EVENLODE

GLOBAL INCOME FUND

EVENLODE INVESTMENT GLOBAL DIVIDEND SUSTAINABILITY REPORT 2021

SUMMARY:

The last year has proven to be quite unlike any other experienced by dividend-seeking investors. As we were penning our last report in late 2019, we had little inkling of the extraordinary events to come. With the benefit of hindsight, the signs were there of the potential impact of the then-novel coronavirus in the form of an increasingly drastic public health response in China. It nonetheless took a few more months for the virus to hit Europe and the Americas and have the full effect of its impact felt on many lives and the global economy.

With a broad impact on the revenues of companies across different sectors it is unsurprising that businesses cut dividends in response. Many felt it prudent to, but some were forced to, as was the case of banks in Europe and those taking state aid around the world. Our list of companies aiming to deliver sustainable and growing dividends was not immune, with one of the ten companies cancelling its dividend. We must add a *mea culpa* in that this business, Bureau Veritas, was only added to the list at the last review... often it is better to do nothing at all! However, as we discuss below the circumstances dictated the firm's course of action and we believe the future to be more optimistic than the recent past. Elsewhere dividends were either maintained or increased by our selected firms, demonstrating a great deal of resilience in the face of adversity.

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RETROSPECTIVE – THE 2020 LIST

	Market Cap ($bn)	Dividend Growth	Dividend Yield	1Y Total Return (USD to End-Dec 2020)	Net Debt/ EBITDA	Free Cash Flow Yield	Free Cash Flow Dividend Cover
Bureau Veritas	13	-100%	0.0%	2.0%	1.9	6.2%	-
Cisco	191	3%	3.3%	-3.5%	-1.0	7.8%	2.4
Johnson & Johnson	423	6%	2.7%	10.9%	0.3	5.1%	1.9
Paychex	32	0%	2.7%	13.2%	-0.1	3.9%	1.5
PepsiCo	196	7%	2.8%	11.7%	2.1	2.6%	0.9
Relx	48	0%	2.6%	-0.3%	2.1	4.7%	1.8
Roche	247	4%	3.0%	11.2%	0.1	6.4%	2.1
Unilever	157	3%	3.4%	7.6%	2.3	4.8%	1.4
Western Union	9	13%	4.1%	-14.7%	1.9	8.4%	2.0
Wolters Kluwer	23	22%	1.8%	17.9%	1.3	4.8%	2.6
Average	129	-4.3%	2.6%	5.6%	1.1	5.5%	1.9
MSCI World		-8.8%*	1.8%	15.9%	1.7	3.7%	2.1

Source: Factset, Evenlode Investment as at end-December 2020. *Dividend growth based on consensus analyst estimates for calendar year 2020.

DIVIDENDS IN A TIME OF TURBULENCE

The descent of dividends

As the coronavirus pandemic took hold and a global response in the form of widespread lockdowns resulted in February and March 2020, there was a good amount of coverage on pay-outs. Interestingly there was as much, if not more, focus on whether companies should pay dividends as there was on whether they could. This casts the payment of dividends as a sort of moral dilemma, but the narrative really comes back to the very basics of returns to shareholders. If a company can't afford to pay a dividend, then it shouldn't. Where a firm has turned to the state in order to secure its future, it seems uncontroversial to us that shareholders should take a back seat. It is, in fact, from the kids' row that shareholders should always maintain their view. Being at the bottom of the pile when it comes to the prioritisation of providers of capital is part of the deal when investing in equity (the quid pro quo is, of course, the potential for superior returns).

Whether or not a company has taken government help, if a good business needs to conserve capital through a time of crisis then it should cut its dividend if it pays one. Much as it pains us to say that as income-oriented investors, we are very aware that dividends to not appear out of thin air. In last year's report we noted that one of the attractive features of the companies on our list is their ability to invest in their futures alongside paying the dividend, but if one must be chosen over the other then in must be the former. Good businesses create excess cash flows that can be given back to shareholders, and if the assessment is that the cash flow is likely to dry up temporarily then no dividends should be paid.

Our assessment as investors must then be on whether cash flows are likely to return in the future, as only then can dividends be reinstated. We'll discuss this point further below.

How much have dividends fallen by?

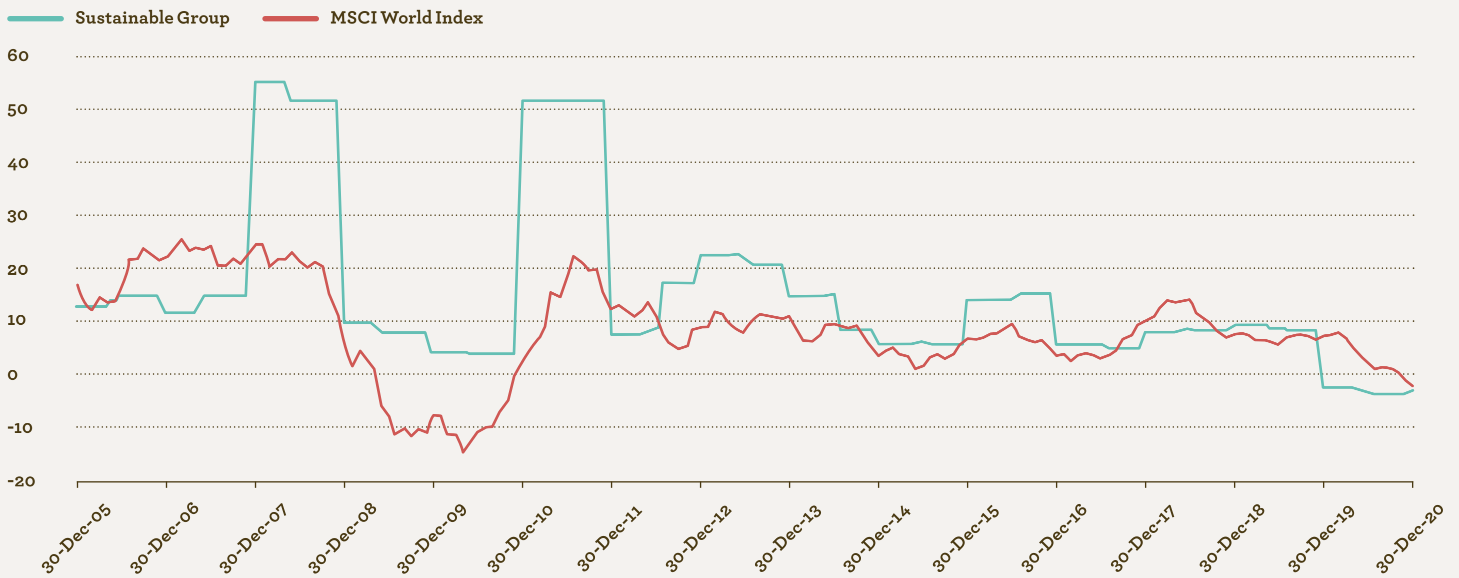
As indicated in the table above, analysts have pencilled in a decline of around -9% for the companies that make up the MSCI World index in 2020 over 2019. However, Janus Henderson forecast -17.5% in the November edition of their global dividend index study[1], the difference perhaps explained by analysts' well-known tendency to err on the side of optimism.

In this context, the -4.3% fall for the sustainable dividend list is respectable, with blot on the copy book of the -100% contribution from Bureau Veritas being offset by some reasonably solid growth elsewhere. Two companies held their dividends, Relx and Paychex, these being the two businesses more exposed to lockdown through their exhibitions and payroll outsourcing operations respectively.

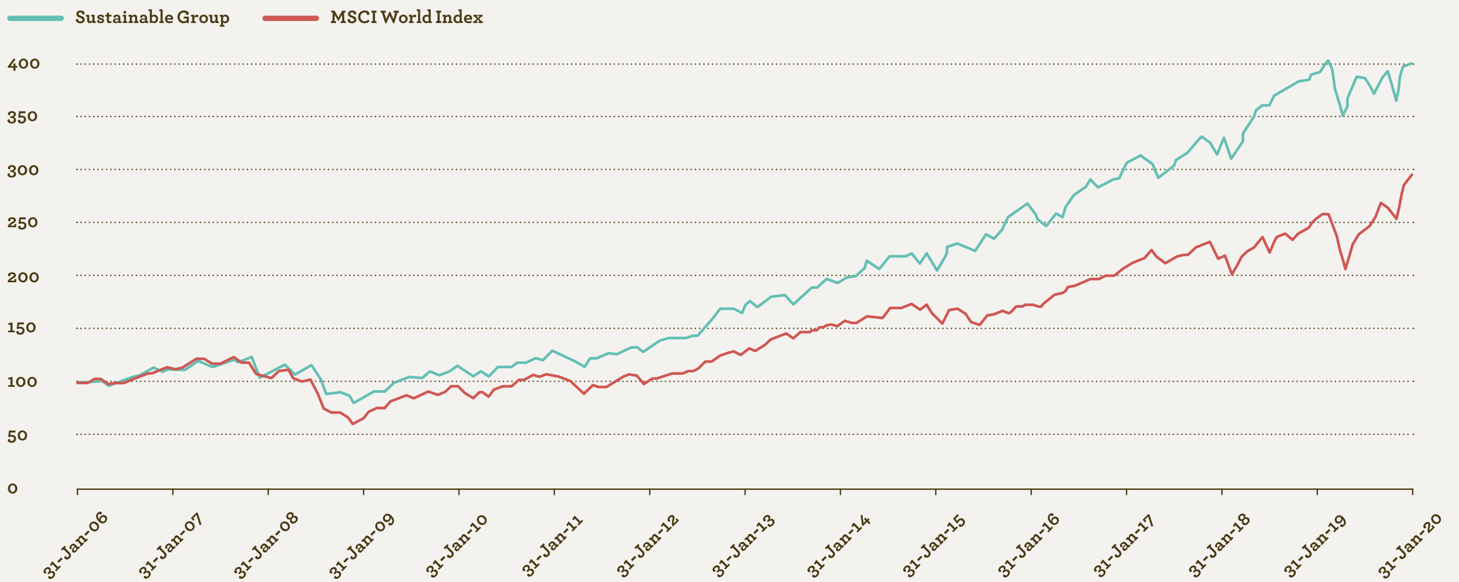
The chart above shows the fall in pay-outs in the context of the history of both our list and the MSCI World index, noting that the index is a backward-looking number, and its level will certainly turn more negative as we go through the coming months. For the index we need to revisit the great financial crisis to see similar reductions in global pay-outs to those anticipated for 2020, and depending on how the final numbers come in the coronavirus crisis could be more severe.

[1] https://www.janushenderson.com/en-gb/adviser/jh-global-dividend-index

Dividend Growth (%)



Total Return (Rebased)



Source: Factset. Returns in US Dollars.

What about returns? In last year's study we noted that the sustainable dividend group really started to diverge positively from the MSCI World index during and after the financial crisis in the late noughties. This crisis has been different. Whilst the sustainable dividend group has recovered in price terms from the falls in March of 2020, the index has recovered and kept on going. The index has been held back by those businesses more economically exposed and specifically those suffering from the effect of lockdown — the travel & leisure sector being the most obvious example, along oil & gas and banking. But it has been powered on more by the big winners of the pandemic, specifically large technology companies that have benefitted from the accelerated trends towards digitisation, remote working and collaboration, and home shopping.

Over the long run the stability of the sustainable dividend list continues to provide superior and lower volatility returns, but the recent past has been a reminder that no approach to investing works perfectly over shorter time periods. However, despite lagging the broader market, our list has delivered positive returns in absolute terms over the last year.

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HOW VISIBLE ARE DIVIDENDS NOW?

The news of several vaccines with high efficacy is of course welcome for humanity, and positive in the short-to-medium term for the global economy and the businesses that operate within it. However, without wanting to sound overly pessimistic there are reasons for near term caution in the prospects for companies and the dividends they might pay.

First, the vaccines are yet to be materially rolled out. It seems likely that a combination of vaccines plus widespread, repeated covid testing will be a big feature of 2021, but there is huge demand for the therapies and tests, and limited supply. There are logistical challenges. We are sure these challenges will be overcome, but there could be a few twists and turns as we traverse down the road to a post-pandemic world, as the recent discovery of more transmissible variants of the virus has shown.

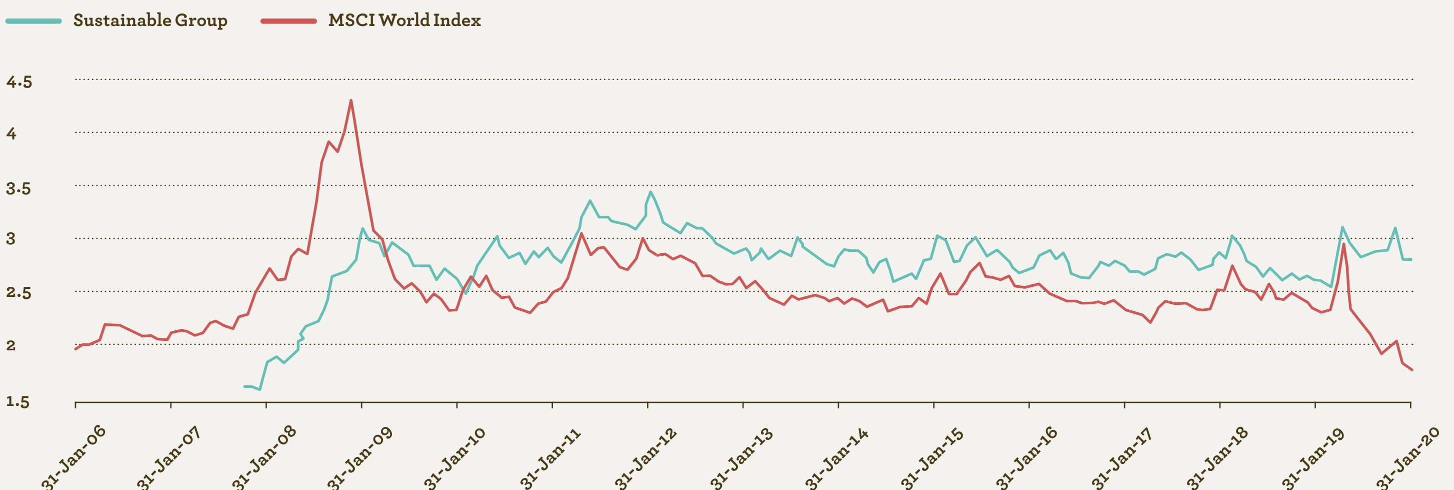
Second, management teams may become cautious in the wake of a bruising experience through the pandemic. Psychologically, business leaders may wish to conserve capital, in fear of another (yet undefined) future shock. This happened to something of an extreme in the aftermath of the Japanese property and equity bubble in the late 1980s. However, this need not necessarily be the response chosen by all companies, and many executives we have spoken to are certainly looking beyond the current crisis. These managers are considering increasing investment, using their strong incumbent positions and (in the main) cash flow to their advantage. Even so, caution could be a feature for some time particularly for those companies and industries that have been hard-hit. The pandemic has shown that many basic activities, like the ability to meet in public, are not unassailable human rights as we might previously have assumed, and companies are likely to factor in a changed risk landscape into their business plans in the future.

BALANCING INCOME & GROWTH

In the balance between corporate preservation and opportunism come dividends. One of the nice things about a sustainable income stream is that one is 'paid to wait' for the underlying economics of a good business to do their work.

The premium yield of our list continues to prevail, and even more so as the rising price of the market has combined with falling distributions to send the yield down below the 2% level. The market is often crudely divided into 'growth' companies and the rest (sometimes dubbed 'value'); the reality is that all companies are somewhere on a growth spectrum. Nonetheless, the balance of the overall global equity market does seem to have tipped towards the growthier end of things or, to put it another way, those companies with lower yields. If these companies can deploy their capital productively then this seeds the future growth in a virtuous circle. However, with yields lower than the mid-noughties, much faith is being put in the future.

There will likely be a rebound in global dividend pay-outs next year which will naturally revert the market's yield somewhat, so things are not as stretched as they might appear based on today's yield alone. Indeed, our own analysis of valuation shows the market to be perhaps slightly overvalued, but not dramatically so. That said, the stability of income and cash flow from the dividend list means that there is an appropriate mix of jam today to go with tomorrow's potential bounty, which goes some way to managing valuation risk. With good corporate fundamentals, we believe the overall risk profile for the sustainable dividend list is lower than for the market.



Source: Factset

THE 2021 LIST

Bureau Veritas

French testing, inspection and certification business Bureau Veritas presents us with a challenge, one that income-oriented investors have had to face with numerous businesses over the course of the last year. Do we stick with the position, or move on? It's our view that equity investing is best done with a long-term mindset, but that doesn't mean that one should hold on to positions for grim death come what may. The sell or hold (or, indeed, buy more) decision comes to an assessment of whether the company is cutting its dividend because of an acute condition that will pass, or because of a longer-term issue that might not.

For Bureau Veritas, the dividend was cancelled early in the pandemic for the sake of prudence in the face of uncertainty, and in order to ensure access to French governmental employment support. On the former, whilst there is still clearly uncertainty around how the pandemic will pan out, it is fair to say that the company has managed to come through what we hope will be the worst of it in good shape. Despite revenue and profitability being dented, its cash flows have proven resilient, which ultimately pay the dividend. Revenues have sequentially improved quarter on quarter, indicating perhaps that the impact is acute rather than chronic. On the question of governmental support, it was used but staff are getting back to work and its utilisation is now estimated to be minimal.

None of these positive signs is a guarantee of a return to dividend payment this year of course. With the firm taking the European approach of making one distribution a year it is possible that this is passed again, but the longer-term business case for Bureau Veritas is positive and we retain it in the list.

Other companies and the pandemic

We have already mentioned Relx and Paychex as having felt the impact of lockdown and furlough. Relx's diversified portfolio has held up very well aside from its exhibitions franchise, which is obviously impacted by face-to-face meetings being banned, but makes up a minority of the overall business. Paychex services small and mid-sized businesses in the US who want to outsource their payroll and human resources functions, and has seen some impact from reduced employee numbers. In both cases the underlying long-term resilience of the businesses and their cash generating ability means they retain their places in the list.

Western Union's money transfer services were impacted as less cross-border travel meant less need for cross-border remittance. This has started to recover, and its long run strategy of developing its digital business has continued. Cisco saw demand for its networking products dip from the corporate sector as companies looked to conserve cash, but with ample cash flow and a net cash balance sheet the company was well placed to cope with this and again demand has recovered.

More positively, business-to-business publisher, data and software firm Wolters Kluwer showed solid results and had a benefit from the provision of tools to help US customers administer the Paycheck Protection Program.

So the businesses on our list were buffeted in various ways, both positively and negatively, but their solid underlying offerings to clients and prudent financing meant they were able to weather the storm.

A change: PepsiCo to Nestlé

PepsiCo has been performing just fine on a fundamental basis but does stand out on our list with a dividend cover of just less than one meaning it is paying out slightly more in its dividend than it is generating in free cash flow. PepsiCo is a very high-quality business with stable cash flows backed by its diverse portfolio of consumer food and beverage brands. We believe that the repeat-purchase characteristics of its products and its long run ability to evolve its portfolio to suit consumer tastes bodes well, and has shown its worth in the pandemic with reduction in beverage consumption in bars and restaurants offset by increased at-home consumption of its products. However, for our focussed list we are going to switch it for another outstanding consumer business with a bit more wiggle room in its finances.

Nestlé will need little introduction as a name, but the sheer breadth of its consumer goods portfolio is worth highlighting. Covering its well-known confectionary brands, pet care, beverages including San Pellegrino, and increasingly a consumer health and nutrition franchise, its diversification leads to very solid cash flows. Its free cash flow covers the dividend one and a half times, and ably supports a prudently managed balance sheet. So whilst it has a similar yield to PepsiCo, it has a bigger cash flow buffer against the unexpected and is more diversified geographically.

BRIEF SUMMARY OF THE TEN STOCKS

BUREAU VERITAS

The French company is one of the market leaders in the highly fragmented testing, inspection and certification industry (TIC). These services are vital to customers, helping them ensure the high quality of their products and suppliers. With the rise of social media, having an ethical supply chain has never been more important. The company dominates the niche of asset inspection for ship construction and industrial machinery, both examples where the cost of failure is very high. As demand for these services is set to grow over time, and although the coronavirus crisis did show some cyclicality for the business in its industrial customer base it also proved able to adapt to the conditions.

CISCO

Cisco is the global market leader in the networking technologies. The core business of selling switches and routers is transitioning to longer term subscription purchase models. This provides a recurring stream of cash flows that can be used to pay dividends. The company has also expanded into providing security services, offering a one-stop shop for customers that have historically relied on a patchwork of products from up to 50 different suppliers. Cisco's services include the ability to detect malicious threats in encrypted internet traffic, preserving privacy.

JOHNSON & JOHNSON

Often associated with its consumer products division, with iconic brands such as Listerine and Neutrogena, J&J is predominantly a pharmaceuticals and medical devices company. The company's pharmaceutical division generates half of group revenues and has a strong position in immunology and oncology. The medical devices division is highly diversified, creating systems that aid surgery, diagnostics, wound care and vision.

NESTLÉ

Nestlé is a multinational consumer goods company, with over 8,000 products and 2,000 brands across a wide range of categories. Originally formed by the merger of milk-chocolate and condensed milk companies (1905), Nestlé makes and sells confectioneries like KitKat, baby food, ice-creams, cereals and coffees Nescafé & Nespresso amongst many other things. Over time Nestlé has expanded into other product lines; including noodles (Maggi), Waters (San Pellegrino), pet food (Purina) and nutrition.

PAYCHEX

Paychex is a US-focused provider of human resources services to small and medium sized businesses. A little over half of revenues are derived from payroll outsourcing, clearly an important function for any business and a task for which smaller firms are very willing to utilise a specialist. The other part of the business is other human resources services, such as pensions administration, and management of workplace policies. Once integrated into a client's business renewal rates are extremely high. The business has proved resilient through the coronavirus crisis, helping its clients to navigate and cope with new legislation and governmental support.

RELX

The Anglo-Dutch media conglomerate provides information services to academics and businesses. Diversification and a large degree of subscription-based revenue give stability to Relx's cash flows. The publishing business, Elsevier, has a portfolio of high-profile journals with an excellent reputation for publishing high-impact, academic research. Risk & Business Analytics provides analysis tools that help improve the efficiency of a range of businesses, from banks and insurers to farms. Similarly, the Legal division provides the LexisNexis database for lawyers, an irreplaceable resource in preparing a legal argument. The diversification of the business has come to the fore over the last year as revenues from its smallest division, trade exhibitions, dried up due to lockdown restrictions.

ROCHE

The Swiss pharmacology giant is at the forefront of development of personalised medicine. Roche are uniquely positioned, with an ability to leverage their diagnostics division and tailor treatments to patients, based on a specific biomarkers or protein expressions. This could result in a paradigm shift from the historic generalised treatment approach. Roche have invested heavily in the field of immuno-oncology. This has yielded breakthrough therapies that are enabling patients to live longer and allow Roche to capture market share.

UNILEVER

Unilever's consumer products are instantly recognisable to the 2.5 billion people who use them globally every day. Selling products from Dove to Domestos, Marmite to Magnums, this diversified consumer goods giant has a history stretching back to the 1880s. Over half of Unilever's revenues are from emerging markets, providing a compelling opportunity for growth as the average salaries for consumers in these markets increase. With fewer people holidaying ice cream sales took a hit in 2020, but the diversified portfolio fared well overall.

WESTERN UNION

Western Union is a leader in global money movement and payment services. The core segment, Consumer-to-Consumer, enables global money transfers usually within minutes of transfer initiation. This utilises a physical network, with agent locations in more than 200 countries and territories, and a compliance network, used to prevent money laundering and fraud. The company is increasingly seeking to supplement these services with online money transfers. Cross-border remittances fell during the first wave of lockdowns in 2020, but have since rebounded as economies and workers developed ways to cope with the restrictions.

WOLTERS KLUWER

Wolters Kluwer is a Dutch information, software and services company servicing the professional service sectors. Its products and services help healthcare professionals to make decisions, accountants to manage compliance, and lawyers draft documents. Knowledge and content in the relevant sectors combined with increasingly cloud based delivery enable Wolters Kluwer's products to become deeply embedded in their customers' operations, demonstrated by 79% of revenues coming from recurring sources.

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APPENDIX: OUR CRITERIA & SELECTION PROCESS

The above list of companies has been selected using a multi-factor market screen, using the following factors:

Risk/Factor	Metric	Comment
Quality compounders	Cash flow return on invested capital (CFROIC)	Quality companies are more likely to increase their dividend sustainably, thanks to the compounding of reinvested free cash flow over time.
Low or no debt	Net Debt/EBITDA	Companies that hold a high level of debt, relative to their potential earnings ability, risk having to sacrifice the dividend to meet interest payments.
Strong free cash flow cover	FCF / Dividend	Where cash entering the business is not sufficient to meet the cost of the dividend then it is unsustainable. Companies with high free cash flow coverage of their dividend have a higher current ability to raise the dividend.
Strong dividend history		A long-term track record of paying dividends through thick and thin is a good sign. Given the impact of coronavirus we have had to take a longer term view on future capacity to pay dividends in order to decide on the final list this year.
Valuation	Dividend yield	Even the highest quality company is not a good investment at too high a starting valuation. Balancing attractive dividend growth with a solid starting yield is one of the keys to income and growth investing.

Following the screen, we then chose ten companies based on our own qualitative analysis. We have selected business models that enjoy market-leading positions in their industries, attractive economics, strong barriers to entry and good potential for medium-to-long-term growth.

FURTHER INFORMATION

Interested in investing in the TB Evenlode Global Income Fund? Get in touch:

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