Evenlode Global Investment View

March 2018 – Adapt

EVENLODE
GLOBAL INCOME FUND

With the year end corporate reporting season having now largely hit investors' inboxes, we have a snapshot of how companies are seeing the world and responding to the various successes and challenges that are out there. For all of the macroeconomic and geopolitical talk of GDP growth, interest rates and Brexit, on the ground the businesses in the Evenlode Global Income portfolio and those we follow with interest are continuing to keep the wheels of the global economy turning. There are regional opportunities and difficulties, and these vary industry to industry, company to company. Here I'll draw out some of the trends and themes we're observing, returning to a timeless and favourite topic of ours, innovation.

Not in a straight line

Growth for economies and companies rarely progresses smoothly, and the recent past is no exception. Through 2016 and 2017 firms have generally seen an improving trend having toughed out the post-crisis years. Consumer goods performance accelerated through 2017, particularly in the more discretionary categories where firms like Luxottica (sunglasses) and Hugo Boss (fashion) had a strong finish to the year. This is arguably linked to consumer confidence and the acceleration, whilst present, was much less noticeable in the packaged consumer goods sector for firms such as PepsiCo and Nestle. Growth was also differential around the world. The disinflationary environment in Europe persists, whilst in the US talk is of strong growth and the potential for the return of an inflationary environment. Away from Western markets Asia Pacific is an almost universally bright spot across industries, particularly for the consumer groups in comparison to their mature markets, whilst some other regions like Brazil continue to prove difficult. That said, there are opportunities to be taken in all regions. Taking global recruitment companies, Adecco and PageGroup are expanding in Germany, France and Italy. These regions have lower usage of third party recruiters than, say, the UK, creating an opportunity to develop the market despite the growth environment having been luke warm for a protracted period of time.

Plus ça change

Recent corporate results show that the global economy is moving along fine, even if growth for some firms is muted compared to prior decades. Performance will naturally vary through time, and as long term investors it is important to examine how companies are adapting to the world as it changes around them. The current time is cited as being a period of particularly rapid change, but a casual glance at the technologies, fashions and politics of the start, middle and end of the 20th Century tells us that a lot has tended to happen in a short space of time since the industrial revolution reshaped the global economy. The recent reporting season highlights some of the ways in which companies are having to adapt as the second decade of the 21st Century rolls on.

<u>Information Technology</u>
The current archetype of a fast-moving industry is IT, and it is certainly reshaping the world during the data revolution. What were once start-ups (Apple began life in Steve Jobs' garage in 1976) have now matured into market-defining behemoths. Even these beasts need to keep on their toes, which they're doing by reaping some of the rewards for years of investment in the next phase of technologies. Microsoft's business is now being driven by its Azure cloud platform, which allows companies and developers to host their applications in an always accessible environment. Intel has focused its research & development efforts on data centre-focused processors, and invested capital in the capacity to produce them, again to facilitate cloud-based applications. Both of these firms have used the resources generated from their dominance in the first wave of the information era (producing PC operating systems and processors respectively) to develop the next. The increasing adoption of cloud technologies is showing itself in positive corporate results, an acceleration that is somewhat disconnected from the macroeconomics that drive other industries.

<u>Media & Services</u>
Media is an industry that has been fundamentally affected by the advent of personal computing and the internet. It is no longer sufficient to simply create content and pump it out to consumers, particularly not on paper through the letterbox. In the world of business-to-business media, companies like Wolters Kluwer and Relx have

transformed their offerings into a hybrid of content and technology, providing data, analytics and tools to help decision making as well as the relevant knowledge around the industries they serve. This has led to steady growth in recurring revenues for these two businesses as the services become embedded into customers' workflows, a trend continued in 2017. Even service companies like the recruiters are in on the technological game. Adecco is increasingly using tools such as chatbots and online matching services like its Adia platform to enhance its offering to clients and candidates, and to increase its own efficiency.

Healthcare

Healthcare companies necessarily have to evolve their product offerings, as the intellectual property protections afforded to them through patents last only so long. Particularly in pharmaceuticals, where generic versions of drugs lead to rapid declines in pricing, it is a fundamental requirement that innovative new therapies are developed. Of course, this is also of interest to patients who benefit greatly from the endeavour. Healthcare systems get more effective ways of reducing illness and keeping people out of hospital, which is an expensive way of dealing with maladies. Like economic development, the innovation cycle does not happen smoothly and many pharmaceutical firms have seen drugs come off patent and not immediately replaced with novel treatments, a process that has come to be known as the 'patent cliff'. However, providing a company invests well in good science and does not stretch itself financially, positive outcomes can occur over the long run. For example Roche is seeing good takeup of its Multiple Sclerosis drug Ocrevus, and its new cancer therapies where it is a leader in the field of immuno-oncology. It also has potential for future innovations in personalised medicine, helped by the build up of data sets from its market-leading diagnostics business. Many of the big pharma companies are seeing modest growth as a result of product innovation coming to fruition.

The threat of the patent cliff keeps healthcare companies innovating to provide new therapies, and they are also looking at how those therapies are costed and delivered to the market. Healthcare budgets were put under pressure following the 2008-09 financial crisis, and greater scrutiny was put on getting value for money from providers to those systems. This has led to the advent of 'value-based pricing', or healthcare payers only paying if the treatment has worked for a patient or patient population. The ability to do this depends on the healthcare system having the necessary information available (Italy is ahead of the game in Europe), but where it is possible it has the potential to enhance trust between the public healthcare and providers. Novartis and Medtronic are pushing this idea in pharmaceuticals and medical devices respectively.

Consumer Goods

Finally, spare a thought for the packaged consumer goods business. Even the world of shampoo, ice cream, beverages and shaving has been put on alert of being disrupted. The narrative goes that the incumbent dinosaurs are going to have their lunch eaten by young upstarts on the one side and Amazon on the other. However, looking at the results we see large consumer firms grinding out low-to-mid single digit sales growth, and improving their profit margins. That's not the go-go years, but it's not too bad all the same. Partly the expansion is through digital channels; although it is still a minority sport, online is the fastest growing method of people doing their day to day shopping. On the web, perhaps counterintuitively, people search around less for different options, and those players with the number one or two brands, like PepsiCo, have higher market shares on-line than in-store. And those upstarts? Indeed some do nibble at the heels of the big boys. Dollar Shave Club forced P&G to examine its Gillette razor business after the former's novel subscription-based offering started to take market share in the US. Dollar Shave Club is now owned by Unilever, having been bought in 2017. So in addition to innovating themselves, a well-resourced consumer goods company can buy innovation ready-made.

Engineering change

There is a lot going on across many industries. Companies are managing to grow, and innovation in products, services and pricing models is important to generating that growth. The examples above are businesses where adaptation is in the DNA, and evidenced by expenditure on research, development, brands/marketing, and cultural attitudes towards investing in the long term success of the company.

One final trend that we can observe from last year's results and activity so far in 2018 is that of engineering growth, either at the top or the bottom of the income statement.

Efficiency

Some activist investors and management teams are seeing slower sales growth and glancing down to the bottom line, wondering how to massage those profit numbers higher. The latest craze to sweep the global consumer goods sector is 'zero based budgeting', where each year all expenditures are set to zero and any increase from there must be justified by the budget owner. We are all for efficiency where it makes no impact on or improves the long term potential of the firm, but are cautious about how far this trend should be taken. For example, marketing spend must be made otherwise brands will ultimately fade into the background, to be superseded in the public consciousness by the aforementioned young upstarts.

Leverage

Leverage is another method of engineering shareholder returns that is being deployed across industries, at the cost of increasing the riskiness of any business. Debt applied to the balance sheet might juice up profit growth to the shareholder, but increasing financial risk makes the firm more susceptible to unexpected events in the longer run. We are not against leverage *per se*, but in our view it should be used appropriately & sparingly. We are vigilant to this trend through our own risk management processes, limiting the position sizes in the fund for those businesses that choose to take on more debt.

Corporate Activity

Merger and acquisition activity has the potential to enhance both revenues and profits through cross selling goods & services, creating better routes to market, and through 'synergies' (removing shared costs). The Evenlode Global Income portfolio has in early 2018 seen the proposed takeover of Dr Pepper Snapple, a purveyor of soft drinks, by Keurig Green Mountain, a seller of coffee. The rationale for combining these hot and cold beverages is that Dr Pepper knows how to get to stores, and Keurig knows how to sell to people on line. By teaming up, they reckon they'll be able to quench consumers' thirst wherever they are, with whatever they fancy, and however they want to purchase. This is another form of innovating via the corporate structure, and time will tell if this is fruitful for Dr Pepper and others that are engaging in similar activity (Thomson Reuters and UBM in the Evenlode Global Income portfolio for example).

Plus c'est la même chose

Currently corporations across many industries are welcoming some brighter trading with the US, Asia and even more recently Europe are experiencing something of an economic upturn. Those that have invested well in their products and services will be able to make hay while and where the sun shines. In order to maintain any successes through to the longer term businesses will have to continue to invest well and adapt to the changing world. Some will merge and some won't keep up; we'll look out for the adapters and be wary of the laggards who fail to invest in themselves. The innovation dynamic, or Schumpeter's 'creative destruction' are nothing new, and the French put it well – The more things change, the more they stay the same.

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Please note, these views represent the opinions of Ben Peters as at 14th March, and do not constitute investment advice.