Evenlode Income Investment View

November 2024 – Niche compounders

EVENLODE
INCOME FUND

November was another eventful month for global stock markets, with the US election dominating news flow. The US stock market and dollar took the news of a Trump victory very well, buoyed by the prospect of corporation tax cuts and an 'America First' economic policy. Outside of the US, equity markets were more mixed, with questions around potential US tariffs creating some uncertainty. Other geopolitical news also competed for the headlines, including elevated Russia/Ukraine tensions, French political uncertainty and an Israel-Hezbollah ceasefire. Though the UK stock market did not keep up with the US, it outperformed its European peers. Evenlode Income rose +3.1% during the month, compared to a rise of +2.2% for the IA UK All Companies sector, and +2.5% for the FTSE All-Share[i].

For the year as a whole, Evenlode Income continues to lag the FTSE All-Share. As discussed in recent investment views, the underperformance occurred in the March-April period. Though performance has been ahead of the FTSE All-Share since the end of April, as I write Evenlode Income has risen +6.4% since the start of January, compared to +10.6% for the IA UK All Companies Sector and +11.7% for the FTSE All-Share[ii].

Results and valuation appeal

Third quarter results season has come and gone, with themes in-line with the year so far. Sectors such as luxury/spirits, recruitment and industrial production markets are still suffering from higher interest rates and a post-Covid hangover (though with signs of green shoots in several cases). We discussed Diageo in September, and we will mention some others below. Elsewhere, the vast bulk of holdings are growing well, leading to solid aggregate earnings growth at the portfolio level, and healthy free cash flow[iii] generation.

Below we discuss several portfolio holdings from both categories to highlight themes we are seeing across the portfolio.

Niche compounders

We have spoken to the management of Compass, Diploma and Halma over recent weeks, following results. They are all niche market leaders offering consistent cash compounding potential over the coming years.

Compass

The lockdown period was challenging for the food catering industry, but it allowed Compass to strengthen its global leadership with the company's scale and expertise allowing the company to navigate health and safety requirements, supply chain complexities and food inflation.

Compass has a significant structural growth opportunity ahead of it and has been progressively winning share from in-house kitchens and smaller regional businesses, which still account for the majority of the market. Compass CEO, Dominic Blakemore, summarised the opportunity from higher levels of outsourcing on the recent earnings call:

"We continue to see stronger outsourcing and favourable market trends, which give us confidence in sustaining higher growth. Food is more valued than ever by clients and consumers. Allergens, dietary

requirements and sustainability initiatives continue to add to operational complexities. Major challenges such as heightened inflation put pressure on organizations, leading to further outsourcing. Our unique competitive advantages, sectorisation, scale and expertise enable us to address complexity, helping us to win more business, especially with first-time outsourcers".

Recent full year results reinforced Compass' cash compounding credentials, with revenue and profit growing at +11% and +16%, respectively. Over the medium-term, assuming a more normalised pricing and inflation environment, management expect continued strength in outsourcing to drive organic sales in a mid-to-high single digit range.

Diploma

Diploma, a value-added industrial distributor, sells mission-critical products such as industrial seals and wiring into a variety of high-performance settings, from the US construction industry to hyper-scale data centres and the life sciences sector. Diploma released full year results in November and grew organic revenue by +6% and operating profit by +20%. Diploma's portfolio diversification and exposure to structurally growing markets more than offset cyclical weakness in some industrial end markets. Diploma's management are relaxed about potential tariffs for their US business (which represents 46% of group sales), noting that more than 75% of all items are sourced from the US, and less than 5% of its US supply chain is from China. The company's high gross margin structure also helps the business to pass on any cost increases with less impact in percentage terms on the price the customer pays.

Management describes the company as *a really hungry, entrepreneurial growth business in a FTSE 100 wrapper*. Subsidiary management are given autonomy to deliver results within a framework of clear financial guardrails that is monitored at the centre. The company has delivered +15% revenue growth and +16% earnings growth over the last fifteen years thanks to a disciplined but entrepreneurial compounding approach. Looking ahead, the company think +5% organic revenue growth is a realistic longer-term aspiration, with self-funded bolt-on acquisitions adding at least another +5% to revenue growth. The acquisition pipeline is healthy, with the average acquisition multiple for smaller acquisitions around 5x Earnings Before Interest and Tax (ie a 20% pre-tax return on capital). These acquisitions tend to be bilateral agreements. They are often founder or family-owned businesses that see Diploma as a good home, attracted by the culture and heritage of the group and the community of like-minded businesses they are able to join.

Halma

Halma is a specialist engineering business with leading positions in niche, growing sectors across safety, environmental and health end markets. It has a decentralised structure with around 50 operating companies which provide mission critical products ranging from fire detection systems, elevator communication systems, to blood pressure monitors. These products 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 has a disciplined bolt-on acquisition strategy, focusing on existing or adjacent markets where it has deep expertise and knowledge. Like Diploma, it typically acquires founder or family-owned businesses, often having built a relationship with the owner over many years, allowing it to avoid competitive auction processes. Over the past 10 years it has compounded revenue and profit at 12% per annum, slightly ahead of its medium-term target for annual revenue growth of at least 10%, split equally between organic and acquisitions. Halma reported half year results in November, building on its successful track record, with revenue growing +13% and profit +18%.

Data analytics

The portfolio's data analytics holdings continue to report positive results, with Experian and RELX, for instance, reporting organic revenue of +7% and +8% in their latest trading period.

We spoke to Sage management after full year results, a market leader in the provision of accountancy and finance software to small and medium sized enterprises (SMEs). Significant investment in technology and customer support over recent years, under the current management team, has left Sage in healthy shape.

Management invested early in generative AI. Sage Copilot is now being used by 8,000 customers who are providing feedback ahead of its imminent commercial launch. Management noted that SMEs are generally not looking to deploy this technology to reduce headcount (employees are after all often family members or friends in smaller companies), but instead to make the people they have more effective. Sage think that the key for adoption is providing companies with use cases that can give customers a clear timesaving, with several use cases for Sage Copilot able to save several hours per week of work.

The extent and speed of adoption of generative AI tools by businesses remains an open question, but Sage appears well positioned, with trusted customer relationships and access to troves of proprietary data. Sage's recent strong growth is before any contribution from generative AI tools, with increasing adoption of Sage's cloud-based products driving revenue and profit growth of +9% and +21% respectively over the past year.

Well invested market leadership

Spirax Group, PageGroup and Victrex have faced operational headwinds this year, and the share prices of these companies have underperformed. We think, though, that they offer very interesting upsides looking ahead. They retain market leadership and have made investments in recent years which will set them in good stead when end market conditions improve. We discussed Spirax in September's investment view and review Victrex and PageGroup below.

Victrex

Victrex makes the high-performance polymer PEEK, which has interesting long-term growth potential due to its unique characteristics, and end market usage in sectors such as medicine, electric vehicles and energy efficiency. Victrex is the market leader globally in this niche, with approximately 50%

share. Barriers to entry are high, with vertical integration, intellectual property and customer specifications as key differentiators.

Its end markets have been in a downturn in the post-pandemic period, a situation which has been exacerbated by customer destocking. Recent conversations with management though, suggest that markets have stabilised, and growth is forecast for the coming year. During the recent downturn, management has continued to invest in the business and think current capacity can deliver the next five years of growth for the group (which could result in sales growing anywhere between +50% and +100% thanks to both business-as-usual demand and larger projects in areas such as electric vehicles and energy). As management put it to us, *"…we've historically been good at outperforming in an up-cycle because we're well invested, with plenty of spare capacity"*. Despite prospects for a significant earnings recovery, the shares are trading at close to trough levels, with a current year P/E ratio of 16.6x, compared to a historical range of 15-22x[iv].

PageGroup

PageGroup is a market-leading specialist recruiter. It had a strong post-Covid period in 2021 and 2022, with high inflation-driven pay awards and significant churn in white collar employment as workers and companies adapted to the post-Covid working environment. Recent years have been challenging with macro and geopolitical uncertainties, pay awards falling to more normal levels, and low churn levels as companies and candidates adopt a wait-and-see approach. The recent Q3 trading update showed no improvement in these trends with net fee income falling -13.5% versus the prior year.

Despite the challenging market backdrop, we expect PageGroup to deliver strong cash compounding economics over the economic cycle. Since the Global Financial Crisis, it has compounded fees at around 8% per annum and paid ordinary and special dividends totalling nearly £1bn, comparable to its current market capitalisation of £1.1bn. PageGroup has built deep candidate and client pools which allows its consultants to source the best people, adding significant value for its client base. Management run a conservative balance sheet, with a net cash position of £93m at the end of September, leaving it well placed for the eventual upturn in the recruitment markets. Valuation also looks attractive, with the shares trading on less than 1x fee income, compared to a historical average around 2x[v].

The Evenlode team will release their winter book list later this month. Then, we will be back again in January to give a full review of 2024 and to discuss the outlook for 2025.

In the meantime, we wish you all a very peaceful and enjoyable holiday season.

Hugh, Chris M., Ben P., Charlotte, Leon and the Evenlode team
11 December 2024

Evenlode has developed a Glossary to assist investors to better understand commonly used terms.

Please note, these views represent the opinions of the Evenlode Team as of 11 December 2024 and do not constitute investment advice. Where opinions are expressed, they are based on current market conditions, they may differ from those of other investment professionals and are subject to change without notice. This document is not intended as a recommendation to invest in any particular asset class, security, or strategy. The information provided is for illustrative purposes only and should not be relied upon as a recommendation to buy or sell securities. For full information on fund risks and costs and charges, please refer to the Key Investor Information Documents, Annual & Interim Reports and the Prospectus, which are available on the Evenlode Investment Management website (https://evenlodeinvestment.com). Recent performance information is also shown on factsheets, also available on the website. 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 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. Current forecasts provided for transparency purposes, are subject to change and are not guaranteed. Source: Evenlode Investment Management Limited, authorised and regulated by the Financial Conduct Authority, No. 767844.

Market data is from S&P CapIQ, Bloomberg and FE Analytics unless otherwise stated.

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[i] *IFSL Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return. Performance from 31 October 2024 to 30 November 2024.*

[ii] *IFSL Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return. Pre-swing price NAV performance from 31 December 2023 to 9 December 2024. Performance based on published (swung) prices is +5.7%.*

[iii] *Free Cash Flow is a measure of how much cash a company can generate over and above normal operating expenses and capital expenditure.*

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

[v] *Price/Fee Income is a measure of a company's current market valuation compared to net annual fees generated, which is equivalent to revenue for a recruitment business.*