

# Evenlode Global Investment View

December 2019

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## 2019 – Action stations

The Evenlode investment process stands ready for action in the Evenlode Global Income fund. At any point in time we are constructing a portfolio of global businesses that matches with our goals of delivering sustainable free cash generation and dividend growth, whilst managing the risks involved in any equity investment. Most of the risks that we examine are fundamental to business operations and intrinsic in nature – such as the strength of the company’s balance sheet, or its susceptibility to competitive forces.

2019 has been notable for the shifting sands in one extrinsic factor though – valuation. We discussed some of the changes that we have made to the Evenlode Global Income portfolio at a high level in our October investment view (“Fourth Quartered”). The level of activity that we have undertaken this year is perhaps the most surprising feature to us of managing the portfolio over the two years since its inception. By and large we prefer to invest and do nothing, but we will shift positions if there is a strong enough reason to do so.

In this investment view we thought we’d dig into some of the biggest additions and reductions within the portfolio. In the below, all positional year-to-date figures are from 1<sup>st</sup> January to 3<sup>rd</sup> December 2019.

### **Addition: Reckitt Benckiser, position size change +3.8%**

We added Reckitt Benckiser to the portfolio in May as the share price fell in absolute terms and underperformed the rising market. When the shares continued to underperform, we continued to build the position. Things have not gone well for Reckitt after a stellar run in the middle of the decade fizzled out during 2017. Slowing top line growth, strategic mis-steps in its footcare business and historic liabilities from the firm’s acquired Korean air dehumidifier and divested pharmaceuticals division (Indivior) all contributed to something of a fall from grace. Arguably part of the issue was an obsessive focus on margins. We are all for corporate efficiency, but with industry-leading operating margins in the mid-20s one might question what is not being invested in. This is starting to reverse now, with new CEO Laxman Narasimhan (formerly chief commercial officer at PepsiCo) committing more resources behind brand investment. The infant nutrition business acquired with Mead Johnson last year is performing well, and the associated debt is being paid down. Reckitt’s portfolio of household brands like Finish, Durex and Nurofen, generate consistent cash flow and a new-found willingness to invest in the business bodes well for the future. We believe that the shorter-term issues are presenting us with a good value opportunity at the current market price.

### **Reduction: PepsiCo, position size change -4.3% (remains in the portfolio)**

Whilst things have been tough going at Reckitt Benckiser, everything has been coming up Pepsi, except perhaps for losing their CCO to Reckitt. Whilst each company has its own set of opportunities and challenges, and operate in different consumer categories, there are interesting parallels to be drawn. PepsiCo was going through its own slower patch around 2017, with a focus on margins more than the top line. There was a change of CEO, who committed to invest behind the brands at the expense of some of those margin gains. Fast-forwarding to the current time we can see that those

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investments are bearing fruit, with organic growth accelerating across its beverage, snacking and food businesses in North America and around the world. An interesting dynamic, and something we like to see, is a willingness to move the portfolio on with the times; the acquisition of SodaStream was designed to play into the trend towards less wasteful consumption, and the firm has recently acquired BFY Brands, a purveyor of less-bad-for-you snacks like PopCorners. The firm's share price appreciation this year took it from cheap to fair value, which is not bad but with other options available in the consumer sector, we have materially reduced what was the biggest position in the portfolio.

## **Addition: Henkel, position size change +2.8%**

Henkel was a new addition to the portfolio in 2018 and we have built into the position as the share price has languished in 2019, with the company now the second biggest holding in the fund. Henkel's largest segment is in industrial adhesives, high-tech glue that holds together anything from planes to cars to smartphones to wooden building structures. Facing some cyclical end-industries this part of the business has suffered a downturn along with its customers. Its next-largest division sells laundry and home care products, notably the Persil brand, and is chugging along fine. There are, however, difficulties in the third division, beauty, which sells amongst other things the Schwarzkopf range of hair care products. The professional salon part of the business is going well, but the consumer-facing part has not been performing, partly due to a misfiring sales effort but also because of some changes in the distribution models of retailers as they move online. In what is a now-familiar refrain, the firm is investing more operating cost in sales and marketing. Not to be outdone by PepsiCo and Reckitt, Henkel has also recently shed its CEO. The replacement is the former CFO and Henkel lifer so we don't expect major changes in strategy, but there could be an element of new-brooming with enhanced investments and tidying up the portfolio of beauty brands, which would be no bad thing for the long term future of the company.

## **Reduction: Procter & Gamble, position size change -4.3% (remains in the portfolio)**

It just so happens that the top two additions and top two reductions by portfolio weight are largely consumer goods companies (Henkel's industrial adhesives business notwithstanding). P&G has been through the process that Reckitt, PepsiCo and Henkel are currently going through, and it looks like it has come out of the other side. Its own slow patch came along in the early-to-mid part of the decade, when organic growth stalled and the portfolio was sprawling. From 2014 to 2017 the company disposed of its long tail of small brands to focus on 10 core categories, restructured itself to become more nimble and, yes, got a new CEO (although David Taylor has been installed since 2015). We have followed P&G for a long time, and it is something of a case study in positive action being brought to bear on a business with an attractive core of assets, in this case consumer brands that are household names. The equity market has given its seal of approval over the last 18 months or so, as top line growth has recovered and the share price has followed accordingly. As with PepsiCo, it has moved into fair value territory, and has moved from being the second biggest holding in the portfolio to a less than two percent weighting.

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## Temporary, or permanent?

The above examples show that businesses do not stay the same but evolve through time to cope with the changing conditions that always occur. The ability of businesses to adapt is something we often talk and write about, and we also often say that a big part of our job is to distinguish the structural from the cyclical, the permanent from the temporary.

It is our belief, based on financial and qualitative analysis of the businesses, that the four companies above are of long-term high quality. It might seem counter-intuitive to be investing more in the ones that are currently doing less well, and less in the ones that are doing better. But that's the market for you, it tends to be the case that doing less well means more bargain prices and things going swimmingly comes with a 'reassuringly expensive' price tag to match.

## 2020 - Crystal clear

We may be wrong in our analysis of course, for Reckitt, Henkel, or Fuchs Petrolub, or Sabre, or Intel or any of the other businesses we've increased the fund's position size in. We remain open to updating and re-evaluating our analysis. We should be steadfast in our conviction but not stand still whilst businesses evolve or new information becomes available. Should we re-evaluate and change our minds, we should not be afraid to act accordingly, just as we expect the businesses we invest in to re-assess and re-prioritise.

Will 2020 be another year of action, or will things be more muted? We're not big ones for gazing into the crystal ball and making predictions, particularly over the short term, but we stand ready with the Evenlode investment process to take the year as it comes at us, whatever happens.

We'd like to take this opportunity to wish you a merry Christmas and prosperous new year, and to thank you for your interest and support during the year just gone. We look forward to updating you in the new decade.

**Ben Peters and Chris Elliott**

**Fund Managers**

6<sup>th</sup> December 2019

*Please note, these views represent the opinions of Ben Peters and Chris Elliott as at 6th December 2019 and do not constitute investment advice.*