Evenlode Income Investment View

May 2024 – Quality compounders

Market data is from Bloomberg, FactSet and FE Analytics.

May was another positive month for the UK stock market, and global equities also resumed their rise after falling in April. Though interest rate expectations remained at elevated levels in May, the general mood was helped by reasonable corporate results and economic data.

So far this year, Evenlode Income has risen +3.7%, compared to a rise of +8.3% for the IA UK All Companies sector and +8.9% for the FTSE All-Share[i]. The underperformance of the fund occurred in March and April. As discussed in the last two Evenlode Income investment views, the bulk of this underperformance was caused by a significant style rotation - with cyclical, asset-intensive sectors such as banks and commodities leading the charge. Meanwhile, the share prices of many repeat-purchase, cash compounding companies – the pool that Evenlode fishes in – were either stuck in the doldrums or falling in price.

Steady fundamental progress

First quarter results have been and gone. Some holdings have been experiencing challenging end markets over the last year (including Hays, Page, Savills, Howden, Diageo, Burberry and Victrex). In aggregate, though, fundamental growth is progressing well. The forecast for the portfolio's average organic revenue growth[ii] is +5% and average operating profit growth is expected to grow at a high-single-digit rate. Free cash flow growth[iii] is also healthy -the fund's free cash flow yield[iv] is 5.1% for this year and forecast to be 5.7% for next year, providing healthy cover for the 2.9% dividend yield[v].

Valuations and takeovers

Last month we discussed the depressed valuation of many UK-listed businesses and how takeover activity had picked up within the UK market - with approximately 4% of the FTSE All-Share by value under a takeover bid at the time. We also mentioned that no Evenlode Income holdings had been affected by this trend, but since then Hargreaves Lansdown (HL) has received a takeover approach. The interested bidders are a consortium of foreign acquirers – another reminder of the interest that overseas investors have in the UK market.

We will start with some comments on HL, and then take a brief tour round a variety of portfolio holdings, to give a sense of recent results and the quality compounding opportunities on offer.

Hargreaves Lansdown – Investing for client satisfaction

We view the offer for HL as opportunistic and support management's rejection. HL has been through a turbulent period over recent years; its end markets have been challenging as the cost-of-living crisis has hit UK savers, whilst internally the company has undergone management changes and a significant step-up in investments in technology, customer service and pricing. These investments have burdened recent financial results, but they are necessary steps for the long-term health of the franchise, and it is important that they continue. The new CEO, Dan Olley (appointed in August 2023) has embarked on a customer-focused, data-driven strategy focused on improving service quality – both to retain existing clients and attract new ones. This is sensible given issues over recent years with underinvestment and customer engagement. Early signs are encouraging, with indications that clients are reporting an improved service, and greater responsiveness. In the latest quarter, Hargreaves reported +6% organic revenue growth[ii], and +13% growth in assets under administration. Net new clients during the period were up by 34,000, taking the number of total active clients to over 1.85 million. The company's market share of the UK retail investment platform sector remains at around 40%.

We support the new management team in continuing to work through the strategy they have articulated and embarked upon; if executed well it could bear considerable fruit, particularly when conditions in end markets turn up again. Longer-term, the opportunity in the UK investment platform market remains interesting, as consumers take greater charge of their financial future.

Compass – A dominant market position

Compass is the global market leader in the food-service industry and supplies a wide range of business sectors – from healthcare to offices, defence and industry. Over time, Compass has been a stalwart compounder within the Evenlode Income fund. This track record was interrupted by Covid, as the world suddenly locked down. The company has subsequently emerged in good shape, and recent results are a reminder of the qualities of Compass's business model and its long-term growth potential.

Organic revenue[ii] grew +11% and operating profit grew +19% in the latest quarter. Targeted investments in technology and digital capabilities have helped to reduce queue times at Compass' food kiosks from an average of 8 minutes to only 2 minutes, and increasing digitalisation is propelling greater average spend per transaction, while simultaneously reducing food waste. These technology investments are empowering clients to take the lead in managing allergies and the calorific content of meals, which is further helping to deepen the strength of the relationship and offering that Compass provides to clients.

As the complexities of food-service delivery have grown over recent years, Compass's expertise at managing these intricacies- along with digital know-how, procurement scale and financial strength – has been driving considerable new customer growth.

Compass management summed up the ongoing growth opportunity at recent interim results:
'*There are significant opportunities for organic growth in every region. We estimate our addressable market to be around $300 billion, and despite being the largest in the industry our global market share is less than 15%. We have multiple levers to drive revenue and profits and a confidence in sustaining mid-to high-single-digit organic revenue growth with ongoing margin progress, which will enable us to grow profit ahead of revenue. This is supported by a strong capital allocation model, which enables us to continue our track record of generating long-term compounding shareholder returns*'.

Informa – The power of physical events in a digital world

Informa is the global market leader in trade exhibitions, with plenty of opportunities for growth in what remains a fragmented market. Like Compass, it was also disrupted by Covid as social distancing and travel restrictions shut the industry down for several months. Informa has now re-emerged in good health. In an increasingly digital world, it has been interesting to observe how physical trade events have continued to thrive and prosper. The more members of a business community spend the year communicating virtually, the more importance they place on the annual opportunity to all get together in person.

Recent results demonstrated healthy growth trends, with the company expecting high-single-digit revenue growth and double-digit profit growth for the year.

Diageo – Covid hangover

After Reckitt (discussed in our two previous investment views), Diageo has been the most significant negative performer within the portfolio over the last twelve months, falling nearly -20%. The company is experiencing a hangover from a post-Covid surge in sales. Consumer demand is easing, whilst wholesalers and retailers simultaneously run down their inventory, accentuating the slowdown for Diageo's sales. Full year results, when they are announced in July, will therefore be uncharacteristically weak, with current expectations for profit to fall by about -8%.

This trend is reflected across the global spirits industry, with similar companies such as Pernod Ricard, Remy Cointreau and Brown Forman (which we follow but are not held in the fund) experiencing similar trends to Diageo. As consumer demand has cooled, destocking trends have created a bullwhip effect in Diageo's supply chain as wholesalers and retailers run down their inventories.

Taking a step back from this current dynamic, we continue to view Diageo as a well-invested global market leader with good growth prospects and an impossible-to-replicate brand portfolio and global footprint. From a valuation perspective, the company's price/earnings ratio[vi] has fallen from over 25x to 18x. The last time Diageo shares were on this low a valuation was over a decade ago, when the company experienced a similar period of weaker sales and inventory destocking trends.

Unilever – A renewed focus

Current sentiment towards Diageo is reminiscent of sentiment towards Unilever in the first quarter of 2022 (i.e. severely depressed). At that time, nothing was going right for Unilever and management's execution and strategic clarity left room for improvement. Though the subsequent two years have not been plain sailing, new management has made some sensible strategic decisions, Covid volatility is now beginning to wash through the system, and operating performance is on an improving trend. Even the share price has begun to show glimmers of life, with a total return of more than +40% since the recent nadir in March 2022.

In the latest quarter, Unilever reported +5% year-on-year growth, with volumes up +2%, building on last year's high-single-digit organic growth[ii] rate. 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 latest quarter, the power brand portfolio continued to outperform with organic revenue growth[ii] of +6%, of which two-thirds was driven by volume.

Howden Joinery – Investing through the downturn

Howden Joinery Group, the UK's leading supplier of kitchens, managed to grow organic[ii] revenue over its latest four months, despite a very tough market in which cost-of-living pressures have continued to weigh on consumer spending. Howden's management has been resolute in their strategy of reinvestment, expanding their depot network in the UK and Ireland, and more recently in France. They plan to refurbish more than 80 of their UK depots and to open 30 new ones during the year. As of January this year, bedrooms have also now become available in all UK depots, reflecting management's commitment to invest and expand Howden's offering over time. When the tide turns, and the market improves, Howden will be in a strong position to benefit.

Test and Inspection – Supply chain complexity and sustainability drive growth

Intertek and SGS, two leading companies in the Testing, Inspection and Certification industry, continue to benefit from the increasing complexity of disclosure requirements, and the growing weight of technology and sustainability regulation. Both companies reported +7% organic revenue growth[ii] at their latest results and guided to strong organic growth and margin progression for the full year.

Digital business models – Long growth runways

The results from the portfolio's high-margin, asset-light digital companies have remained strong, and the rapid build out of AI capabilities has been a recurrent theme, as companies such as RELX, Microsoft, London Stock Exchange Group and Sage invest heavily in expanding their capabilities in this area.

Microsoft reported organic revenue growth[ii] of +17%, with its cloud computing platform, Azure, growing well ahead of expectations, at +24%. London Stock Exchange Group also reported strong organic revenue growth[ii] of +6%, and their 10-year partnership with Microsoft on next-generation data analytics and cloud infrastructure solutions has shown good early progress.

Experian, which we added to the portfolio in June 2022, reported organic revenue[ii] and profit growth of +6% and+ 8% respectively at its recent full year results. The company benefits from high switching costs and brand strength - it would be very difficult for a competitor to build up a comparable depth of data - and management continue to invest heavily in the business to drive growth. This is the way they put it at recent results:
'*We continue to grow despite major credit downturns, including this period in which rates rose rapidly, and our track record demonstrates that the business can deliver good growth even in difficult circumstances. In fact, in each successive down cycle, we've bottomed out at a higher level of organic growth, which reflects the shift of the business over time with better products positioned in higher growth areas. Today, we're a broad-based data analytics and software company operating across many industries*'.

Experian's growth prospects look attractive - as financial inclusion expands globally, the requirements of fraud and risk management become more demanding, and Experian's services become increasingly embedded in customer workflows over time. In recent published results, management set a new target of achieving high-single digit organic growth over the medium-term, and an aspiration for low-double-digit growth over the longer-term.

A source of comfort

For any company, including all those discussed above, there are of course both fundamental and valuation risks that need continual assessment. We aim to reflect these risks in our position sizing framework and our 'nudging' of the portfolio over time. But in the current context, in which the valuations of many holdings have been de-rated, we find great comfort in the diverse range of cash generative, competitively-advantaged companies from which the portfolio's healthy fundamental growth is being produced.

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

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[i] *IFSL Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return, bid-to-bid, GBP terms. Performance from 31 December 2023 to 6 June 2024.*

[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] *Free Cash Flow Yield - 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.*

[v] *Dividend Yield - A dividend yield is calculated by dividing the dividends per share by the current share price.*

[vi] *Price/Earnings Ratio (P/E Ratio) – A measure of a company's current market valuation compared to its earnings potential, calculated by dividing a company's share price by its Earnings per share (EPS). EPS is calculated by dividing a company's profit by the number of shares in issue.*