Evenlode Global Income Investment View

February 2022 – Corporate Performance

Before starting an examination of the portfolio and business performance, we must acknowledge the outbreak of war in Ukraine. It is a tragedy for the peoples directly affected and brings tension and instability to Europe. Post-cold war peace had been hard won and has ensured a very welcome environment on our continent for the last two decades. We hope for a rapid end to hostilities, for the diplomatic temperature to drop, and for international collaboration and cooperation to win out over military measures.

Where the Evenlode portfolios are concerned, the direct exposure of companies to Russia and the Ukraine is low. Some companies do have operations in those geographies which will need to be managed. For example, German industrial and consumer goods conglomerate Henkel has four small production sites in Ukraine out of 179 globally. However, the bigger impact on companies will be from energy price inflation should the price of oil and gas continue to climb, and commodity price volatility. The extent to which cost inflation will affect companies will differ by business model, but all companies will likely be affected in some way. Equally their ability to absorb input price shocks will differ. The companies that we invest in on behalf of our clients have high gross margins and consistently generate cash, which enables them to better weather cost inflation without hampering the long-term prospects for the business. In the shorter-term margins are affected, something we have already been seeing and will discuss further below.

Whilst Ukraine and Russia have rightly been at the top of the news agenda in recent weeks, the traditional corporate reporting season has also been proceeding as normal. Over two thirds of the portfolio have provided an update on performance in recent weeks, with over half reporting full financial year numbers. The overall picture is of robust demand, solid profitability, and good cash flow. Following on a theme from last month's investment view, we are seeing strong dividend increases backed by this solid financial performance.

Portfolio Picture

The chart below sketches out the portfolio's experience according to the results that have been received so far, in terms of revenue, operating profit (EBIT – earnings before interest and taxation), free cash flow (FCF) and dividends. With revenues being broadly flat in 2020 compared with 2019, we can see that companies are now progressing ahead of pre-pandemic levels of revenue and profitability is recovering. Portfolio FCF continues to rise, despite having proven resilient through the pandemic. Different sectors and holdings have had varying experiences though, which we will discuss further below.

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EVENLODE
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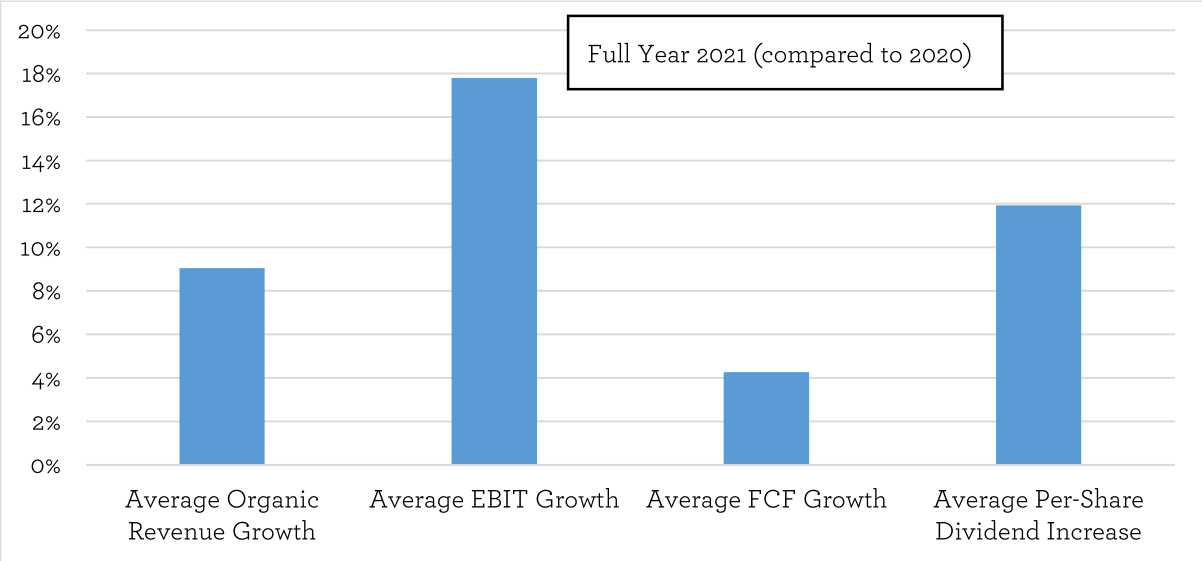
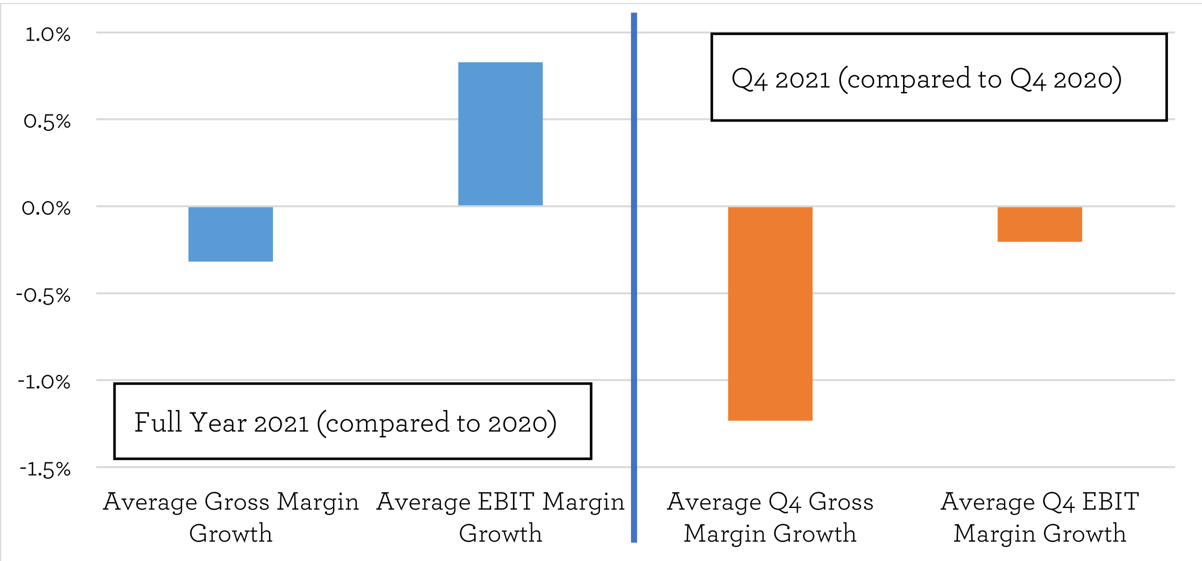


Source: Corporate Reports - 56% of portfolio by number (69% for Dividend Increase figure).

The strong through-pandemic cash flow record of the portfolio is now flowing through into dividends, with the average increase announced so far being 12%. The figures from the fourth quarter are, however, starting to show the impacts of cost inflation related to disrupted supply chains and increasing commodity costs. The chart below depicts the change in gross and operating margins[i] for both the full year and the fourth quarter. Fewer companies report these numbers on a quarterly basis, but those that do have overall shown a decline.



Source: Corporate Reports – approx. 50% of portfolio by number for full year numbers (approx. 30% for Q4 numbers).

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Inflation

The headline rates of inflation reflect, in part, increased energy costs - now likely to rise further due to the outbreak of violent conflict in Ukraine. However, disrupted supply chains have already led to transportation and packaging costs increasing amongst others, factors that are independent of the situation in Eastern Europe. Businesses are reporting transport cost inflation well into the double digits as robust demand fuelled by our economic emergence from (hopefully) the worst of the coronavirus pandemic has met with limited capacity of carriers.

Consumer Goods

The Consumer Goods sector has been the most immediately impacted by inflation. Indeed, it is primarily responsible for the gross margin decline shown in the chart above. It has been most affected because it is the essential input ingredients of these businesses that have been challenged by inflation. However, something we generally like about the branded Consumer Goods sector is its ability to generate cash, and to price its products appropriately to customers through time. Within the portfolio the average gross margin is 54%, and 51% for the Consumer Goods sector, which compares to 31% for the MSCI World Index. These high gross margin levels mean that not all a business' increase in costs need to be passed on to customers to maintain profitability, which mitigates the raw inflation effect somewhat. Strong brand strength also means that customers have historically been willing and able to bear those costs that need to be passed through.

There is some debate around whether that historic willingness to bear price rises remains in the contemporary world. We will only know in the fullness time, but early signs are that companies across consumer categories from Procter & Gamble's home and personal care brands to PepsiCo's snacks are successfully starting the process. It will take time though. The most margin-affected company in the portfolio is US household products business Clorox. They say, along with all the other Consumer Goods companies, that it typically takes 12-18 months to pass through price, but in the current circumstance it may take a little longer.

Business Services

Business-to-business data and media companies have seen steady demand through the course of the pandemic, and last year's results reflected this for Wolters Kluwer and RELX. These businesses have a multitude of products that help other companies in specific sectors such as tax & accounting, law, healthcare and financial services to be more efficient and reduce risk. They represent a very practical manifestation of the digitisation trends that have accelerated through the pandemic.

Other business services have also been strong, partly driven by more cyclical factors. Bureau Veritas's testing, inspection and certification services were in demand and, having paused its dividend in 2020, it reinstated a pay-out in 2021 at a lower level and caught up in 2022 with a 47% increase.

Healthcare

The results of Healthcare technology and service companies need a little unpicking as some parts of the sector delivered services directly related to the pandemic, whilst others were affected by the focus on tackling Covid-19. For example, testing laboratory operators Sonic Healthcare and Quest Diagnostics have rolled out covid testing, in the case of Sonic quadrupling its US testing capacity. This has created additional revenues that are likely to abate, so we need to look through to the 'base' testing businesses. These were impacted in 2020 as Healthcare focus switched from 'routine' illnesses to Covid-19, but are now back to more normal levels. Similar is true of the companies that supply the kit to do the testing, in which Siemens Healthineers and Roche are big players. Both companies have other large business divisions, in medical imaging equipment and biopharmaceuticals respectively, which have been progressing well.

Looking Ahead

The full-scale invasion of Ukraine by Russia is shocking. It marks a distinctly different trajectory to the more-or-less continuous move towards more peace and cooperation in Europe over the last four decades. We hope that it will prove to be a temporary change of course rather than a complete change of direction in the medium term, and that there is a rapid end to violence.

The direct exposure of the portfolio to these geographies is low, but the effects of volatility in energy and commodity markets that might result from conflict will be felt by all businesses. Each situation and challenge that comes up is different and unpredictable, as the coronavirus pandemic and the geopolitics of Eastern Europe have vividly demonstrated. For the portfolio, the Evenlode investment process moves us towards companies with solid demand and cash generation in broad range of scenarios. These characteristics have certainly been put to the test over recent years, but the response of business performance has been as robust as we would have hoped before the event. We believe this will be the case in the future too, but likely with a new set of challenges and opportunities to navigate.

Ben, Chris, Bethan, Rob and the Evenlode Team
28 February 2022

Please note, these views represent the opinions of the Evenlode Team as of 28 February 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 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.

Current forecasts provided for transparency purposes, are subject to change and are not guaranteed.

Source: Evenlode Investment Management Limited, authorised and regulated by the Financial Conduct Authority, No. 767844

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[i] Gross margin is revenues less the direct cost of manufacturing products and delivering services, which tend to be more flexible, whilst operating margin also factors in the fixed costs of a business.