Evenlode Investment View

August 2017 - Some Themes From Results

EVENLODE
INVESTMENTS FOR LIFE

The year is ticking by – nearly two thirds of 2017 has passed – and as is customary for stock markets, there's been no shortage of uncertainty for investors already (US political comings/goings and policy setbacks, mixed macro-economic messages, European elections, Brexit negotiations, North Korean tensions etc.). Global stock markets have, however, eked out positive total returns. Since the beginning of the year, the UK market has risen +7.6%, whilst Evenlode has returned +11.2%*.

We have been pleased with the overall progress that your fund's companies have been making in what is by no means a straightforward environment for most industries. Following on from the recent interim results season, I'd like this month to briefly discuss some themes that we are seeing and thinking about in respect of Evenlode holdings and the broader business environment.

Disinflation

The three 'D's – high global *debt* levels, ageing *demographics* and technological *disruption* (software, Amazon, artificial intelligence etc.) have been signature motifs of the last few years and they remain key drivers of the macroeconomic backdrop. These disinflationary trends continue to provide a challenge for companies in terms of pricing power and overall growth rates, and we are seeing the effect across all industries. Whilst no business is immune, companies that enjoy the following factors are in our view equipped with important defences and sources of resilience against these trends:

- Strong economic moat (i.e. difficult to replicate competitive advantages)
- Durable product offering with good customer loyalty and a low risk of obsolesence
- Willingness and ability to invest in innovation and future growth to help evolve the franchise over time.
- Healthy cash generation

We remain very keen on businesses that fit these criteria.

Opportunities Not Just Challenges

The current backdrop is providing opportunities as well as challenges. The majority of the companies in the Evenlode portfolio sell to other businesses (rather than to consumers), often in specialist niche markets with high barriers to entry. Many are seeing the ability to harness technological change, helping their customers cope with a changing world by offering products and services that increase efficiency and productivity (as discussed in my March investment view: *Data, Data, Data*). Software analytics and proprietary data are often key planks in this strategy and some of the best Evenlode examples are in the business-to-business information and software sectors - companies such as Informa, DMGT, Relx, Euromoney, UBM, Sage, Fidessa, Aveva and EMIS. Relx's Eric Engstrom sums this theme up well when he describes the company's overarching strategy: *our number one priority is the organic development of increasingly sophisticated information-based analytics and decision tools that drive higher value for our customers*. As recent results for this group of companies demonstrate, delivering such services tends to command pricing power and good customer loyalty, with renewal rates on subscriptions often 80-90% or more.

Even in the traditional engineering sector, we are seeing a similar theme emerge for companies such as Spectris and Rotork, whose customers are becoming increasingly aware of the benefits that data analytics and interconnectivity ('the internet of things') can bring to their operations. Rotork announced an increased focus on R & D investment alongside results with the aim of developing more products to address these needs. As Rotork management put it, *the ability to put in smart feedback systems that enable predictive maintenanace and ensure critical components don't fail is a very powerful value proposition.*

Balancing Efficiency With Investment

This general drive for efficiency is perhaps the most ubiquitous theme we see across all the different sectors and industries we follow. Wherever you look: better data analytics, upgraded IT infrastructure, more rational manufacturing facilities, improved supply chains and procurement systems are being worked on. When done well this represents a positive development. Management information is better, less mistakes are made, customers are happier and profits rise. The risk with 'efficiencies' of course, is that they sometimes come not only from operational improvements, but also from *investment cuts* to those things that drive product quality and future growth (brand investment, innovation, R & D, geographical expansion etc.). We think it's important that management get the focus right here and is one of the topics we've been discussing with companies in detail of late. Two good case studies are Informa and Smiths Group. Both were in my view underinvesting several years ago, but new management teams have made good progress in stepping up organic investment levels to drive future growth.

In the consumer staples sector, this balance between efficiency and investment is particularly interesting at present. The threat of real and perceived acquisition activity has put some pressure on the industry to optimise financial results (the advertising industry is feeling the pinch from this, as WPP's latest results demonstrated - the company has several large clients in the consumer staples industry).** But equally, consistent investment remains very important - even in a stable, mature industry such as consumer branded goods. The world is moving on: consumer preferences are changing, the retail landscape is evolving and as shoppers we are beginning to purchase more of our groceries and personal care products through digital channels. Globally dominant brands are very well placed to cope with these shifts, but they will need to keep investing in branding, innovation and channel development. They also continue to have a tremendous growth opportunity in developing markets, which they should ensure they invest behind fully. Per capita spend on repeat-purchase food, household and personal care brands is six times larger in developed markets than the emerging world and the gap continues to close - despite economic downturns in some of these regions over recnt years ***. Unilever's latest results showed continuing good growth and outperformance of its markets, and it was interesting to note a more optimistic tone from management on the emerging market outlook than has been heard for some time****. Elsewhere, we have been encouraged by the investments that holdings such as Diageo, Pepsi and PZ Cussons are making in innovation, branding and distribution networks.

The Capacity To Suffer

Some portfolio companies are pursuing more ambitious programmes than 'business as usual' organic investment. Larger-scale projects can help strengthen market positions and drive long-term growth in a muted, low growth backdrop - but they may burden financial results in the short-term. Back in my November 2015 investment view (*Earnings Will Jiggle*) I discussed Jardine Lloyd Thomson and Fidessa and their 'capacity to suffer' this type of investment - from both a cultural and a financial perspective. JLT has been building a speciality insurance franchise in the US whilst Fidessa has been developing a derivatives software platform to expand on its very successful, entrenched equity software platform. We were pleased to see good progress made at recent results for both companies, with these organic investments now set to make significant contributions to earnings over coming years.

Free Cash Flow

Free cash flow remains a key sign of health for us and good progress is being made on this front. This applies both for large holdings such as Unilever, Diageo, Sage and Microsoft (it is particularly pleasing to see Diageo return to its normal, cash generative ways, with its inventory issues of 2014-15 now behind it) and for a diverse range of other companies lower down the portfolio. For some holdings such as Page Group and Victrex, cash continues to pile up on the balance sheet to a degree that makes ongoing special dividends likely over and above the ordinary dividend stream.

It would be remiss not to mention two exceptions to this theme for whom free cash flow has been depressed of late - healthcare holdings Glaxosmithkline and Astrazeneca. We have reduced the fund's positions in these companies over the last eighteen months, in part to reflect this cash flow dynamic, and continue to monitor the risks. However, we do view the prospects for free cash flow recovery as good at both companies. For Glaxo, cash generation is beginning to improve as restructuring costs from the Novartis transaction finish. We have also been encouraged by new management's focus on free cash flow, which will include a change in staff incentives to place more emphasis on the measure. For Astrazeneca, the company's newest products and late-stage pipeline are promising (not withstanding last month's disappointing Mystic trial data) and should drive improving free cash flow from 2018 and beyond.

Dividend Yield

Dividend progression has been steady over the latest results season. The fund will go ex a second quarter dividend of 1.54p***** on 1st September, in-line with the first quarter and representing +6.2% year-on-year growth. Attractive long-term real dividend growth remains a key objective for the fund. However, as we have said before, the current economic backdrop does temper our expectations for dividend growth somewhat. In my view moderate real dividend growth is currently a realistic expectation for the quality businesses on which Evenlode is focused, assuming the economic environment does not pick up materially from current levels.

It is also worth noting that whilst there is plenty of headline dividend yield available in the market today, some of these dividends may come with non-trivial risk in the form of factors such as high debt levels, economic sensitivity, a lack of free cash flow and structurally challenged business models. Risk management therefore remains as relevant as ever, and striking a sensible balance between current dividend yield and the portfolio's overall quality and resilience is of key important to us. A somewhat boring message I admit, but hopefully a familiar one for long-term readers.

Hugh Yarrow
Fund Manager
24th August 2017

Please note, these views represent the personal opinions of Hugh Yarrow as at 24th August 2017 and do not constitute investment advice.

*Source: Trustnet, total return data to 23rd August 2017, Evenlode B shares

**We think these operational headwinds are providing an attractive valuation opportunity in WPP shares, which enjoys a diverse customer list and a business model increasingly oriented to digital services and data analytics. The stock is offering a dividend yield of more than 4% that is very well supported by free cash flow (the latest dividend increase was +16%).

***Source: Bernstein

****We did raise an eyebrow to the reduction of brand investment in Unilever's first half - one of the factors that led to unusually strong profit growth in the half. Management were at pains to point out that this was a phasing issue rather than a change in policy, and we do expect a reversal in the full year.

*****B Income Estimated