Evenlode Investment View

May 2017 - Compounding Cash

EVENLODE
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Despite a considerable amount of uncertainty in the political realm, global stock markets have enjoyed a period of relative calm in the first few months of 2017. Economic data and company results have remained reasonable, and sentiment towards several areas of the global economy that were deeply unfashionable at the beginning of 2016 (oil, commodities, emerging markets etc.) has improved significantly. Stock market volatility has been running at unusually low levels and global indices are on track to post positive returns for the first half of the year. As I write the UK stock market has risen +7.7% year-to-date, and Evenlode +10.4%*.

Gently rising stock markets feel more 'enjoyable' than falling ones, but they also tend to result in less compelling valuation opportunities. As I have discussed in these monthlies over the last three years or so, the returns on offer from UK shares are, in aggregate, less attractive than they were in the early days of Evenlode's life (particularly compared to the post-crisis period 2009-11). However, we continue to manage valuation risk in the fund and think that reasonable returns remain available for the patient, careful investor. Also - importantly - we remain very reassured by the health and development of free cash flow for the aggregate portfolio**.

We view this free cash flow stream (i.e. the spare cash that a business has left each year after meeting its capital investment requirements) as a key 'safety buffer' for both the portfolio's current and future dividend flow. We therefore think carefully about free cash flow, both in terms of how much is being generated by a business at present, but also (even more importantly) the potential for free cash to develop over coming years, and how resilient it might be in less favourable economic conditions.

Cash Compounders

On this theme, I'd like to touch on a few portfolio holdings this month (some long-held and others newer) that have updated the market recently and continue to generate healthy levels of spare cash. Most encouragingly, these companies are achieving this whilst also investing meaningfully in attractive growth opportunities. We call a business with these characteristics a 'cash compounder', able to fund healthy current dividend payments but also possessing the potential to create a virtuous circle of reinvestment over time.

Sage
(2.6% dividend yield, 1.5x free cash flow cover)

A long-standing holding for Evenlode, Sage is a classically asset-light software business. The company released results this month which reiterated Sage's core strategy of significant investment in organic growth (particularly via new product development - including the build out of increasingly sophisticated machine learning capabilities - and sales/marketing capabilities). As a sign of customer embeddedness, renewal rates on recurring revenue (which now represent 77% of total revenues) have ticked up steadily from 80% to 86% over recent years, forming a steady bedrock of cash flow. Sage are now looking to build on this progress with an acceleration of new customer acquisition over coming years. The latest dividend increase was +8.8%.

Diageo
(2.8% dividend yield, 1.4x free cash flow cover)

Held since Evenlode's launch, Diageo enjoys a portfolio of iconic brands including Johnnie Walker and Guinness, and a strong distribution footprint across both developed and emerging markets**. After supply chain issues in 2014-15 (not helped by the slowdown in emerging markets), the company has returned to its normal cash generative ways, helped by a shift to cash-based incentives for sales staff which is now complete. In my view Diageo's low ticket repeat-purchase business model is well placed to compound cash flows over coming years, particularly given its opportunity in emerging markets, as the affordability of international brands to aspirational middle class consumers continues to grow (730 million new consumers are expected to become able to afford international spirits over the next decade, with 85% of this growth coming from emerging markets). We are particularly encouraged by the company's decision to reinvest two thirds of its expected efficiency savings over the next three years back into brand investment, rather than letting in all accrue to expanding margins. Diageo's latest dividend increase was +5% and free cash flow looks set to grow at a higher rate. As management flagged at the recent investor day, this may lead to further shareholder returns, over and above the ordinary dividend.

Informa
(3.2% dividend yield, 2.2x free cash flow cover)

Informa was introduced to the fund in 2014. The company owns a strong portfolio of business-to-business media brands (academic journals, digital analytics, trade exhibitions etc.) which enjoy a high level of cash flow recurrence and attractive long-term growth potential. As with Sage and Diageo, Informa's new management team have prioritised investment plans ahead of short-term margin expansion, which we support. These investments are beginning to pay off and drive growth. Informa's dividend is well covered by cash flow, and the latest dividend increase was +4.2%.

UBM
(3.3% dividend yield, 2.3x free cash flow cover)

A new holding for Evenlode last month, UBM has a strong portfolio of trade exhibition brands. These events businesses enjoy high barriers to entry (due to the network effect that builds up over time) and good cash flow recurrence as exhibitors are keen to retain a presence at key industry events through good times and bad (exhibitor sales proved resilient for instance, during the 2008-9 downturn). Following a period of portfolio reshaping we are encouraged, as with Informa, by new management's strategy of prioritising investment in its strongest brands to drive organic growth. Our experience of this industry is that the steady, incremental expansion of existing franchises can generate very attractive compounding returns. In my view the potential for dividend growth at UBM is good, particularly in light of healthy free cash flow cover.

Page Group
(3.5% dividend yield****, 1.5x free cash flow cover)

A new holding following the EU referendum last year, recruiter Page Group is an asset-light people business and one of the purest 'organic growth' companies I have come across. Since the company began in the 1970s, it has developed its strong global position in specialist recruitment through a culture of internal development and promotion (the turnover of management staff only runs at about 5% per annum) and without having ever made an acquisition. Though an economically sensitive business, this strategy has led to a strong compounding of cash flows over the long-term, and Page's dividend has never been reduced. A recent trading update last month confirmed that cash continues to build up on the balance sheet. Page's last increase in the ordinary dividend was +4.2% and the company pays a regular special dividend too.

Pepsi
(2.7% dividend yield, 1.6x free cash flow cover)

Pepsi was a new holding for Evenlode last year. The company enjoys very strong competitive positions globally in both savoury snacks (Walkers, Doritos, Lays etc.) and soft drinks (Pepsi, 7Up, Tropicana etc.): the eponymous Pepsi brand in fact only generates 12% of the company's sales these days. We continue to be impressed with the long-termist culture that has built up in the business, the returns that the company continues to generate on incremental investment (building out its global footprint, developing its product portfolio etc.) and the strength and consistency of cash generation. At recent results, management announced a +7% increase in the dividend, representing the 45th year of consecutive dividend growth.

More generally, we have been encouraged by recent dividend flow in the portfolio and the expected increase in Evenlode's first quarter dividend is +6.2%*****. We also remain positive on the long-term dividend flow from portfolio holdings, with their cash compounding characteristics helping to offset a range of possible environments that coming years may bring.

Hugh Yarrow
Fund Manager
24th May 2017

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

*Total return, B Inc, bid-bid. Source: *FE Analytics*.

**Portfolio dividends are covered approximately 1.5x by free cash flow for the aggregate portfolio (all free cash flow yields in this piece are quoted after interest, tax, maintenance and growth capital expenditure. *Source for dividend yields and free cash flow cover: Evenlode, Cannaccord, current year estimates*). There are two holdings worth mentioning where free cash flow is currently lower than dividend payments - Glaxosmithkline and Astrazeneca. As I have discussed in prior monthlies, we think the prospects for longer-term free cash flow at these companies is good. We have been encouraged by early signs of recovery in GSK's cash generation as it emerges from a period of restructuring related to the Novartis transaction. With Astra, we believe its strong therapeutic pipeline should drive free cash flow from 2018. This month's announcement of a positive trial for its Imfinzi lung cancer treatment is a reminder of the signfiicant value embedded in Astra's late-stage immuno-oncology pipeline.

***The strength of Diageo's competitive position was reiterated at the recent investor day. The company enjoys, for instance, a 41% share of the global Scotch industry. Diageo continue to lay down Scotch to drive future growth, with the average ageing process for each bottle taking seven years - not a bad barrier to entry!

****Includes current year estimate for regular special dividend.

*****Ex dividend date, 1st June 2017. B Income share class, estimated at 1.54p versus 1.45p last year.