

# Evenlode Investment View

April 2020 – Operating through a world in lockdown

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Over the last few weeks, global stock markets have remained volatile, though they have recovered somewhat from the lows plumbed in the middle of March.

The short-term picture remains bleak with thousands of new coronavirus cases each day announced worldwide, and a significant proportion of the global population remaining at home. *'The Great Lockdown'* has led to significant areas of the world's economy either shutting down temporarily or operating at much lower activity levels than normal, and unemployment levels have soared (particularly in the US). Worries are now turning to the difficulties of extricating ourselves from lockdown without creating a 'second wave' of infections, and the longer-term scars that the crisis will leave on the global economy (which I will discuss later in this view).

Mr Market has though, at least for now, glimpsed some chinks of light at the end of the pandemic's tunnel. China has continued to return to a semblance of normality, and several European countries have begun to tentatively remove lockdown restrictions as new cases and hospital admissions begin to fall. Meanwhile, the level of fiscal and monetary stimulus announced to help plug the lockdown-gap in most regions has been huge. And looking further ahead, there has been positive news on antiviral therapies and vaccine candidates, with several now entering clinical trials.

As I write, Evenlode Income has returned -15.2% since the start of 2020, compared to -25.3% for the FTSE All-Share and -25.4% for the IA UK All Companies sector\*.

For interested readers, I have included a review of the first quarter (January to March) for Evenlode Income in the appendix to this investment view. This appendix also includes a discussion of the 2020 dividend situation for the market and the fund, which as I mentioned last month will be very challenging.

## Operating Through A World in Lockdown

Since the beginning of March, most companies have released Covid-19 related trading updates and we have been busy analysing these updates and speaking to management teams. The broad effects of coronavirus on the portfolio have, so far, been largely as discussed in my investment view last month.

Many of the holdings in the consumer branded goods, healthcare and digital sectors are relatively well insulated to both the lockdown-measures and broader economic fallout, and this forms a core bedrock of resilience in terms of the portfolio's cash generation. Procter & Gamble, for instance, announced organic sales growth of +6% in the January-March quarter, and management continue to expect sales growth of +4% to +5% for their full year results. As P & G management put it at results last week:

*"Consumption of our products is not likely to dissipate. In fact, the relevance of our categories in consumers' lives potentially increases. We will serve what will likely become a forever altered health, hygiene and cleaning focus for consumers who use our products daily or multiple times each day. There may be an increased focus on home, more time at home, more meals at home, more cleaning of homes, with related consumption impacts."*

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Unilever is more impacted than P & G given a portion of its sales are generated from out-of-home food consumption. However, approximately 80% of sales are through the supermarket and online channels and the company's exposure to categories such as soaps, hand sanitisers and surface cleaners will be helpful over coming weeks. Organic sales were flat in the company's first quarter (January-March).

Large software and technology firms such as Microsoft and Intel have noted a pick-up in demand for digital services (Microsoft Teams etc.) and IT infrastructure products (to increase server capacity, facilitate working-from-home etc.). Sage, though impacted given its customers are mainly small and medium-sized businesses, is helped by its recurring revenues and still currently expects to grow organic sales for the full year, though at a lower rate than previously expected. Though Relx has a trade exhibitions division, 87% of profit is generated from its more digitally-orientated subscription-based businesses. These divisions continued to grow in the first quarter and have only seen a limited impact from coronavirus so far. New healthcare holding Roche this week announced sales growth of +7% in the first quarter, and reiterated guidance of growing sales and earnings for the full year. Roche has infection and antibody diagnostic tests for Covid-19 and has moved quickly to increase production for both products. The company also has a promising combination therapy to help treat severe Covid-19 pneumonia.

As discussed last month, there are two holdings that are experiencing a larger short-term lockdown impact within these sectors: Diageo and Smith & Nephew. Once this immediate impact has passed, we expect both businesses to quickly return to their more normal patterns of steady, incremental growth. For Diageo, when lockdown comes to an end people will return to bars and restaurants in the US and Europe (as they already have in China). For Smith & Nephew, those surgeries that have been postponed during lockdown will still need to happen. There are also a handful of other companies in the portfolio that are normally quite resilient to economic conditions but have been specifically impacted by recent lockdown measures. The most notable are Informa and Compass, given the portion of their revenues generated from (respectively) trade exhibitions and workplace catering.

Then there are some holdings operating in more traditionally economically sensitive sectors (though these companies, by design, never represent a huge part of the portfolio). A few face very challenging operational conditions in the short-term and will need to hunker down to weather the storm (e.g. Howden Joinery, Hays, Page Group and WPP). Market-leaders in hard-hit sectors that emerge from this downturn in good shape will be well placed to improve their competitive position and return to healthy growth on the other side. They also potentially present very interesting valuation opportunities for the patient investor. However, this opportunity should be balanced with the short-term risks they are currently confronting. With this in mind, we have completed significant stress-test, liquidity and solvency analysis over the last few weeks across the portfolio. We have been very reassured by this work but we're equally not complacent and will continue to manage fundamental risk carefully within the portfolio.

## **Adaptability**

I have often discussed, over the years, how one of the nicest things about owning the shares of good quality, well managed businesses is their general habit of being able to incrementally adapt to

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changing conditions in the economy, the political environment and their own industries as time passes.

A strong culture of adaptation has been more valuable than ever this year, given an operational environment unlike anything seen before. We have been impressed with the speed at which companies have dealt with and adjusted to the issues at hand. Where deemed essential, operations have largely continued to run with new measures in place. Spectris, Smiths Group and Intertek, for instance, have all been able to keep the majority of their facilities open through the period on a 'business as usual' basis, whilst working hard to ensure they are complying with World Health Organisation guidance and keeping their employees safe. All of these companies, among other things, form an important part of the supply chain for vital medical devices such as ventilators and diagnostics testing kits.

A strong culture of adaptation will remain important over coming weeks and months. The operational environment will remain subject to quite dynamic levels of change, as will shifts in customer demand trends, habits and mindsets as life begins to get back to a 'new normal' post lockdown. I would note that companies operating in emerging markets are perhaps particularly well practiced at responding to unpredictable, dislocating shocks, given that these events can be quite regular occurrences in these regions, even at the best of times. Companies that have effectively digitalised their businesses over recent years will also be well placed to adapt quickly and flexibly.

## Good Stewardship

We have also been impressed at the thought that companies are putting into the health of their long-term franchise and the important role that they play in the ecosystem in which they sit: *the actions that companies take this year will be remembered for many years to come*. The following two factors will be of paramount importance:

- Retaining the resources and people required to pursue long-term growth, where possible.
- Helping staff, customers, suppliers and the wider community through this crisis.

On this second point, Unilever has been managed, over the years, with an eye to the long-term and pursues a 'multi-stakeholder' approach to running the company. True to form, management have been quick to free up 500 million euros of working capital specifically to support its smaller suppliers where necessary. The company has also quickly re-jigged its production lines to maximise the manufacture of products such as soaps, hand sanitisers, surface cleaners and basic food - donating more than 100 million euros of these products to healthcare systems and vulnerable individuals globally. It is difficult to measure intangibles such as these and they won't be easy to spot in a financial spreadsheet. But these incremental actions (now and always) add something important to the long-term health and reputation of a company from a multitude of perspectives.

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## The Shadow of The Crisis

No one knows quite how this crisis will unfurl from here. However, it is likely that life will in many ways begin to return to normal as we exit lockdown, and there will be a release of pent-up demand, at least initially. Then, antivirals and vaccines are likely to emerge, which should also help the mood.

However, this path may be rocky, and consumer habits will change, with many of these habits outlasting the proximate crisis. Health and hygiene will likely remain a key priority for instance, well after the peak of this crisis has passed. International travel may be slow to recover, people may work from home more often, and online shopping is likely to continue its inexorable rise.

The psychological scars are also likely to be significant. A brief scan of economic history demonstrates that ‘once in a generation’ downturns tend to happen more regularly than, well ... once in a generation. We have now experienced two in just over a decade, and consumers will inevitably want to spend less and save more in response. Higher levels of unemployment, borrowing and (potentially) higher tax rates will add to this sense of caution.

A similar psychological scarring will occur within the corporate sector, which is likely to lead to a desire for a greater margin of safety from both an operational and financial perspective. The zeitgeist will shift from ‘efficiency at all costs’ to ‘appropriate resilience’. Globalised just-in-time supply chains won’t seem as attractive after Covid-19, and the cheapest supplier may not always be the most reliable. There may also be some shift towards more localised production (a trend that had already begun prior to the crisis as a result of trade tariffs) and a higher level of investment in automation and digitalisation. Meanwhile, externalities such as pollution, waste and climate change will be taken even more seriously than pre-crisis as companies vigilantly scan the horizon for possible sources of risk in the future.

In terms of financial resilience, I have discussed many times over the last few years the rising levels of borrowing in the corporate sector across global markets, as cheap debt has been used to fund acquisitions and buy-backs to artificially ‘juice up’ earnings growth (and, *in extremis*, to fund unsustainable dividend payments). This move to more ‘efficient’ balance sheets will, in hindsight, appear questionable. At the market level, I suspect we will see a shift back to more financial conservatism and a subsequent retrenchment from large buy-back programmes and acquisitions, at least over the next year or two.

Many of these shifts may impact profitability in the corporate sector somewhat over the short-term, but should in many ways be viewed as a healthy development that will lower the stock market’s risk profile for the long-term investor. However, not all consumers and companies will stay prudent for ever! Many of the above lessons were learnt following the 2008/9 crisis and promptly forgotten over the subsequent decade. As seasoned financial market observer Jim Grant once put it, *in science knowledge is cumulative, but in finance it is cyclical.*

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I look forward to updating you on the portfolio over coming months. We will continue to emphasise financially strong, competitively advantaged businesses that we believe are well placed to ‘stay the course’ and grow cash flows and dividends over the long-term.

## Hugh and the Evenlode Team

23<sup>rd</sup> April 2020

Please note, these views represent the opinions of Hugh Yarrow as at 23rd April 2020 and do not constitute investment advice.

*\*Source: Evenlode, Financial Express. TB Evenlode Income B Inc shares. All figures total return, bid-to-bid, GBP terms - 31/12/2019 to 21/04/2020*

## Appendix: Q1 Review and Dividend Discussion

After a relatively quiet start to the year, global stock markets took a significant turn for the worst in the last week of February and March. The highly contagious nature of Covid-19 became increasingly apparent, as did the need for governments and societies across the world to take extreme measures to help contain and manage the subsequent public health crisis.

Market falls were broad-based, and particularly in the early part of the correction were relatively undiscerning. Evenlode Income fell -19.0% compared to a fall of -27.9% for the IA UK All Companies Sector and -25.1% for the FTSE All-Share.

Top Contributors	Contribution to Return	Top Detractors	Contribution to Return
Reckitt Benckiser	+0.17%	Informa	-1.95%
Microsoft	+0.11%	WPP	-1.33%
Roche	+0.07%	Compass	-1.07%
Kone	+0.00%	Sage	-1.05%
Intel	-0.02%	Smiths	-1.04%

*Source: Evenlode & Factset*

The most negative contributors were Informa, Compass, WPP, Smiths Group and Sage.

Informa and Compass’s revenues are both directly impacted by lockdown, given the portion of their revenues generated from (respectively) trade exhibitions and workplace catering. WPP is economically sensitive and therefore will see revenues fall as a result of the current economic contraction. We are reassured by the company’s strong balance sheet and liquidity position (particularly having just received significant cash proceeds from the disposal of its Kantar stake) and its variable cost base. Smiths Group is also economically sensitive, though its medical division is growing, and the provision of spare parts/servicing for critical infrastructure provides some stability elsewhere. Sage will see some impact from the economic follow-through of lockdown measures, albeit

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mitigated by the company's strong balance sheet and predictable, cash generative business model (with 88% of revenue recurring).

The best contributors during the quarter were Reckitt Benckiser, Roche, Intel, Microsoft and Kone. Reckitt has attractive category exposure for the current environment with health and hygiene brands such as Lysol, Dettol and Durex. Reckitt sales are generated through the supermarket, convenience and online channels, which remain open during lockdown.

Roche was a new holding during the quarter (see portfolio changes section below). Intel and Microsoft are financially strong market leaders that are well-placed to benefit from the long-term digitalisation of the global economy, an already entrenched structural growth trend that may well accelerate as a result of this crisis. Kone is another market leader with an excellent balance sheet, and also enjoys bedrock of recurring cash flow generated by its maintenance business.

## Portfolio Changes

As the coronavirus crisis developed, we completed a very significant amount of analysis, revisiting all the companies in the fund in the light of the new world we are living in, running downside-scenarios and analysing debt and liquidity where relevant (in terms of debt, the portfolio is helped by the fact that 18 of the 39 holdings have a net cash position). Most of the holdings that have debt are relatively resilient businesses, but it is important for us to have a clear, up-to-date picture of the debt profile and liquidity situation of each company in the fund, particularly those that will see some pressure on their cash generation over coming weeks.

We have not made any major changes to the portfolio. However, we have used cash to top-up several existing positions with a focus on more repeat-purchase business models and also built a new position in Swiss pharmaceutical company Roche in the first half of March. The holding offers a 3.3% dividend yield backed by resilient free cash flow yield and a net cash balance sheet. More generally cash flow resilience, balance sheet strength and liquidity will all be important characteristics for companies over coming weeks and months. With the initial sell-off in the market relatively undiscerning, it has been interesting in the last few weeks to see that these qualities are beginning to be recognised somewhat by Mr Market, as he slowly sifts through the rubble of what has been a dramatic correction.

## Dividends

2020 is shaping up to be a very difficult year from a dividend perspective, with many companies deciding to cancel/postpone a payment scheduled for the current lockdown period. The management teams and boards of many companies most impacted by the crisis are feeling that it is prudent and (from a social/political/reputational perspective) sensible to pass/cancel dividends that were due to be announced or paid during lockdown and look again at the situation later in the year. This is the case even for some companies that clearly have the balance sheet and liquidity to pay them.

The Evenlode Income fund won't be immune and in the short-term (i.e. the fund's financial year to February 2021) we expect the income stream to fall. For reference, cancelled/postponed dividends in

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the fund that have been announced (as at 22nd April) account for approximately c.25% of the dividend stream, which includes assumptions for certain companies where we expect they will also choose to pass dividends for the remainder of the year. Of the dividends passed in lockdown, based on management comments we expect a portion may be paid later in the year depending on how conditions look. However, given the unprecedented nature of the current lockdown situation, there may be some other companies that decide to cancel/postpone dividends during the next few weeks, which we will continue to update on.

Mitigating this situation somewhat is the fact that many of the fund's larger holdings are repeat-purchase businesses models, which provides some core resilience through this period. More generally, the portfolio is focused on market-leading businesses that we think will be able to endure this crisis and, in many cases, emerge with their competitive positions strengthened. This should bode well for free cash flow and dividend growth over the medium and long-term.