

Evenlode Income Investment View

November 2022 – Results and Silver Linings



November was a strong month for global equity markets. The backdrop remains difficult: inflation is still running high and interest rates are rising, the cost-of-living crisis is biting, China's zero covid policy has led to further lockdowns and demonstrations, and the Ukraine/Russia war remains unresolved. At the margin, though, investors have seen some silver linings in this cloudy sky. Inflation and interest rate expectations have begun to ease back, with supply chain bottlenecks beginning to ease, and several commodity prices having fallen back from their peaks earlier in the year (oil is down -35%, copper is down -25%, the Baltic Dry Freight index is down -60%), thanks partly to the slowing global economy. Meanwhile, though corporate earnings are seeing some pressure from the economic backdrop, results have been reasonably robust relative to expectations.

Following the recovery in markets during October and November, year-to-date returns have improved. For 2022 so far, Evenlode Income's total return is now flat (i.e. +0.0%), compared to a fall of -7.5% for the IA UK All Companies sectors and a rise of +1.9% for the FTSE All-Shareⁱⁱ.

Resilient Fundamentals

In terms of the operational backdrop for companies, November saw the completion of the third quarter results season. As mentioned last month, we have been impressed with the progress companies are making. The essentials, little-luxuries and mission-critical items that most of the portfolio holdings sell, help to underpin demand in tougher times. Meanwhile, pricing power and attractive margin structures are providing relative insulation from input cost inflation.

For portfolio companies reporting over recent weeks, third quarter organic revenue growth averaged +12% and year-to-date organic revenue growth averaged +15% (or +11% if Covid-recovering holdings Informa and Compass are excluded)ⁱⁱⁱ. Not many companies report earnings progress at this stage, but management commentary suggests a similar trend to that seen at half year results, with earnings growth running a bit behind revenue growth in aggregate (due to high input cost inflation), but still healthy in absolute terms.

To bring some more colour from across the portfolio, below is a brief discussion of four Evenlode Income holdings, all of which released full-year or interim results during November.

Sage – Investments bearing fruit

Sage is a market-leading global provider of accounting, financial, HR and payroll software to small and medium-sized businesses – over 10 billion invoices are sent and received by Sage customers annually, and over 20 million employees are paid globally by Sage payroll products. Sage has undergone a transition to cloud-based software services over recent years and has invested significantly in both innovation and customer support to help drive this shift. The company's annual R & D budget, for instance, has increased by more than +50% over the last three years. This has burdened financial results, but the investments are beginning to bear fruit. 95% of Sage's revenue is now recurring, and 75% of revenue is now generated from cloud-based software solutions. Sage is also benefitting from structural growth as the digitalisation of the global economy continues. As management put it at recent results *'Our opportunity for growth is significant. Many businesses face an uncertain economic environment at the moment, but small and medium-sized businesses are continuing to prioritise technology investment. Our solutions are mission-critical for millions of small and medium-sized businesses globally, helping customers to streamline processes, unlock productivity and achieve more with less'*.

Over the 12 months to 30 September, Sage grew revenue by +6%, operating profit by +8%, and increased the dividend by +4%. With much of the company's cloud transition now out of the way, management expect revenue growth to accelerate and profit margins to gradually increase over coming years.

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Experian – Demand for digital services

Experian was added to the portfolio in June this year. Like Sage, the company is a beneficiary of the digitalisation of the global economy. Experian is one of the leading credit bureaus in North America and the UK, with a growing presence in emerging markets. Experian's data assets are incredibly difficult to replicate with credit histories and repayment data on 1.2 billion people and 145 million businesses. The core business serving banks with credit data and scores is highly cash generative, and growth potential is significant as Experian invests in expanding the use cases for its data assets into new areas, such as employment verification for landlords and governments, and fraud detection for retailers. Experian is a resilient business which continued to grow through the 2008-2009 downturn and the company is also performing resiliently this year, despite a significant slowdown in the US mortgage market. At recent interim results, Experian reported revenue growth of +9%, operating profit growth of +8% and increased the dividend by +6%.

Looking ahead, the global economic backdrop remains challenging, but Experian management are quietly confident in their ability to navigate these complexities: *'Our own innovation-led agenda has positioned us very well, which is becoming increasingly evident in our clearly strengthened competitive position. And our financial position is also very strong. All of that gives us great confidence as we look ahead'.*

Diploma – Hidden champion with pricing power

Diploma was also introduced into the fund in June this year. The company, with a portfolio ranging from electrical connectors to medical equipment to industrial valves, may at first glance look a bit dull and boring, but this niche, value-adding distributor of industrial products is one of the great 'hidden champions' of the UK stock exchange. The company enjoys market-leading positions, selling its mission-critical products to loyal business customers, whose spend with Diploma is a small percentage of their overall project spend. This creates attractive economics, including high gross margins, pricing power and the ability to compound free cash flows and dividends at a good rate over time.

The company, like Experian, is not immune to the economic environment, but in recent results management noted several sources of resilience worth noting in this difficult inflationary, slow-growth backdrop: *'First, increasing revenue diversification means we are exposed to exciting, structurally growing end segments like diagnostics, technology, renewables and infrastructure. We can also grow addressable markets with product extension and take share with geographical penetration too. So, if demand starts to moderate, there will still be plenty of reasons for continued optimism. Second, our products are critical to our customers' needs and are a low proportion of costs. So, together with continuous improvement of our service provision, margins have held up really well through cycles. And finally, we have a low capital intensity model, which means that our cash conversion performance has been strong in the tougher times too'.*

For its latest financial year, Diploma grew both revenue and operating profit by +15% and increased the dividend by +26%.

Compass - Strong grow stronger

Compass is the global market leader in the provision of outsourced food services to a wide variety of clients and locations (offices, hospitals, schools, universities, sports stadiums etc.). Social distancing measures meant Compass was one of the most pandemic-impacted Evenlode Income holdings. The company has, though, seen a strong subsequent recovery. For its latest financial year, Compass benefited from its second year of strong recovery, with revenue growth of +38%, operating profit growth of +88%, and a dividend increase of +125% compared to the previous year. This recovery brought Compass's fourth quarter revenue to a level +16%

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November 2022 – Results and Silver Linings



higher than the equivalent pre-Covid period in 2019 (the dividend recovery has a bit further to go, with the current annual dividend now standing at 79% of the pre-Covid 2019 level).

Looking ahead, Compass represents a good example of ‘the strong growing stronger’ in adversity, and the company is emerging with good potential for the sort of long-term cash compounding it generated for many years prior to the pandemic. The company’s reputation, scale and ability to manage complexity have meant that Compass has seen a ‘flight to trust’ from competitors less well placed to deal with recent challenges (hygiene requirements, food sourcing, volume variability, changing consumer preferences, staff sourcing, input cost inflation, digital capabilities etc.). At this month’s full year results, Compass noted that both client retention rates (at 96%) and new business wins are running at all-time highs. New client wins are coming both from market share gains and from companies deciding to outsource their food catering for the first time. Management expects this trend to continue as their clients look to remove hassle and inefficiencies from their ancillary operations in order to remain flexible and adaptable in a fast-changing, complex world.

Of course none of the companies mentioned above are without challenges – they all face a complex operating backdrop, rising input and wage costs, and a slowing global economy. So, as ever, there is no room for complacency. But given the market zeitgeist of the last year (in which the negatives have been focused on more than the positives), it is worth noting that many high quality, resilient businesses are navigating this troubled period well, generating healthy cash flows along the way and continuing to invest in their long-term futures.

Hugh, Ben P, Chris M, and the Evenlode Team

1 December 2022

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Past performance is not a guide to future returns. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Fund performance figures are shown in Pound Sterling, inclusive of reinvested income and net of the ongoing charges and portfolio transaction costs unless otherwise stated. The figures do not reflect any entry charge paid by individual investors.

Source: Evenlode Investment Management Limited, authorised and regulated by the Financial Conduct Authority, No. 767844.

ⁱ Source: Rosenberg Research.

ⁱⁱ TB Evenlode Income B Inc class. Source: Evenlode, Financial Express, total return, bid-to-bid, GBP terms. Year-to-date figures are for the period 31 December 2021 to 1 December 2022.

ⁱⁱⁱ Source: Evenlode, company results (organic constant currency measures used where available). Q3 figures are all for the 3-month period to end-September 2022. Year-to-date figures are either 9 months to end-September 2022 or 12 months to end-September 2022, depending on company reporting period.