

# Evenlode Income Investment View

October 2022 – Marathon not a Sprint



In October, global stock markets recovered a little. Input cost pressures have hung in the air over the summer, and central banks have raised interest rates sharply in response. These two factors are acting as a brake on economic activity (they push up both the cost of living and the cost of investment), and leading indicators are now suggesting recessionary conditions in most regions. Meanwhile, geopolitical uncertainty is clear and present - with the Russia-Ukraine war rumbling on and the US mid-term elections rapidly approaching. For those looking for a silver lining, there are signs that input cost inflation will slow over coming months, with many raw material prices off recent highs. This easing of expectations for inflation and interest rates helps explain Mr Market's improved mood as October progressed. In the UK, there was also some relief for sterling and UK government bonds as most of September's mini-budget proposals were reversed.

In 2022 so far, Evenlode Income has fallen -6.2% compared to a fall of -5.0% for the FTSE All-Share and -14.5% for the IA UK All Companies Sector<sup>i</sup>.

## Resilience and Pricing Power

In October, the third quarter results season kicked off and we are busy analysing results and speaking to company management teams. Overall, 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.

## Third Quarter Results

We will give a more complete update in next month's investment view, but thus far approximately 50% of the portfolio has reported, with both third quarter and year-to-date organic revenue growth averaging +12% for these holdings<sup>ii</sup>. These growth numbers do not include the currency benefit that most UK-listed multi-nationals are receiving on top of this, thanks to the pound's weakness (which is typically adding at least another 5% to reported revenue). 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<sup>iii</sup>.

Below is a brief discussion of the largest ten holdings that have reported so far, grouped by business model:

## Consumer Branded Goods

Of all the holdings, consumer branded goods companies have seen the most extreme input cost inflation this year, due to their exposure to energy-related and agriculturally-derived inputs. These companies are generally guiding to full year 2022 input cost inflation in the high-teens, which is a very extreme dynamic relative to anything seen over the last forty years for the sector - not helped by Putin's invasion of Ukraine. In this context, it is reassuring that companies have been able to steadily pass prices through, with less volume impact than they and analysts had initially expected. Revenue growth for the fund's largest holdings in this area (Unilever, Reckitt, P&G and PepsiCo) have ranged from +7% to +16% in the most recent quarter.

Unilever, P&G and PepsiCo are expecting some margin compression in their current financial year, whereas Reckitt expects growth. Over the winter, global consumers will continue to feel the pinch, which will lead to some continued pressure on volumes. These companies are, though, very repeat-purchase relative to the average company, with consumer loyalty high. They may also begin to see input cost inflation lessen

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significantly over coming months: if key raw material costs stay roughly where they are, high-teens year-on-year inflation would swing to year-on-year deflation by the second half of 2023 – a meaningfully positive operating backdrop relative to recent months.

## Software and Analytics

Demand for software, digital information and data analytics services remains strong. As Satya Nadella, Microsoft's CEO, recently put it: *in a world facing increasing headwinds, digital technology is the ultimate tailwind*. The share prices of some of these businesses have fallen back this year as valuations compress (most notably Microsoft's and Sage's), but operating performance has in-the-round been steady and healthy. Organic revenue growth for the three largest Evenlode Income holdings in this area (RELX, LSE and Microsoft) has ranged between +6% to +16% for the most recent trading period. As asset-light companies, they are also relatively well placed to deal with inflation thanks to their loyal customers, mission-critical product, high gross margins and a low reliance on raw materials.

## Other – Bunzl, Hays, Spectris

A range of other business models have also reported in October. Bunzl, for instance, the global distributor of not-for-resale consumables (think packaging items for the food service sector and PPE for industrial and healthcare sectors) reported a third quarter trading statement with revenue +6% (and its base business +10%, when Covid-related sales are excluded). Bunzl's embeddedness with customers and low-cost mission-critical service leads to helpful pricing power – as management noted, the base business's growth benefited from inflation, as expected.

Hays, the specialist global recruitment company, is one of the most economically sensitive companies in the portfolio, and its shares have fallen as concerns grow on the economy this year. Employers are beginning to take longer to make hiring decisions in some areas, though Hays's most recent quarter was a record for gross profit (+15%), with management noting that demand continues to be underpinned by skill shortages globally, whilst the current trend of rising wage inflation is helpful for the company's *ad valorem* business model.

Spectris, a market leader in measurement technologies and software, noted that demand remained strong and reported +10% revenue growth in its latest quarter. Though the company is exposed to industrial markets, its products are mission-critical and help to ensure the safety and efficiency of customers operations. Management have also repositioned the portfolio over recent years, focusing down on subsidiaries with the strongest competitive advantages and more economically resilient sectors such as pharmaceuticals- a good case study in how businesses can evolve and adapt their portfolios over time.

## Marathon not a Sprint

We are not complacent about this coming winter – it will be tough period for the global economy. But Mr Market is not unaware of these difficulties and, as the old adage goes, *you make your money in a bear market, you just don't realise it at the time*. Short-term financial results are important, but we also appreciate the spirit of this epigram and would note that it is particularly worthy of recitation in a global recession, when the average investor time-horizon is prone to truncate even more than normal. And who knows, maybe things won't be quite as bad as the consensus currently fears: *prepare for the worst and hope for the best*, to use another old saying. As the downturn progresses, we are interested in how each company in Evenlode Income's investable universe navigates through this downturn, and we will keep an eye on any share prices that look to be undervaluing companies with a fundamentally strong competitive position and healthy long-

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term outlook. With this in mind, we continue to monitor an interesting watchlist of potential holdings and remain open to evolving the portfolio further.

More generally, equity investment is an activity best treated as a marathon not a sprint. We find comfort in the quality and resilience of the Evenlode Income portfolio, and the structural cash compounding ability of underlying holdings. The portfolio's valuation is also healthy, with a free cash flow yield of 5% for 2022 (currently forecast to be 5.8% next year) providing healthy cover for its forecast dividend yield of 3%<sup>iv</sup>.

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

**31 October 2022**

*Please note, these views represent the opinions of Hugh Yarrow and the Evenlode Team as of 31 October 2022 and do not constitute investment advice.*

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*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 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.*

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<sup>i</sup> 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 31 October 2022.

<sup>ii</sup> Source: Evenlode, company results (organic constant currency measures used where available).

<sup>iii</sup> Only about 10% of the portfolio has reported third quarter organic revenue and earnings thus far. For this very small subset, the average revenue growth has been +13% and earnings growth +9%.

<sup>iv</sup> Source: Evenlode, FactSet. Free cash flow yield based on 2022 estimates (and 2023 forecasts for next year). Forecast dividend yield of 3.0% based on TB Evenlode Income B Inc class 31 October 2022 share price and current forecast dividend for fund's distribution for 12 months ending February 2023. The historic dividend yield based on the previous 12 month's distributions is currently 2.8%.