

Evenlode Investment View

February 2017 - Results Round Up



It's been a busy few weeks for results, with more than 80% of the Evenlode portfolio having updated the market since the start of the year. In an economic and geopolitical environment that one might benevolently describe as 'mixed' or 'volatile', we have been very reassured by the fundamental progress and healthy cash generation that the aggregate portfolio continues to grind out.

Below is a brief update on some key themes, sectors and stocks for the Evenlode fund:

Currency

Across both the UK market and the fund currency has been a positive theme for the results of UK multinationals, with reported earnings benefiting from the depreciation of sterling in the second half of 2016 (in many cases by +10% or more). Most companies are guiding for a further significant currency benefit in 2017 if sterling stays at current levels for the rest of the year. Conversely, for businesses selling to the UK domestic market, currency has presented a headwind to overcome in terms of rising input costs. Evenlode holdings such as PZ Cussons and Halfords fall into this category, and both are using a combination of price rises and sourcing efficiencies to offset these pressures.

Consumer Branded Goods (27% of portfolio)

Evenlode's largest consumer branded goods positions are currently Unilever and Diageo. Emerging market conditions remain very mixed and deflationary pressures in developed markets continue. Despite this backdrop both businesses continue to generate steady growth and raised their dividends by +6% and +5% respectively. These dividends are well backed by free cash flow generation, and it was particularly good to see Diageo back to its normal, highly cash generative ways in recent half year results, with the company's inventory problems of 2013 and 2014 having fully worked through. Lower down the portfolio P & G, Pepsi and PZ Cussons also released reassuring updates.

'Kraftilever'

Results season for the consumer branded goods sector was, however, eclipsed somewhat by Kraft Heinz's aborted takeover attempt of Unilever last week.

This brief flirtation by Kraft Heinz was a thought experiment in what the British stock market would lose if Unilever ceased to be a listed company. Unilever offers a fairly unique combination of characteristics to UK investors:

- The global number two player in homecare (after P & G), the number three player in beauty and personal care (after P & G and L'Oreal) and the number six player in food.
- A highly diversified business both by category and geography.
- An unrivalled, impossible to replicate footprint in emerging markets (the company has been in India since the 1880s for instance, and Brazil and Indonesia since the 1930s - Unilever's distribution network in Indonesia is bigger than the Indonesian post office!)
- A low ticket, repeat purchase business model with economic resilience and pricing power.
- A business model generating high, compounding returns on invested capital and converting its earnings consistently to cash.

- A strong balance sheet.
- Long-term dividend growth, which has averaged more than 10% over the last fifty years. Despite the current low inflation environment the company continues to grow its dividend at +6% per annum.
- A starting dividend yield of more than 3%.

As such, we greeted the news that talks had been terminated with no disappointment. It would be a great shame to permanently lose such a high quality dividend stream from both the UK market and Evenlode's investable universe.

Following this failed takeover approach, Unilever's management have subsequently announced improved profit margin guidance for 2017 and a strategic review to 'accelerate delivery of value', the results of which will be announced in April. This tightening of the bootstrings is a positive development in many ways for shareholders - there are undoubtedly efficiency improvements and portfolio rationalisation opportunities available to Unilever management in the near-term. But Unilever's relatively low margins (compared to peers) are also the side effect of significant, consistent investment in its brand development and global footprint. We appreciate this long-termist culture that has built up in Unilever (which still to some degree echoes William and James Lever's mindset from the company's origins at Port Sunlight in the late 19th Century). Long-termism is a valuable asset for the patient shareholder but not something that is easy to measure on a spreadsheet! As Einstein once said, *'not everything in the world can be counted, and not everything that can be counted counts'*. *

Software and Data Analytics (Software and Media, 25% of fund)

After consumer branded goods, Evenlode's second largest sector is software, and there are also several other companies in the fund, particularly media holdings such as Informa, DMGT, Euromoney and Relx (and to some extent engineering companies such as Spectris and Smiths Group too) for which software and data analytics are central to the business model.

Competitively advantaged businesses with embedded customer relationships are generally a favourable pool in which to fish. When this combines with a runway of structural growth, as we think it often does in areas such as software and digital analytics, it creates particularly good long-term potential for cash flow and dividend growth.

The latest results season was a reminder that demand growth for software and data analytics isn't going away. Larger companies such as Microsoft, Sage and Relx are enjoying good organic revenue growth but we also think smaller companies such as Aveva (engineering software), EMIS (healthcare software) and Fidessa (financial software) are well placed in the niche sectors in which they operate given strong competitive positions.

As discussed in reference to Unilever above, a commitment to consistent investment is important for the long-term health of any franchise, but I think it's particularly important in the software sector as technology and client requirements move on over the years. Fidessa is a good example. Having built a dominate global position for its equity platform the company is now building out a derivatives platform. Earnings for 2016 would have been (we estimate) approximately 40% higher than they actually were if Fidessa had passed on this organic investment opportunity. But as long-term shareholders, we very much support this project. And despite the burden on

current results, Fidessa still generated good free cash flow growth thanks to healthy growth in its existing business. The company also increased both its ordinary and regular special dividend by +11%.

Healthcare (16% of fund)

The healthcare sector has been unfashionable over recent months. This can partly be attributed to some uncertainty over US healthcare policy as the new administration arrives in Washington, and partly to sector rotation, with 'defensive'/'boring' sectors having underperformed over the last year.

We continue to like the healthcare industry's high barriers to entry, economic resilience and the potential for growth thanks to innovation and demographics. We also like the sector's asset-light nature (these are companies for which intangible assets such as research expertise are key). Price scrutiny will remain an issue over coming years in the pharmaceutical sector (as it has over the last few years), but in our view innovative companies providing therapies that help improve patient outcomes and reduce costs for global healthcare systems are well placed.

We have spent some considerable time on the sector over recent weeks as valuations have become more attractive relative to other areas of the market. This has resulted in us broadening out our healthcare exposure with the introduction of new positions in Novartis and Smith and Nephew**. Both companies very much 'tick our boxes' in terms of their strong, diversified franchises and asset-light, cash generative business models. We initiated these positions on starting dividend yields of 3.7% and 2.3% respectively, and in our view the potential for long-term dividend growth at both companies is attractive.

In terms of existing holdings, Johnson and Johnson performed well in 2016 with strong free cash flow and a dividend increase of +7%. GlaxoSmithKline and Astrazeneca had more difficult years, as they deal with falling sales from some key legacy products. We continue to view the long-term prospects for both businesses as good, but the impact of restructuring costs on current free cash flow means these companies are (quite rightly) not growing their dividends***.

Elsewhere In The Portfolio

Elsewhere there have been some good updates from several of the fund's smaller holdings such as Page Group, Burberry, Victrex, WS Atkins and Paypoint. All of the above continue to generate healthy free cash flow and have net cash balance sheets, despite having faced very mixed end markets over the last year or two. This bodes well for future dividends, and several of these companies (Victrex, Page Group and Paypoint) also have policies to pay special dividends from time to time when cash positions begin to pile up.

Quality, Resilience, Value

In summary, we are encouraged by the progress portfolio holdings have made, and future growth potential. However, the wider economic and market outlook remains by no means straightforward. Structural deflationary pressures remain significant, with global debt levels still very high. Meanwhile rapid innovation and political change are creating challenges for corporates, as well as opportunities****. It should also be noted that valuations aren't generally as

attractive as they were four or five years ago.

With all these considerations in mind we will aim - as normal - to strike an appropriate balance in the Evenlode portfolio between quality, resilience and value as 2017 progresses.

Hugh Yarrow
Fund Manager
22nd February 2017

Please note, these views represent the personal opinions of Hugh Yarrow as at 22nd February 2017 and do not constitute investment advice.

*Interestingly, a recent McKinsey study had a go at quantifying some key traits of long-termism with interesting results. It's worth a read: *Measuring the Economic Impact of Short-Termism* by Dominic Barton, James Manyika, Tim Koller, Robert Palter, Jonathan Godsall, and Josh Zoffer (<http://www.mckinsey.com/global-themes/long-term-capitalism/where-companies-with-a-long-term-view-outperform-their-peers>)

**Both have been Evenlode holdings in the past.

***As with Diageo, it was encouraging to see a much improved free cash flow performance from Glaxosmithline in the second half of 2016 as restructuring costs from the Novartis transaction begin to fade away.

****I discussed the challenges and opportunities that innovation is creating in my April 2016 investment view 'Disruption' (<http://evenlode.wiseinvestment.co.uk/news/evenlode-investment-view-april-2016>). In terms of political challenges, there was some initial discussion on possible US policy changes during the results season, but much is still conjecture at this point. In general, trade tariffs would be negative for companies exporting into the US (though most companies in the fund that sell products in the US market have US manufacturing facilities too). For the fund's US holdings reductions in the corporate income or repatriation tax rate would be clear positives. A capital repatriation tax holiday would be particularly positive for Microsoft and might lead to a special dividend, given most of its c\$100bn cash position is currently sitting in overseas bank accounts.