce some surprisingly powerful results.

In an old FT interview from 2004, another ex-CEO of Halma, Stephen O'Shea said the following:

*I'd like to see more companies, particularly in the UK, try to emulate what we've done.*

We subscribe to this sentiment - and when we engage with companies, the principles outlined above are always front of mind. We also feel encouraged, when we look across the portfolio, by the many great UK businesses that are quietly applying these principles, investing in their futures, and laying the foundation stones for healthy future compounding.

### Hugh, Ben, Chris M and the Evenlode team

1 June 2023

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<sup>i</sup>TB Evenlode Income B Acc (GBP). 31 December 2022 to 31 May 2023. Source: Evenlode, Financial Express, total return, bid-to-bid, GBP terms.

<sup>ii</sup>Source: Evenlode, company reports. 1 June 2023.

<sup>iii</sup>A full transcript of the speech is available [here](#).

<sup>iv</sup>8th October 1997 to 31 May 2023. Source: Evenlode, Financial Express, total return.

