Evenlode Investment View

April 2017 - Jumping Up and Down

By Ben Peters

EVENLODE
INVESTING FOR LIFE

"I just want to live my life without politicians jumping up and down"

Scottish voter soundbite, Today, BBC Radio 4 19th April 2017

I sympathise with the Scottish lady accosted by a Radio 4 reporter to canvas her opinion on the upcoming UK general election and the possibility of a further Scottish independence referendum. Humans, in general, have a habit of 'jumping up and down' quite a lot. If we want to get a taste of our collective inability to keep still we need look no further than the United Kingdom. As intimated by our voter in the street, in the space of a little over seven years, by the end of 8th June we will have enjoyed three general elections and three referenda.

With such frequency of votes at home and more internationally, a long-term investment strategy must be able to deal with them as a matter of routine. Recent geopolitical events bring into focus once more the concept of tail risk, the very small chance of something really big happening. Risk, as professor Elroy Dimson puts it, means more things can happen than will happen, a statement that is true at all times. So the current state of political affairs shouldn't cause the long term investor any particular alarm. Our focus at Evenlode is on the things that we think matter in an investment case (strong competitive positions, repeat-purchase business models, compounding cash flows, strong balance sheets, geographical diversification etc.) and we aim to let the positive factors shine through, whilst being cognisant of the potential for negative outcomes and protecting against them. As we often put it, we look to insulate the portfolio from a wide range of outcomes, rather than make big predictions about the future.

The positive side of restlessness

Not all agitation is bad. In the last Evenlode investment view Hugh looked at some of the technological innovations that are providing a runway for growth in the Evenlode Income portfolio. Hermann Simon, in his book *Hidden Champions of the 21st Century*, states that 'Innovation is the only effective long-term means of succeeding in competition'. Companies that strive to innovate stand the best chance of flourishing to their own benefit and to broader society.
Dissatisfaction with the status quo can be a driving force behind positive investment and societal outcomes together. As an example, medical software firm EMIS enjoyed a dominant market position in on-premise GP patient record databases a few years ago. The company could have technologically stopped there, but if it had then it we would not enjoy the benefits that are now being delivered by its EMIS Web cloud-based service: on line access to bookings, prescriptions and medical records, the start of connectivity between different parts of the NHS. The benefits will continue to be developed in future years. But there is clearly a business risk factor at play; if EMIS did not innovate, a competitor probably would have come up with a cloud-based solution, and threatened the incumbent's position. An economic moat can be dug but it has to be maintained. Business considerations cause agitation, which spurs innovation in a virtuous circle.

Restlessness as a risk

One example of restlessness risk lies in merger and acquisition activity (M & A) that can create questionable outcomes to the investor. M&A, often funded by debt, is a feature of the current market environment. We had a particularly high profile M&A case recently with Unilever. Since Kraft-Heinz approached the firm about a takeover and was swiftly rebuffed, Unilever has revisited its strategy and pressed 'fast forward'.

A reassuring element of the announced strategic plan was that long term growth driven by investment is still front and centre; another instance of the virtuous circle of business agitation at work. Elsewhere, there is a plan to accelerate margin improvements, and to increase leverage from 1x to 2x Net Debt/EBITDA. These are areas where we must pause to take a look. Increasing margins could mean that the intended investments don't happen, or are not as effective as they might otherwise be in the long term. Doubling the debt burden increases financial risk to the equity holder, the potential payoff being improved returns if things go right. In other words, investment risk may be enhanced. There are many other considerations to the investment case, but Unilever provides a current case-in-point for exploring where we can analyse activity, and make risk-based judgments on the outcomes.

On the margin/investment front, it is impossible to state precisely what the 'right' level is. We can look to competitors for clues – the suitor Kraft-Heinz has operating margins in the mid-20s, and Reckitt Benckiser in the high-20s, already significantly higher than Unilever's new medium-term target of 20%. It should be noted that these are different businesses with different category and geographical profiles, but in the round we think Unilever have struck a good balance between ongoing long-term investment and increased efficiency.

Debt is something that we tend to shy away from, and we have been talking much recently of deliberately positioning the Evenlode Income portfolio with low overall gearing in order to manage risk. That is not to say there is no debt of course, and some of the higher levels in the portfolio are found in consumer goods companies. Since they tend to have more stable cash flows than the average firm, the chance of these falling to a level that risks (first) the dividend and (then) the equity base is lower. Nonetheless, there is a level of debt for any business that is too high. Comparing again to other firms we can see that Unilever's proposed 2x is not out of the ordinary, and in our view remains prudent. Thinking critically about what could happen on the downside, demand for Unilever's low-ticket goods tends to be solid due to their nature and has remained resilient through a wide range of economic conditions. This gives us comfort in the new targeted capital structure.

Some commentators and analysts were calling for higher margin and leverage targets than the targets that Unilever have laid down (in some cases significantly higher). We are pleased that Unilever have settled on a compromise – a bit more efficiency, and a bit more leverage, without sacrificing a low risk profile and an ability to continue investing consistently in long-term growth.

People just do things

Back to the exasperated Scottish voter, we can expect people (be they politicians, business managers or anyone else) to do things. Whether an action is a good idea at a particular moment in time is always open to question and opinion, and analysis is possible for us in the case of Unilever through the Evenlode investment process. When business people do things involving our investee companies we have a chance to examine specifics and question whether the result still fits with our investment criteria, and whether the potential benefits balance the risks. In the case of Unilever, we think that the answer is 'yes', but as with all companies in the Evenlode universe, we will of course continue to monitor risk factors as the strategy develops.

In politics, politicians, political scientists and commentators will take the election and run with it, and we can be certain of much 'jumping up and down' in the coming weeks. In our own field, investing our clients' savings in high quality businesses, we'll certainly be interested observers of the UK general election but we'll deal with it, as with all 'event risk', via our ongoing through-cycle risk management.

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Please note, these views represent the personal opinions of Ben Peters as at 24th April 2017 and do not constitute investment advice.