Evenlode Global Dividend Investment View

June 2023 – Business Development

Market data is from Factset and FE Analytics.

We are very nearly halfway through 2023 and some of the economic questions that arose in 2022 are still being grappled with. Inflation, monetary response in the form of rising interest rates, and the effects on demand continue to be discussed at length, with some businesses also still seeing the effects of demand distortions from the covid pandemic.

Meanwhile enthusiasm for all things artificially-intelligent has taken hold in the market, as commentators and investors try to figure out what it all means for demand creation, competitive dynamics and, from some, the very future of humanity. These are fascinating questions that we will enjoy seeing unfold in the fullness of time, and we have heard from many portfolio companies how they are using or plan to use new technologies in their product offerings. Many are keen to let it be known that they are at the most cutting of edges; IT consultancy and outsourcer Accenture claims to have doubled the number of employees who have AI-related skills as one example. New exciting technologies grab the headlines and the imagination, and certainly have the ability to transform the economic landscape over many decades - think of the railroad, the telegraph, air travel, the personal computer, and now, maybe, AI. However, on a day-to-day basis companies must continue to deliver in whatever field they themselves specialise in and incorporate new tools over time.

Over recent weeks and months we've continued our usual work of talking to companies about the broad range of opportunities that they see, challenges they face and investments they are making. Yes, some of those are Accenture-like investments behind an emergent technology, but many are more practical and prosaic. Here we'll mention three examples where we have recently met representatives of the company and discussed the current business environment and evolving product and service offerings.

Shimano

Shimano is the global market leader in bicycle components, and an addition to the portfolio in March of this year following a decline in its share price. This valuation opportunity was catalysed by the company seeing a clear deterioration in sales, in part because strong demand for bicycles during the pandemic had pulled forward purchases. This isn't quite the whole story though, with two other factors at play. Not only was there strong demand, but Shimano's customers, who manufacture the bikes onto which their components are fitted, over-ordered and are still digesting the stock that they bought, meaning they don't need to buy so much from Shimano at the moment. Also, with Shimano operating at the higher-end of bicycle componentry, if bike enthusiasts are feeling the pinch then they will postpone purchases in the short term. With a new product set in each price tier every four to five years some customers wait to upgrade, but longer-term demand drivers of government incentives for more environmentally friendly travel and increased awareness of cycling's benefits for health and wellbeing are still very much in place.

While the near-term sales picture is weak, Shimano remain undaunted. As a century-old business they've seen some ups and downs in the bike market and accept this, preferring to focus on what they can control – primarily product quality and sales and marketing. Product quality is absolutely vital; whilst bicycle manufacturers will look to cheaper competitors (notably from China) if they need to create a cheaper overall packaged bike, they want components that won't need fixing or replacing on their mid-to-high-end models and Shimano's reputation for delivery on that front is world-leading.

In order to maintain that all important product quality whilst improving the features to match high end competitors, Shimano is upping its investments in capital expenditure this year compared to last. About half of the expenditure is in new moulds and casts for components for the next generation of products, so that the company will have the gear that bike purchasers want when they come to invest in a new two-wheeled machine. The other half will be spent on equipment to improve production efficiency, environmental impact and operational efficiency through IT spending.
Shimano can make these investments despite their near-term demand challenges because the company is extremely well financed, with a lot of cash kept back from the many good years the company has experienced. Its sixth-generation Shimano family management team perhaps is looking to ensure that their great-great-great grandchildren can continue to enjoy the benefits of being the global market leader.

SGS

SGS is a Swiss testing, inspection and certification (TIC) company, which helps businesses across a range of sectors to test their products, certify their supply chains and ensure their facilities meet environmental and safety standards. These services are essential to ensuring their customers can continue to operate in an increasingly complex web of regulations globally, and with ever more demand from consumers surrounding matters like the environmental sustainability of the products that they buy.

To that end SGS have been investing behind their offering in a range of areas including environmental inspections. As one of the three global players in the TIC space they can also deal with global supply chains, which is becoming more important as their customers diversify their operations, notably from China to other geographies. Other areas of focus are in certifying for cybersecurity, connectivity and in providing their own services through digital channels. Cybersecurity assessment is scalable, project based, early in regulation, and SGS are building a degree of specialism not matched by others.

So SGS can be seen to be investing behind some very big, long-term themes. Given that they service global business, a potential downturn in global demand might be seen as a near-term negative. Some revenue is indeed linked to the volume of goods sold around the world, but the company estimate that 60% of revenues are essential to their customers' operations and are thus less cyclical. This contrasts somewhat with the example of Shimano – whilst many cycling enthusiasts do not view the purchase of components as optional, there is certainly not the same level of necessity as SGS's services enjoy. We reflect that cyclicality in a lower maximum position size for Shimano.

The investments SGS has made in developing its service offering have led to an increased growth profile for the business, and in our estimation positions it well for meeting increasingly complex customer requirements into the future.

Wolters Kluwer

Being in the world of data, software and analytics, Dutch business Wolters Kluwer is well-placed to comment on the possibilities of artificial intelligence. For the company, which services professions such as legal, tax and accounting, the near-term possibilities are quite prosaic; they have highlighted the processing of legal bills as something that AI is well suited to – quite a long way from predictions of the humanity-destroying potential of the technology, but probably very helpful for law firms' operational efficiency and bottom line.

Wolters Kluwer has also been developing various services that help companies audit themselves across environmental, social and governance matters such as health and safety, carbon reporting, and regulatory compliance. These are now being reported under a new ESG segment, which makes up about 12% of sales – quite significant and with the potential for cross-selling from its industry-specific businesses. Investment in developing knowledge behind specific industries and themes ('domain expertise' in the lingo) has been part of the reason for Wolters Kluwer's success in recent years and it is encouraging to see the company continue in that vein.

Developing our understanding

These three examples of businesses that we have talked to recently are quite different propositions to each other – physical components, business services, and software and data. But all three have to invest in themselves, to evolve to stay relevant to their customers and deliver a high-quality service whatever the economic conditions and technological advances are throwing at them. For us, discussing these with the businesses that are delivering the goods and services provides an important part of the picture that helps us to understand the company's ability to generate profits and cash flow into the future, but we also look to other sources. As a team we have spoken to independent experts and carried out other research on bicycle components, artificial intelligence, and supply chains. By talking to a broad range of businesses and experts, we can piece together a more fully formed image of a business from an opportunity and risk perspective. We think this keeps our minds open to the business possibilities, but also keeps our feet firmly on the ground in managing businesses risks as well as opportunities within the portfolio.

Ben, Bethan, Chris, Rob and the Evenlode team
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