Evenlode Global Investment View

June 2020

EVENLODE
GLOBAL INCOME FUND

Delayed arrival

That the coronavirus pandemic is affecting the operations of and prospects for businesses is no longer news. Now the guessing game is ramping up to identify which companies will be the winners and losers when the dust settles. In Europe and Asia we have tentative easing of lockdown restrictions, but South America is going the other way. Whilst the US was hit hard it may be recovering but is grappling with long-lived social issues as well as the pandemic. In other words, the picture is messy, and trying to pick a precise path through the coming months is as difficult as ever.

We do however have a clearer picture of the effects of the initial lockdown measures on companies and their individual responses. For income-aware investors the effect on dividends is particularly interesting. Estimates for reductions in total pay-outs from global companies range from -15% to -35%[i], and for UK-listed companies by more than half[ii], with the UK market particularly suffering from exposure to oil, resources companies and financial institutions.

We are currently forecasting a reduction in the distribution from the Evenlode Global dividend strategy in the mid-teens in percentage terms. This takes into account already announced cuts and cancellations, and some of our own conservative estimates for companies that have not yet taken that course of action. We'll discuss this in more detail for portfolio companies below.

Dividend mysticism

Dividends have sometimes taken on a mystical air in the investing world. The income-focussed Evenlode strategies hold that attaining a decent and growing distribution to shareholders is a good starting point for delivering attractive total returns through time. However, the income is not just conjured from nowhere. It must be paid from cash flow generated by real companies, with real operations. That is why we look for companies with good customer propositions, great competitive positions, and as a result deliver attractive returns on capital and cash flows for shareholders.

Whilst we put a great deal of emphasis on the sustainability of distributions to shareholders, even businesses that tick all of our investment criteria boxes should take a breather on their dividend in highly adverse circumstances. Good companies, boards and management teams are aware that there are no magic tricks to delivering shareholder returns. Developing and protecting their businesses with 'muggle'[iii] practices is the only way to deliver in the long run.

A myopic focus on maintaining dividends come hell or high-water can lead to underinvestment in the business at the better end of potential outcomes, and a liquidity or solvency problem at the more serious. We are supportive of companies that choose the long run success of the firm over clinging on to dividends for dear life, even if growing distributions is our ultimate aim.

That the Evenlode Global dividend strategy has seen some temporary cuts to dividends is not the ideal situation, but in the context of the broader swathe of reductions in the market a mid-teens reduction would not be too bad an outcome. Where we have seen cuts there are clear reasons why they are necessary, and our retained holdings are those where we think the balance of probability is towards positive medium-term outcomes. As Chris and Sawan noted in the April 2020 Evenlode Global Investment View[iv], companies are also taking actions as a result of the pandemic that benefit a broad range of stakeholders including staff, suppliers and healthcare systems, which will further their long run credentials even if they are financially negative now.

Dividends disrupted

Nine companies, making up 15% of the portfolio by weight, have announced reduced, postponed or cancelled dividends. These are firms that we have characterised as 'walking wounded' or 'severe cases', where there is some significant impact to supply, demand or both at the current time[v].

Some like eyewear giant EssilorLuxottica and industrial automation technology company Hexagon have postponed a decision on the dividend until later in the year. We are not assuming that one will be paid. However, with relatively strong balance sheets to cushion a temporary blow, if there is a rebound in demand for either of these companies then it is possible that a resumption could occur at some level.

Others are unlikely to make a payment this year. Recruiter PageGroup experienced a -32% decline in revenue in March, and with global economic risks remaining it would seem imprudent to expect returns to shareholders to resume in 2020. Walt Disney is slowly reopening its resorts but with limited capacity and facemasks for all a return to profitability will be slow. New holding CTS Eventim, Europe's largest ticketing company, is clearly fundamentally challenged until gig-goers can return to the mosh pit, but has enough cash to withstand two years of absolutely no events at all (let's hope that doesn't materialise, not just for Eventim's sake).

It's of note that Hexagon and CTS Eventim are new holdings despite their lack of near term payouts. They are both good companies that in the better times had looked a little expensive to us at their respective market valuations, but the market reaction to their deteriorating circumstances created an opportunity to invest. We remain confident in their ability to navigate the crisis, to improve their competitive positions, and to re-instigate growing dividend streams.

Dividends undisrupted

Companies representing 83% of the portfolio have announced no disruption to dividend payments as yet. Some will almost certainly continue to pay a dividend, although the rates of growth will obviously be affected. Consumer companies like Nestle are relatively unaffected, and others like Reckitt Benckiser are benefitting from an increased focus on health and hygiene. Some, like Unilever, are seeing a mixed picture – not so many ice creams are being eaten by holidaymakers in sunny spots at the moment.

Technology firms are being held up as obvious beneficiaries of the crisis as we all pile onto the internet to replace our face to face contacts. Microsoft was always likely to increase its dividend, partly because of its low payout ratio, and the growth in Azure and Teams use is not going to hurt. eBay has benefited from at home shopping. But Cisco, whilst benefitting from supporting greater network traffic, will find some corporate IT infrastructure spending postponed or reduced.

Media companies in the business to business or academic world such as Wolters Kluwer and John Wiley have steady income from subscriptions that are holding up well, but some disruption is being seen in events and higher education businesses.

Dividends complicated

There are a few businesses where the situation is more complicated. In the healthcare space a global pandemic might be an obvious catalyst for bumper performance. But whilst drug makers like Roche and Sanofi have seen robust demand and supply chains, other healthcare firms are suffering from global health systems turning their focus towards COVID-19.

Clinical testing laboratory outsourcer Quest Diagnostics has experienced declines in non-covid testing, with a 40% reduction in overall test volumes in the last two weeks of March as the pandemic took hold. As a medical service provider it is eligible for support under the Provider Relief Fund[vi] segment of the US' Coronavirus Aid, Relief and Economic Security Act, or CARES (never let a good crisis go to waste on a bad acronym).

Other parts of the CARES Act offer support to businesses in the form of loans but with restrictions on the payment of dividends[vii]. Similar stipulations are part of the UK government's Coronavirus Large Business Interruption Loan Scheme[viii], or CLBILS (a more utilitarian acronymic approach from Her Majesty's government).

So whilst a company like Quest may choose on the basis of its operations to pay or not pay a dividend, there are other regulatory, governmental, or social pressures to not pay. In the fund there are only a few holdings where this is likely to be a significant complication, but again we are keeping our eyes and minds open to developments for all companies regardless of industry.

When this is all over

Ultimately, having companies that are successful is good for the economy, society, and shareholders. Corporate actions and activities during this time will determine whether firms do indeed emerge successfully.

Dividends represent just one decision that a company can make. An important one for sure, but that should not obscure clear thinking from investors and management teams about what is best in the long run. We have been encouraged that within the portfolio of companies that we have selected for our clients, those that have needed to take dividend actions to preserve the qualities of their businesses have done so, those that have been able to carry on somewhere near normal operations have done so, and those in the middle are taking a prudent view.

We have also taken actions with the management of the portfolio, disposing of two holdings and buying four more. But the larger part of our effort has been in monitoring, analysing and communicating with companies, both within the portfolio and those that might be candidates in the future. Comparing our findings to the Evenlode investment criteria enables us to have as much confidence as possible in the future of the companies we invest in, whilst acknowledging that we don't quite know what the future holds. One area of confidence is around the future ability of portfolio companies to pay a dividend when this is all over, whenever that is.

Ben Peters, Chris Elliott and the Evenlode Investment team
04th June 2020

Please note, these views represent the opinions of Ben Peters, Chris Elliott and the Evenlode team as of 04th June 2020 and do not constitute investment advice.

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i https://www.ft.com/content/74216261-1ecc-45f4-a1c3-e9457c98eb50
ii https://www.ft.com/content/12e2a225-a6ff-4375-847f-6ee3499df9a2
iii https://en.wikipedia.org/wiki/Muggle
iv https://evenlodeinvestment.com/news/evenlode-global-investment-view-april-2020-1
v https://evenlodeinvestment.com/news/evenlode-global-investment-view-april-2020
vi https://www.hhs.gov/coronavirus/cares-act-provider-relief-fund/general-information/index.html
vii https://www.natlawreview.com/article/effect-dividend-prohibition-cares-act-loans-mid-size-and-large-pass-through-entities
viii https://www.british-business-bank.co.uk/ourpartners/coronavirus-business-interruption-loan-schemes/clbils/faqs-for-businesses/#f7