EVENLODE
GLOBAL INCOME FUND

EVENLODE INVESTMENT DIVIDEND SUSTAINABILITY REPORT 2022

SUMMARY:

2021 was a catch-up year for dividends as companies learned to live with the new world of public health measures and supply chain disruption. Although aggregate global dividends are yet to return to pre-pandemic levels, our list of sustainable dividend payers has returned to growth. Within the group, dividends per share increased by between low single digits and mid-teens in percentage terms.

The effects of the pandemic on our selected businesses have varied by sector and with the underlying business mix of the companies. However, the list has benefitted from a focus on firms with repeat-purchase and value adding products, solid cash generation and moderately geared balance sheets.

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RETROSPECTIVE – THE 2021 LIST

We select companies for this list based on their prospects for a steadily growing dividend through time. Last year's selections are shown in the table below, and all exhibit key characteristics that give them a good chance of meeting this aim. They have good competitive positions in their markets, which lead to high returns on capital, solid cash generation and limited need for leverage in their business models. See the appendix at the end of this document for more detail on the criteria we use.

	Market Cap ($bn)	Aggregate Dividend Growth* (%)	Per Share Dividend Growth** (%)	Dividend Yield (%)	1Y Total Return (USD to End-Dec 2021) (%)	Net Debt/ EBITDA	Free Cash Flow Yield (%)	Free Cash Flow Div. Cover
Bureau Veritas	15	N/A	N/A	1.2	26.3	1.9	5.6	4.6
Cisco Systems	266	N/A	2.8	2.3	45.8	-0.9	5.6	2.4
Johnson & Johnson	452	N/A	5.3	2.3	11.4	0.4	4.5	1.9
Nestlé	399	N/A	1.9	2.1	21.2	1.6	2.7	1.3
Paychex Inc.	49	N/A	1.6	1.8	50.2	-0.1	2.4	1.3
RELX	63	N/A	16.1	2.0	36.0	3.0	2.5	1.2
Roche	290	N/A	1.1	2.5	22.1	0.1	3.5	1.4
Unilever	137	N/A	3.5	3.6	-7.7	2.1	6.0	1.7
Western Union	7	N/A	12.5	4.9	-15.2	1.4	9.4	1.9
Wolters Kluwer	30	N/A	15.3	1.3	41.9	1.5	3.3	2.5
Average	**171**	**8.7**	**6.7**	**2.4**	**23.2**	**1.1**	**4.5**	**2.0**
MSCI World Index		7.0		1.5	21.8	1.9	2.9	1.9

Source: FactSet, Evenlode Investment as at 31 December 2021. *Aggregate dividend growth based on total of last twelve months dividends paid, 2021 vs 2020 assuming equal weighted portfolio. **Average growth in local currency, excluding Bureau Veritas, 2021 vs 2020

DIVIDENDS IN A TIME OF TURBULENCE

The return of dividends

Despite the ongoing disruption to the global economy and the supply chains that enable it, businesses have, overall, started to learn to live with the coronavirus pandemic. The hardest hit sectors, including travel and leisure, continue to face ongoing challenges. Even with welcome support from governments and central banks, these challenges may last well into the new year. Elsewhere businesses have seen improving prospects, enabling the reinstatement of dividends that were prudently cut in 2020.

In aggregate, corporate profitability and dividends have not quite recovered the prior year declines. However, the sustainable dividend companies on our list have achieved that feat.

Global equities declared 7.0%[1] more in dividends in 2021 compared to 2020, and the aggregate of dividends from our selected companies grew marginally ahead of this. An equal weighted portfolio of the companies on our list achieved dividend growth of 8.7%[2]. Both our list and the wider market were heavily affected by the welcome resumption of dividends as pandemic pressures eased. Within our ten selected stocks, the French testing, inspection and certification company, Bureau Veritas, resumed its dividend, although at a lower level than pre-pandemic. Some of the larger companies on our list enjoyed more modest dividend increases, so the average dividend growth was a little lower at 6.7% (excluding Bureau Veritas)[3]. This growth is particularly pleasing when you remember that these companies were already paying a significantly higher dividend yield than the market.

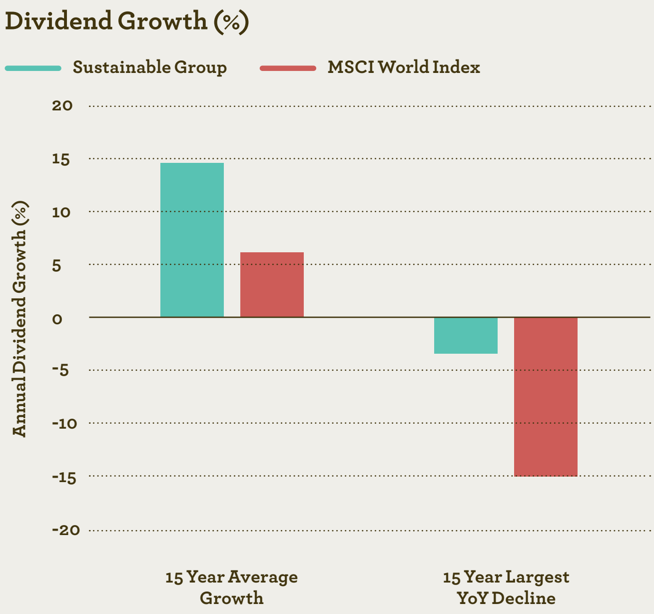

Figure 1: Source FactSet, US dollars

Consistently higher dividend growth is only one of the two aims of our list. The second is to provide growth with lower volatility than the market over time. This has also been achieved and is shown on the chart in Figure 1 above. To take a more recent case study, our list also outperformed in dividend growth terms over the course of the pandemic, with lower dividend drawdown than the market in 2020. We will discuss the performance of individual companies on our list in more detail below, but first we will zoom out and take a look at dividends more broadly around the world.

Where have dividends recovered?

The table opposite shows the aggregated dividend growth for the sectors that make up the MSCI World Index. The varying fortunes of different areas of the economy can be seen in the figures, but closer inspection is warranted to see some of the underlying drivers.

GICS Sector	Aggregate Dividend Growth (%)
Materials	36.3
Financials	15.0
Consumer Discretionary	11.1
Health Care	7.6
Industrials	6.3
Information Technology	4.9
Utilities	4.0
Real Estate	0.9
Communication Services	0.5
Energy	-3.7
Consumer Staples	-4.0
MSCI World Index	7.0%

Source: FactSet, Evenlode Investment. Dividend growth based on last twelve months dividends paid, 2021 vs 2020 in US dollars

1 Source: FactSet – USD data for the MSCI World Index, 1 Jan 2020 – 31 Dec 2021.
2 Source: FactSet – USD data for an equally weighted portfolio of selected stocks, 1 Jan 2020 – 31 Dec 2021.
3 Source: FactSet – Average growth in local currencies, excluding Bureau Veritas, 1 Jan 2020 – 31 Dec 2021.

The standout rebound has come from the **Materials** sector, where there have been significant special dividends from basic resources businesses on the back of (perhaps surprisingly) very robust demand. Some of these businesses had naturally conserved cash by cancelling payouts during the early stages of the pandemic so there is an element of catching up with their dividends, but nonetheless there is clearly a mini-boom of sorts going on in the extractives industry. Countering this, chemicals companies servicing general industry reduced their dividends in response to both supply and demand challenges, having maintained their distributions in 2020.

The growth in the **Financials** sector was driven by the reinstatement of bank dividends. Early in the pandemic, central banks raised concerns over increased loan defaults by businesses. To preserve the financial system's ability to withstand both this possibility and further economic shocks, European central banks placed strict limits on shareholder returns, often necessitating the cancellation of dividends. Affected companies included NatWest and Barclays in the UK. These limits have now been largely removed.

Negatively the **Energy** sector is seeing the effects of 2020's very low oil prices feeding through, although it should be noted that dividend increases are now being seen as energy prices have recovered significantly. This sector is also coping with the longer-term transition to low carbon energy sources around the world, which is destined to fundamentally alter energy company business models and thus the dividends that they are able to pay.

Health Care was a bright spot particularly in the health equipment space, where companies like Medtronic and Abbot Laboratories increased payouts, although in many cases this is from quite a low base. The **Pharmaceuticals and Biotechnology** sub-sector witnessed broad increases that averaged in the mid-single digits.

Information Technology has been a standout performer in market return terms over the course of the pandemic, but this has not been driven by yield considerations with the 4.9% increase in the sector's dividends not keeping pace with either the market action or the growth in profitability. Semiconductor production equipment manufacturers put through healthy dividend increases, whilst some hardware companies with legacy product portfolios reduced their payouts. Software companies were somewhere in the middle despite these companies performing extremely well in terms of cash generation; there is certainly scope for much increased dividends to be paid from this sector in time.

The fall in payments from the **Consumer Staples** sector requires some unpicking. Retailers Tesco and Costco paid large special dividends in 2020 which acts as a drag on the headline number. There were reduced dividends from companies exposed to out-of-home consumption such as brewers, and there were dividend cuts from tobacco companies which face longer term pressures from reducing smoking rates and weak capital structures. More positively, food, household and personal product companies increased their dividends as demand continued to be robust.

DIVIDEND SUSTAINABILITY FROM HERE

There has been quite a lot going on under the surface of the market's growth where dividends are concerned. Dividend performance largely reflects the divergent business fortunes of companies during the pandemic, but for certain sub-sectors such as oil & gas and tobacco firms, there are longer term structural dynamics at play. For those companies more closely tied in to the effects of pandemic-related lockdowns, any return of dividends will clearly depend on how immunisation, herd immunity and the emergence of new variants plays out from now.

At an aggregate level we see dividends being covered around twice by free cash flow, for both the market and for our list of sustainable dividend payers. We have selected our list on the basis of having business models that are less economically sensitive than the average company, and with more repeat-purchase revenue characteristics. This is no guarantee of success of course, but the level of dividend cover combined with good business resilience means that the outlook for steadily growing dividends from the companies we have selected is positive.

QUESTIONS OF VALUATION

Whilst the dividends have a similar level of free cash flow coverage for our list and the global stock market, there is a marked difference in the price being paid to access the cash flow and dividend streams. We noted this valuation discrepancy in last year's report and the picture has changed little since then on a relative basis, with the yield on the MSCI World Index remaining considerably lower than the sustainable list.

Dividend Yield (%)

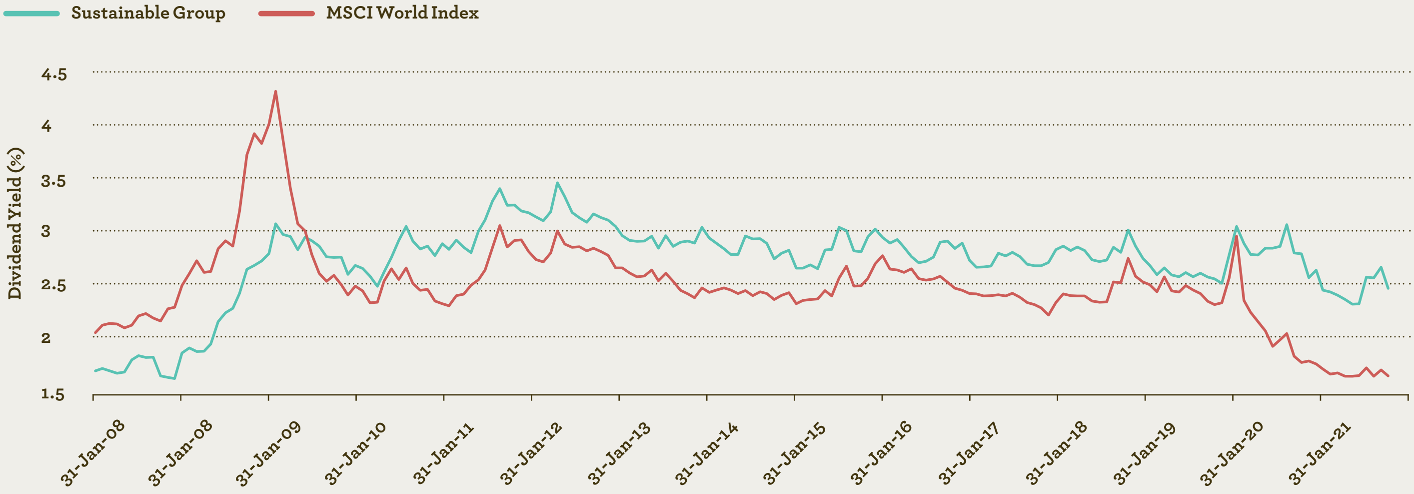

Figure 2: Source FactSet

The chart above in Figure 2 shows that yields have fallen over the course of the last year. With increasing dividends paid, this must mean that capital values have increased ahead of the growth in dividends. It has, in fact, been a very strong year for equity returns, and having lagged the market by some distance in 2020, our list marginally outperformed in 2021. This is slightly surprising; given the 'steady Eddie' nature of our list of companies we would not normally expect outperformance in a strong market. To put it another way such companies more usually exhibit 'low beta' characteristics, but there has perhaps been some catching up to be done after the prior year. The list has also outperformed the MSCI World Index over a longer period of time as shown on the chart below, despite underperformance in 2020. That slower performance meant, in part, that at the start of 2021 our business' collective dividend yield was healthy at nearly 3%. This figure certainly compares well with the list's own history. The valuation of these businesses continues to look attractive in absolute terms with yields averaging 2.4%, and so there is a decent prospect of satisfactory total returns for patient investors. Good total returns will only occur if yields are backed by sustainably generated cash flows, which as we have already noted is a core aim of our selection process.

Total Return (Rebased)

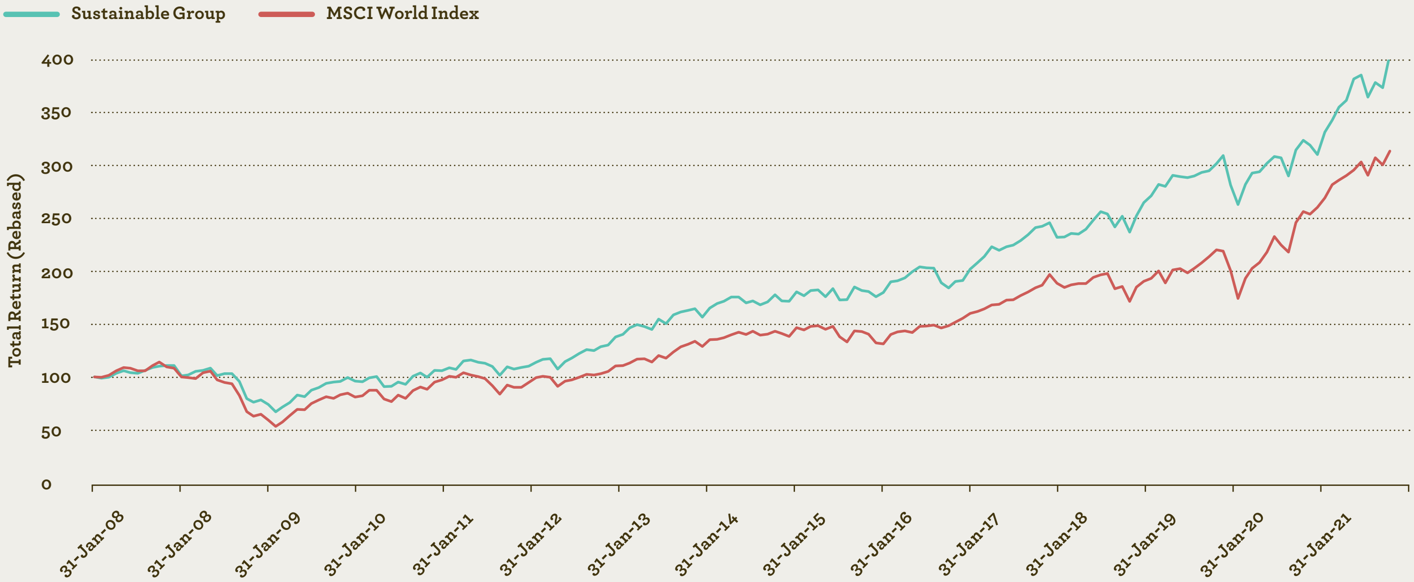

Figure 3: Source FactSet. Returns in US dollars.

THE 2022 LIST

Here we will take a look at some of the edited highlights from our list, focusing on those companies that have had greater impacts from the coronavirus pandemic. Finally we will detail a change to the list for 2022, replacing Johnson & Johnson with Sanofi in a swap within the Health Care sector.

Bureau Veritas
We gave the French testing, inspection and certification business the benefit of the doubt when it cut its dividend during 2020, and the patience has been rewarded with a return of the dividend and a market-beating performance. Revenues and margins have recovered to pre-pandemic levels, with customers returning to more normal operations and having to catch up with regulatory audits previously postponed. The company has resumed the dividend at a lower level than previously paid, meaning that it has ample free cash flow coverage and scope to return to a higher level over a suitably prudent timescale.

RELX
The diversified media and analytics company's exhibitions business was understandably hit hard in 2020, and whilst it has seen some recovery latterly in 2021 it remains heavily subdued. This was the smallest division pre-pandemic and the rest of the business has picked up the slack. Traditionally its academic publishing arm, known for the Elsevier brand of journals, has been the largest operating segment but the Risk business, built both organically and by acquisition, is now snapping at its heels and growing at a high single digit rate. The division has data and analytics products that help companies from airlines to insurers reduce their risks by analysing data in real time, a secular growth story in an ever-digitising world.

Cisco
Networking equipment and software giant Cisco was impacted by reduced corporate spending in 2020. Expenditure on networking capability has returned in 2021 and the longer-term growth in connectivity bodes well for the future. However, revenues have been held back by supply chain bottlenecks and the cost structure impacted by input cost inflation. Despite this, Cisco put in a market beating return in 2021.

Unilever
As with much of the Consumer Staples sector, Unilever turned in a solid revenue performance in 2021 but profits have been held back by input cost inflation thanks to supply disruption. A consistent message that we have received from management teams in this sector is that pricing of products to end consumers will ultimately be able to make up for this inflation, but near term it has certainly had an impact. Branded Consumer Staples companies have historically been able to cope with inflation and we have started to see price rises come through as companies reported results towards the end of the year. However, the concerns have weighed on share prices and Unilever's was no exception, ending the year below where it started.

A change: Johnson & Johnson to Sanofi
We have decided to make a switch within the sustainable dividend list's healthcare exposure, from Johnson & Johnson to Sanofi. Crossing the Pond from the US to France, we are favouring the valuation appeal of Sanofi which provides a diversified portfolio of healthcare products with a better yield than its US rival.

Johnson & Johnson has been enjoying a rebound in its operations from 2020. This is particularly true of its medical devices division which saw the postponement of purchasing as healthcare systems around the world coped with the initial wave of the pandemic in 2020. Its pharmaceutical division is enjoying solid growth thanks to 'biologic' (large molecule) drugs for autoimmune diseases and cancers. The slower-growing consumer health business also rebounded in 2021, and the company plans to spin the business off, reflecting a broader trend within this sub-sector globally. GlaxoSmithKline is doing similar, having integrated the consumer health businesses of rivals Novartis and Pfizer in recent years.

Sanofi also has a significant consumer health business, which it is holding on to unlike its peers. Whilst the consumer division has enjoyed a rebound, long term growth is being delivered by its pharmaceutical operations, particularly the Specialty Care division that was borne out of the acquisition of Genzyme in 2011. The purchase has turned out to be a success, with the business making up for the loss of patent protection on a number of Sanofi's legacy drugs, notably the insulin Lantus. This patent cycle affects all pharmaceutical firms. It is encouraging to see biologic therapies like the blockbuster Dupixent, used to treat a range of autoimmune diseases, coming through as older therapies move into their post-patent protection phase.

Completing the business profile is Sanofi's vaccines division, which is a very steady business making up about 17% of total revenues. The company is working on vaccines against Covid-19, but it has a market-leading position in some of the more traditional causes of illness like influenza.

So why make the switch? These businesses are not quite like for like; Sanofi does not have a medical devices division to highlight one key difference. However, they do both provide exposure to attractive end markets with products that materially improve the quality of life for people and can help healthcare systems save money. The switch is driven by the more attractive valuation of Sanofi at current market prices. The 3.6% dividend yield is attractive and superior to the 2.3% delivered by Johnson & Johnson, and 1.5 times covered by the free cash Sanofi generates. The purpose of this report is more to examine the sustainability of dividends than it is about market valuations. However, there have been some interesting divergences in between different markets that are worth noting and reflecting in our chosen list.

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. Having an ethical supply chain has never been more important, and helping clients to demonstrate their environmental sustainability is a core part of the company's strategy. The company dominates the niche of asset inspection for ship construction and industrial machinery, both examples where the cost of failure is very high. Demand for these services is set to grow through time, and the rebound from the coronavirus-related disruption demonstrates that the services Bureau Veritas offers are 'must haves' for clients.

CISCO

Cisco is the global market leader in IT 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. Covid-related disruption to corporate spending affected the company in 2020, but this has reversed in 2021.

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 amongst many other things. Over time Nestlé has expanded into other product lines; including noodles (Maggi), waters (San Pellegrino), pet food (Purina) and nutrition. It has proven adept at recognising fast growing categories such as pet care, and innovated within categories to drive growth as demonstrated with Nespresso in coffee.

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. 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. Around a quarter of Roche's portfolio by revenue is formed of its Diagnostics division, which supplies diagnostic testing equipment to laboratories worldwide. This has clearly been beneficial during the coronavirus pandemic, but also has longer term drivers from the increased use of personalised medicine and the need for efficiency within healthcare systems.

SANOFI

Sanofi is a diversified, French pharmaceutical and consumer healthcare company that operates across a wide range of therapeutic areas. The business is structured into four business units. Specialty Care includes the growth pharmaceutical specialisms; Immunology; Rare Diseases (Genzyme & Rare Blood Diseases); Neurology (including MS); and Oncology. The General Medicines division consists of therapy areas with off-patent products including those addressing diabetes and cardiovascular disease. Alongside the two pharmaceutical divisions, Sanofi operates sizeable Vaccines and Consumer Healthcare businesses. The company has performed well through the pandemic across its divisions, demonstrating resilient demand including vaccines for non-covid illnesses.

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 taking holidays, ice cream sales took a hit in 2020, but the diversified portfolio fared well overall, and demand has remained robust in 2021. However, as with much of the Consumer Staples sector, the company has suffered from input cost inflation which it plans to offset through price increases to consumers in the future. This has impacted margins in the near term, leading to the underperformance of the company and sector.

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. Despite this positive development, the share price has languished as investors have worried about the impact of digital remittance replacing its traditional cash-driven business. Countering this, Western Union has a digital business that is growing strongly, and there are considerable barriers to entry in the form of cross-border compliance requirements.

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. The company has been a solid performer from an operational point of view in 2021. The market appears to have awoken to its attractive business model, awarding it a 42% total return in 2021.

APPENDIX: OUR CRITERIA AND SELECTION PROCESS

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

Risk/Factor	Metric	Description
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

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