EVENLODE

GLOBAL INCOME FUND

EVENLODE INVESTMENT GLOBAL DIVIDEND SUSTAINABILITY REPORT 2020

SUMMARY:

In the year following our last Evenlode Global Dividend Sustainability Report, geopolitics has once more dominated the headlines. Markets have retained their volatility in response to a cascade of news flow that includes; Brexit, trade-wars, and the escalating situation in Hong Kong. However, in stark contrast to the disappointing second half of 2018, global equity markets have spent much of 2019 pushing upwards towards record levels. In such markets, identifying companies with excellent fundamental progress to match the increase in their share prices is a key focus. Our search for reliable dividend streams has identified companies with strong balance sheets and predictable cash flow. By combining these factors with strong competitive positions and pricing power, these companies are set to deliver sustainable distributions to shareholders into the future.

RETROSPECTIVE – THE 2019 LIST

	Market Cap ($bn)	Local Dividend Currency Growth	Dividend Yield	1Y Total Return (to End-Oct 2019)	Net Debt/ EBITDA	Free Cash Flow Yield	Free Cash Flow Dividend Cover
Cisco	190	7.8%	3.1%	6.8%	-0.54	7.5%	2.5
Givaudan	26	3.4%	2.1%	21.4%	2.49	2.2%	1.1
Johnson & Johnson	363	5.9%	2.8%	-3.1%	0.38	5.0%	2
Kone	33	0.0%	2.9%	37.7%	-1.57	2.8%	0.9
Paychex	30	11.0%	2.9%	31.6%	0.03	3.8%	1.3
PepsiCo	187	8.7%	2.8%	25.8%	1.86	3.2%	1.2
Relx	46	8.0%	2.3%	22.8%	2.39	4.3%	1.9
Western Union	11	6.0%	3.0%	44.5%	1.77	4.0%	1.4
Unilever	68	6.3%	3.1%	15.9%	1.52	3.4%	1.2
Wolters Kluwer	19	6.0%	1.6%	33.8%	1.49	4.0%	2.7
Average	97	6.3%	2.7%	23.7%	1.0	4.0%	1.6
MSCI World		5.5%	2.3%	13.1%	1.6	4.3%	1.7

Source: Factset, FE Analytics

The companies selected for the 2019 Sustainable Dividend list again outperformed the MSCI World index in terms of dividend growth. The average increase of 6.3% is however, lower than we would expect given the strong fundamental performances and the levels of dividend cover.

Once more the American companies on the list grew their dividends faster than their European counterparts. This may be perhaps surprising, given their higher initial average yield. The largest dividend increase came from Paychex, an American supplier of human resources services to small and medium sized businesses. The company has been a leading consolidator in the professional employer organization (PEO) outsourcing market, deploying cash reserves to acquire companies and increase revenues. Other notable positives included PepsiCo and RELX, both of which increased dividend returns on the back of continued cash flow growth. The no-growth outlier is Kone, the Finnish producer of elevators and escalators. This statistic is perhaps a harsh judge of the company's performance, given that it was paid in a single lump-sum in February and is more reflective of the performance in the prior year. Given the far better performance posted in 2019, growth is likely to return, though shareholder returns could be affected by rumoured acquisition activity.

We view dividend growth as a better indicator of the underlying health of a business' fundamentals than the share price, which represents market confidence and is prone to bouts of optimism and pessimism. Over the long term, total shareholder return should be steered by the growth in the dividend yield. Viewing the (relatively short) window of performance over the past year, total shareholder returns for the Sustainable Dividend list was 23.7%, far outpacing the MSCI World index. This can largely be attributed to the high rates of return on invested capital shared by the companies in the list. The highest total return came from Western Union at 44.5%. The payment services company made a promising start in the transition to digital payments and signed several high-profile partnership deals to supply compliance services to credit card providers. The weakest was Johnson & Johnson, which posted a 3.1% decline after a series of high-profile litigations. Such lawsuits, though often relating to tragic outcomes for patients, are common among pharmaceutical companies. The fundamentals for J&J have improved throughout the year however, and the company retains a spot in our list for 2020.

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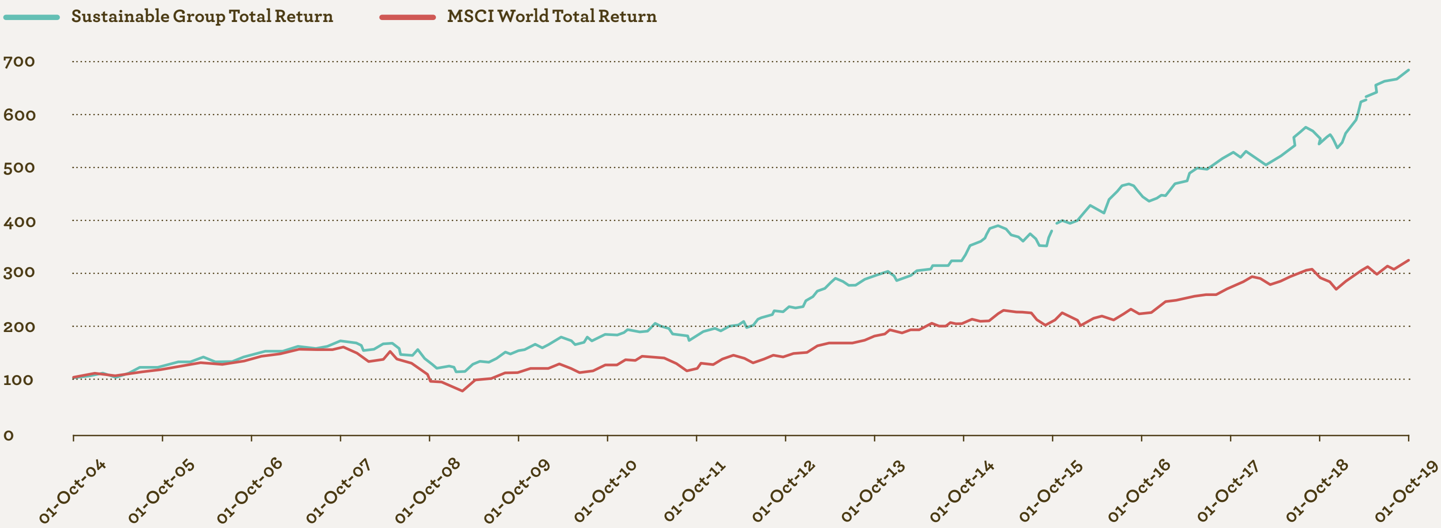
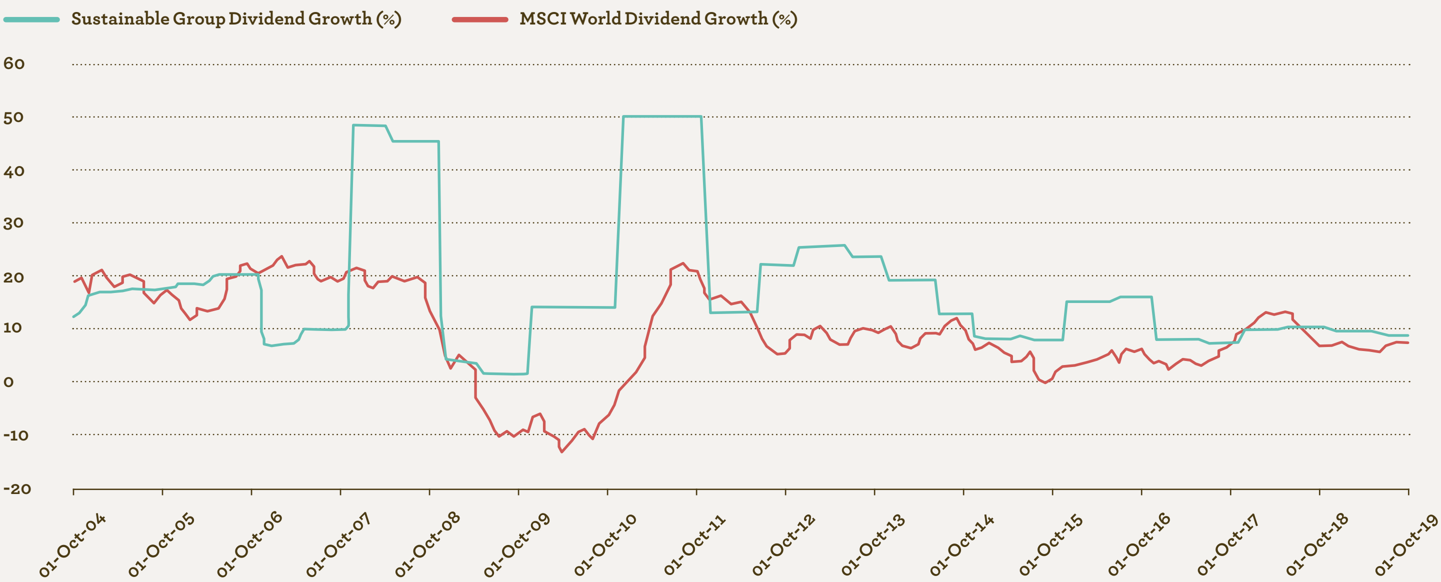
RESILIENCE AS STRENGTH

While the recent relative performance of the sustainable dividend group has been pleasing, a single year is a too brief time frame to prove superior long-term performance. To gain greater context and answer the question of whether these attributes truly contribute to long term returns, we can examine the performance of the selected group over the past decade and a half.

Total Return



Dividend Growth



Source: Factset

The charts above show dividend growth and total return over the last fifteen years for our list and the MSCI World index. Notably, there is not much separation in total returns between the dividend group selected and the index up until the great financial crisis of 2008-9. However, after this, a clear divergence emerges with the high-quality names posting over double the overall return of the index from this point. So, what changed? The key differentiator is the resilience of the sustainable companies, which maintained their dividends as a group during the crisis. While less robust, rivals struggled or met their end, the companies we selected continued to make shareholder returns and invest back into their operations. As the economy recovered, this has enabled them to take share and produce a higher quality product or service.

HIGH CASH VISIBILITY AND FAR SIGHTED INVESTMENT

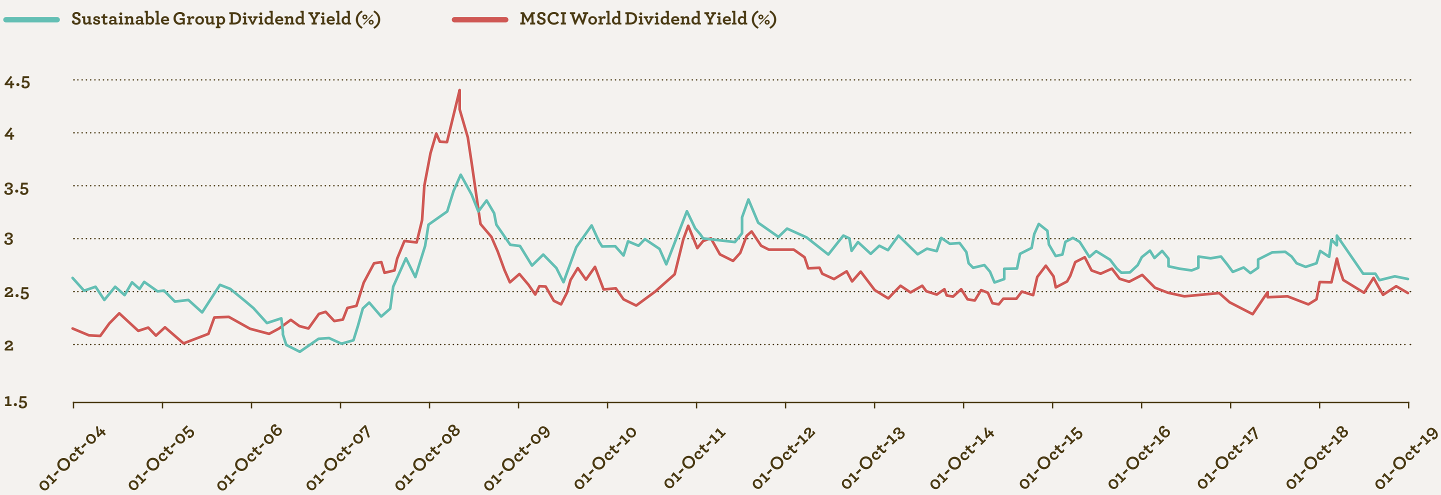
The selected sustainable businesses have strong competitive positions and excellent pricing power (a brief summary is provided for each business in our list below). Vitally, these companies have built long-term relationships with customers that help drive a recurring stream of revenues. In some cases, this relationship is directly with the consumer. The brands of Unilever, Johnson & Johnson, and PepsiCo are trusted, and this drives higher repurchase rates. Other companies, such as Wolters Kluwer, RELX and Paychex, generate much of their revenues from business-to-business subscriptions, which are renewed in advance. The resulting high visibility of cash flows gives companies the confidence to invest in their business throughout the year.

The ability to make the prudent investments to support future growth is further supplemented by taking a responsible attitude towards the balance sheet. Fundamentally, a lower level of debt reduces the risk that the company will have to divert cash from investment or paying the dividend. This increases the stability or defensiveness of these businesses. The average net debt to EBITDA ratio (a measure of leverage) for these companies is 1.0x, significantly less than that of the MSCI World index. Combined with cash flow visibility, this gives us confidence in the companies' ability to weather the next storm and continue to grow.

BALANCING INCOME & GROWTH

Despite the strong price performance over the past year, the sustainable group currently pay a dividend yield of 2.7%. This is comfortably in excess of the yield for the MSCI Index of 2.3%. Despite having lower financial risk, these companies offer investors a premium income return. This is partially due to the maturity of the companies, with many having shifted from the initial growth phase to returning capital to shareholders.

Dividend Yield



Source: Factset

However, that these companies can maintain a premium yield over time (as illustrated in the chart below) and generate higher total returns over time, demonstrates their fundamental strength is not a passing phase. By combining operational efficiencies and investment in new technologies, these companies are able to generate a good and growing stream of cash flows that should fund higher shareholder returns over the cycle.

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THE 2020 LIST

Two businesses from our 2019 Sustainable Dividends list no longer meet our screening requirements. Dutch media firm, Wolters Kluwer has seen its yield fall further below the 2% cut-off, standing at 1.6% at the time of writing. In the past year, the dividend grew by 6%, though less than the appreciation of the share price. However, we continue to believe that the long-term investment case for Wolters Kluwer remains sound and the valuation not unattractive, given the excellent cash flow generated and prospects for future dividend growth. We have thus retained the company in the 2020 list.

Finnish elevator and escalator maker, Kone, is the other company to miss the screening constraints, with a dividend no longer covered by free cash flow. The business operates in the competitive and cyclical construction industry, with a particular exposure to Asia Pacific. While this market has seen some recovery, the high valuation (following rumours of M&A deals) does not sufficiently reward investors for taking the risks associated with cyclicality. As a result, it has been removed from the 2020 list.

While Swiss ingredient manufacturer Givaudan does pass the screen, the margin by which it passes many of the metrics has declined. Due to a strong share price performance, the yield offered to investors has fallen to the 2.1% mark. The company also carries the highest debt position of the 2019 list. Combined with an emphasis on cost reduction from many of their consumer goods clients, we believe that there are better opportunities for investors elsewhere.

To replace Givaudan and Kone, we selected two high quality businesses that have created differentiated competitive positions. The first is Swiss pharmaceutical and diagnostic company, Roche. The company has an exciting pipeline of new molecules and a fantastic record of delivering on R&D, with a disciplined and innovative process. This allows the business to replace income lost to generic versions of their blockbuster drugs with new revenues from life-saving therapies. The company has a dividend twice covered by free cash flow and an encouragingly conservative attitude to the balance sheet.

The second new addition is Bureau Veritas (BVI), a French testing, inspection and certification company. In recent years, BVI has struggled to grow the dividend, while contending with slower end markets in shipping and resources. However, these have recovered significantly over the past year, giving management the ability to reward patient shareholders. By offering a critical service to a highly fragmented customer set, the company has generated a stream of predictable cash flows, which will support future dividend growth.

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, both earnings and dividends can be expected to grow in step.

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. While the company has been embroiled in lawsuits for the past year, earnings have continued to grow.

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 cash flows that back the 2.9% yield are very stable as a result.

PEPSICO

Something of a misnomer, Pepsico derives only 12% of sales from its (near) eponymous drink. The company also owns a wide range of food and beverage brands including Tropicana, Lays, Doritos, Quaker Oats and Cheetos. In total, twenty-two of PepsiCo's brands generate more than $1bn of sales annually. Under new CEO, Ramon Laguarta, Pepsi have continued to increase marketing investment and innovating both in terms of products and packaging.

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.

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.

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, which have been built into several global social media networks.

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. We screened for companies that have not cut their dividend over at least the last 10 years.
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 the key to income and growth investing. We have filtered the markets in the US, Canada, EU, Switzerland, Australia and Japan for companies on a dividend yield of more than 2%.

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

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