Evenlode Investment View

May 2020 – Field Notes from the Crisis

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After posting some recovery in April, global stock markets have edged a little higher so far in May. As I write, Evenlode Income has returned -11.2% year-to-date compared to -20.0% for the FTSE All-Share and -21.1% for the IA UK All Companies sector*.

Investors have plenty to contemplate, with the shape and duration of the pandemic still uncertain. Many nations are seeing their infection curves decline rapidly and are emerging from lockdown, but the risk of a second wave of infections in at least some geographies is clear, and in others such as Brazil the number of cases continue to rise. Encouraging progress is being made globally on testing technology, antiviral treatments and potential vaccines, but the timescale and efficacy of these developments is still uncertain (with mass-produced vaccines within the next 9-18 months perhaps a best-case outcome**). The monetary and fiscal stimulus in response to this crisis has been huge, but the psychological and financial scars that it will leave are difficult to ignore. And within the corporate sector, some companies have been desperately challenged by the crisis (particularly those in sectors such as travel and leisure), whilst others have proven much more resilient.

Field Notes from the Crisis

Over the last two months, all the companies in the Evenlode portfolio have released updates on how they are adapting and coping to this 'new normal'. Given the quantity of results over the last month, in this investment view I'd like to give a further update on some of the key themes we have been hearing and thinking about.

The Quest for Reduced Fragility

I mentioned last month a zeitgeist shift away from 'maximum efficiency' and towards 'appropriate robustness' (or from 'just-in-time' to 'just-in-case'). The benefits of operational resilience and flexibility are rendered clear in this environment and therefore investments in systems, quality assurance, sustainability, automation and supply chains are all hot topics. These are trends that were in place prior to the crisis, will accelerate through it, and will likely outlast it. Market-leading quality assurance business Intertek released a trading update this week and underlined the point:

the exciting structural growth drivers in the global quality assurance market pre-Covid-19 have now been joined by a wide array of new opportunities in many areas. These range from health, safety and wellbeing-oriented quality assurance in the workplace, public spaces and the home … and stronger infrastructure. Further, we are seeing the increasing need for risk management across supply chains and more robust protection against online piracy and other cyber threats in a connected world.

Software is Eating the World

I apologise to regular readers for returning so often to this leitmotif, but the digitalisation of the global economy is a secular trend which has only been accelerated by events of the last two months (one might categorise this trend as a sub-category of the anti-fragility trend discussed above).

Microsoft is always an interesting window into this world, and as CEO Satya Nadella notes:

we have seen two years' worth of digital transformation in two months….in a world of remote everything. There is both immediate surge demand and systemic structural changes across all of our solution areas that will define the way we live and work going forward.

The number of organisations integrating their business with Microsoft Teams trebled during March and April, for instance. The software now has more than 75 million active daily users and there have been days on which more than 200 million people participated in at least one Teams meetings. For Intel and Cisco, some areas of their business are being impacted, but the overall trend is also clear: companies (and other entities such as governments and educational institutions) are looking to accelerate the resilience, flexibility and capacity of their technology infrastructure. As Intel put it at recent results:

we run 95% of the world's internet, communication and government digital infrastructure, and in a world where we are all working remotely and social distancing, the PCs and networking technologies delivered by Intel and our customers are providing a unifying fabric that's bringing us closer together.

Over the most recent quarter Intel scaled its cloud and communications service provider businesses by 53% and 33% year-on-year respectively to help its customers meet these growing needs.
In summary, companies and other institutions across the global economy will accelerate investment in technology as we endure and emerge from this crisis. Those that were under-invested in technology prior to the crisis are regretting it and are desperate to catch-up, and those that were early to digitise are relieved that they were and now want to invest further. Market-leaders in sectors that sell digital services and products to help us meet these needs will continue to enjoy a healthy operational tailwind over the coming years.

A Greater Appreciation of Healthcare Innovation and Hygiene

GSK's businesses and portfolio are highly relevant to helping tackle the COVID-19 virus, whether that's respiratory products in Pharmaceuticals, pandemic adjuvant technology in Vaccines, or needed everyday products in Consumer Health. We are determined to help by offering solutions using our portfolio, science, technology, and resources to support the global response.

Emma Walmsley, Glaxosmithkline CEO

Astrazeneca and Glaxosmithkline released results this month and, though seeing some operational disruption from the pandemic, have both reconfirmed guidance for the year. Looking longer-term, innovative new healthcare therapies and vaccines technologies that can help improve patient outcomes, relieve pressure on healthcare systems and reduce the risk of future health crises are likely to remain highly valued. Companies operating in these areas require several key ingredients to succeed including strong scientific leadership and consistent investment in research. There is also a particularly important need for good governance, ethics and a multi-stakeholder approach in this sector. On this subject, Astrazeneca's recent pandemic partnership with Oxford University's vaccine programme is interesting. Working with governments and other organisations such as GAVI (The Vaccines Alliance) and the WHO, the company are lending this project their expertise in running clinical trials and managing healthcare supply chains, and will have secured the capacity to produce and begin delivering more than a billion doses of Oxford's vaccine by September, if it proves to be efficacious. These activities are not expected to generate a profit during the pandemic, but seem appropriate from a long-term, multi-stakeholder perspective. How every company (not just in the healthcare sector) responds to this crisis and treats all of its stakeholders (i.e. not just shareholders) will be remembered for some years to come.

The pandemic has also placed an increased focus on hygiene. Intertek, for instance, are seeing significant interest in their new quality assurance programme which helps companies ensure their workplaces are clean, hygienic and safe. Reckitt has also been a beneficiary, with sales growing +13% during the first quarter of the year, driven particularly by brands such as Dettol and Lysol, but also thanks to demand from other consumer healthcare products and home-cleaning products. Some of this demand has been driven by consumers stocking-up of course, or 'pantry-loading' as it is called in North America. But as Reckitt management noted at their recent results:

improved penetration and usage, particularly for products such as Lysol and Dettol, may well sustain.

The Little Things in Life

The beauty of our snacks is that … consumers will eat them. They will not stock them forever. So, we see the cycles of repurchase very clearly in the snack business, these are products that people buy, put in the pantry and then get consumed by the whole family.

Ramon Laguarta, PepsiCo CEO

On the subject of pantry-loading, I discussed P & G and Unilever last month. Since then PepsiCo have released results. The company posted organic sales growth of +7%, and had a similar message to these other two consumer staples companies (i.e. it's a tough environment to navigate but the sector is well placed to weather the storm, particularly those companies with a high portion of sales through supermarket and digital channels - Pepsi's e-commerce sales grew +45% over the first quarter, for instance). In addition to its soft drink business, PepsiCo is the market-leader in the global savoury snack category with brands such as Doritos, Lays and Walkers. It is perhaps a rather obvious point to make, but as the quote above highlights, the repeat-purchase nature of the company's business model is helpful during times such as these.

The most impacted of the key Evenlode Income holdings in this sector is Diageo, due to the company's exposure to bars and restaurants. This impact is, however, being mitigated somewhat by a pick-up in at-home consumption, which in more normal times represents approximately 80% of Diageo's key US market and approximately 50% in Europe. The US has seen the biggest pick-up, with at-home alcohol sales running at a rate of growth quite consistently above +20% since the crisis began***.

The Most Impacted

So far, I have discussed some of the fund's more resilient sectors and business models: these form the bedrock of the portfolio. Elsewhere in the portfolio there are other resilient holdings, but several others are feeling the impact of the crisis more acutely. This includes traditionally economically sensitive companies such as the specialist engineers and industrial companies (Smiths Group, Spectris, Victrex, IMI, Rotork), the two global recruiters (Page Group and Hays) and WPP, all of which are experiencing varying degrees of revenue pressure as a result of the current crisis. However, we believe their market positions, balance sheets and cash generation will help them through, and on a long-term view their valuations look interesting. Test and measurement company Spectris released results this week and summed up the balancing act that more economically sensitive businesses need to strike during a period such as this:

we entered this crisis with net cash on the balance sheet and good liquidity. Since then, we have continued to generate cash and take further cost actions. We are taking a balanced approach, implementing mitigation actions while acting in accordance with our values, as the way to deliver our long-term financial health and sustainability; thereby ensuring we emerge from this crisis a stronger and even more resilient business.

Arguably the two most problematic holdings in the fund this year have been Informa and Compass Group. In a more 'traditional' recession these companies would be quite resilient, but the pandemic-related lockdowns and social distancing restrictions are having a significant impact on their cash generation. We think both companies will be able to endure this very difficult period and emerge from the other side with their competitive positions ultimately strengthened. The crisis will also present some opportunities. As the largest player in a global market, Compass noted at results this week that:

we are in a strong position to consolidate our position as the most trusted provider, able to offer clients and consumers the safest and most innovative solutions. With only about 50% of the market currently outsourced, approximately half of which is in the hands of small and regional players, we continue to see a large and exciting structural growth opportunity.

We have, however, reduced the fund's positions in Compass and Informa somewhat for risk management reasons (now both a little over 1.5% of the fund). These reductions reflect the operational challenges that these companies now face, and the resultant pressure on cash generation and dividends over the next 12-18 months. We acknowledge, in hindsight, that our pre-crisis position sizes for these two holdings did not take account of the possibility of global social distancing for an extended duration of time.

Other than these reductions our main focus in recent weeks, in terms of the 'portfolio nudge', has been to use cash inflows to add to existing holdings that we believe offer an attractive combination of operational and cash flow resilience today, good potential for long-term growth, and attractive valuation appeal.

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Managing Fundamental Risk and Valuation Risk Carefully

Investors should always keep in mind that the most important metric is not the returns achieved but the returns weighed against the risks incurred. Ultimately, nothing should be more important to investors than the ability to sleep soundly at night.

Seth Klarman

At Evenlode, we see the long-term craft of investment management as primarily an exercise in risk management (as Seth Klarman sums up well in the above quote). Looking ahead, we will therefore continue to plough our usual furrow, managing both fundamental risk and valuation risk carefully on behalf of our co-investors along the way. The current operating environment is incredibly challenging, and risks abound. As I discussed last month, 2020 is also proving to be a particularly difficult year for dividend investors (for a dividend update, please see the short appendix below). However, we have been impressed with how quickly companies have adjusted and adapted to the crisis and the bedrock of repeat-purchase, resilient cash generation from many holdings within the portfolio is a comfort. More generally, the portfolio is focused on market-leading businesses that we think will be able to endure this crisis and, in many cases, emerge with their competitive positions strengthened. This should bode well for free cash flow and dividend growth over the medium and long-term.

Hugh and the Evenlode Team
22nd May 2020

Please note, these views represent the opinions of Hugh Yarrow as at 22nd May 2020 and do not constitute investment advice.

*Source: Evenlode, Financial Express. TB Evenlode Income B Inc shares. All figures total return, bid-to-bid, GBP terms - 31/12/2019 to 21/05/2020. Past performance is not a reliable indicator of future performance.
**See, for instance, *The First Modern Pandemic* (Bill Gates): https://www.gatesnotes.com/Health/Pandemic-Innovation
***Source: Bernstein Research

Appendix: Dividend Update

The 2020 dividend situation is incredibly challenging with many companies having passed or cancelled their dividends in the last two months. Some forecasts suggest the UK market's dividend stream may drop by 40%-50% or more this calendar year. The Evenlode Income fund won't be immune to this trend and in the short-term (i.e. the fund's financial year to February 2021) we expect the income stream to fall. At present, we believe the reduction is likely to be in the region of -20% to -25% year-on-year, based on dividends paid or confirmed, dividends passed/cancelled, dividends delayed, and dividend assumptions for the rest of the year. However, the situation still remains somewhat uncertain, so we will keep you updated as the year progresses.