Evenlode Investment View

Wise Funds

AUGUST 2013 – FIELD NOTES

After a very strong July, global stock markets have spent the first two weeks of August in consolidation mode. The second quarter reporting season is now largely over and almost all Evenlode holdings have updated the market. Below are some 'field notes' from the latest results season which give an update on three significant areas for Evenlode - consumer brands, digital information and healthcare.

Consumer Brands

Operating results remain predictably solid for the consumer brand franchises held in the portfolio, which represent 34% of the current fund. Our three largest holdings in this area (representing nearly 20% of the fund) all reported results last month and their sales growth for 2013 compared with 2012 is summarised below:

	2013 Sales Growth*	**2012 Sales Growth***
Unilever	+5%	+7%
Reckitt Benckiser	+6%	+5%
Procter & Gamble	+3%	+3%

.... and here is their 2013 emerging markets sales growth compared with 2012:

	2013 EM Sales Growth*	**2012 EM Sales Growth***
Unilever	+10%	+11%
Reckitt Benckiser	+8%	+9%
Procter & Gamble	+8%	+8%

As can be seen, despite the well-documented slowdown in emerging market economies, rising demand for life's little luxuries continues to fuel good demand growth in this diverse group of geographies. Industry veteran A.J. Lafley, re-appointed as CEO of Procter & Gamble in July, reiterated the long-term opportunity at P & G's recent results presentation:

All you have to look at are demographics and economics and you can see there is a long arc of growth for this industry and a big opportunity for our company. Since the Berlin Wall came down and Guangzhou markets started to open up for us in the late 1980s, we have grown +9% a year compound in developing markets and +14% in the last ten years. We've grown at +10% in the BRIC markets this last year. That growth is there for a lot of the players in this industry, because a lot of it is still tailwinds. It's babies being born, households forming, incomes rising. All this will continue to drive the high market growth.

And the opportunity is not just about market growth. A common theme amongst these companies is their confidence in the potential for steady improvements in profit margins over the medium and long-term. They are benefitting from numerous efficiency gains as both fixed costs and common operational expenditures (R & D, IT systems, finance, marketing, packaging design, procurement, manufacturing etc.) are spread over an increasing number of geographies and a larger revenue base (which continues to grow thanks not only to unit volume growth, but also thanks to pricing trends as consumers move to premium products). While some of these efficiency gains can be reinvested back into the business for future growth, the remainder drop through to profit increases.

Here are a few snippets from recent results on the subject of margin improvement:

1) P & G have converted sales growth of +8% in their top ten developing markets into profit growth of more than +35% over the last year. For the total company, P & G expect to convert +4% sales growth into earnings growth of +11-13% over the next year thanks to operational leverage, efficiency gains and share buy-backs.

2) Diageo have converted +11% sales growth in emerging markets into +18% profit growth over the last year. As Diageo management noted at their full year results last month, *sales from emerging markets now have a scale from which we can leverage our marketing and distribution network to deliver consistent margin improvement*. For the company as a whole, sales growth of +5% converted to +11% earnings growth over the same period.

3) SABMiller's Chinese joint venture is the largest beer company in China, with 22% market share – twice as large as the next biggest competitor. Economies of scale and the move to premium products are starting to benefit margins. Helped by China, SABMiller expect their Asia Pacific business to grow sales at approximately +8% per annum over the medium term, and profits at +14-15%. For the company as a whole, sales growth of +7% converted to earnings growth of +11% over the last year.

4) Unilever CEO Paul Polman had the following to say at results last month on Unilever's turnaround strategy: *This is*

a journey that needs to be completed in stages. The first stage has got Unilever back to being a growth company. We have now moved to the second phase of the journey – getting the balance right between top-line growth and margin improvement. As an example, three quarters of Unilever's product pipeline will now come to market at a higher gross margin than the current group average.

These positive earnings trends are also translating to dividend growth. The most recent dividend increases for the companies mentioned above were as follows:

	Dividend Growth
Procter & Gamble	+7%
Diageo	+9%
SABMiller	+11%
Unilever	+10%

As I said last month, we are under no illusions – there will be plenty of bumps along the road for these businesses (such as the current weakness in emerging market economies/currencies), and they will periodically fall in and out of favour with investors. But we look forward to benefiting as their attractive, hard-to-replicate economics unfurl over the longer-term.

Digital Information

Media and technology companies make up about 23% of Evenlode. The common thread across all of these businesses is their proficiency in producing and analysing digital information. '*Big Data*', the ever-increasing volume of data in the digital universe, is a well recognised trend. The amount of data in the digital universe grew nine fold in the last five years and is expected to increase fifty fold by 2020.**. However, of more economic significance for these stocks is the increasing demand from customers to harness this data in ways that make their businesses more effective and efficient. As Eric Engstrom, chief executive of Reed Elsevier puts it, *we provide solutions that typically represent less than 1% of our customer's costs but have a meaningful effect on the other 99% of their business.*

Gartner recently predicted that, by 2020, 75% of employees in an average organisation will have access to and utilise data analytics software and services. This compares with only 10% today***. Companies such as Sage, SAP and Microsoft (in the provision of enterprise application software/digital infrastructure) and media companies such as Reed Elsevier (in the provision of data analytics and digital content) are well positioned to benefit from this growing demand for analytics and digital content. These software and services businesses become embedded in the everyday workflow of their customers. As a result, switching costs are high and market share tends to evolve steadily. These favourable economics lead to pricing power and a high level of recurring revenues (in stark contrast to the IT hardware industry which is regularly faced by cycles of commoditisation, pricing pressure and disruptive technologies). As an example of this customer loyalty, SAP is winning 9 out of 10 Cloud contracts for customers who already have SAP installed on-premise. SAP now has the biggest presence in the Cloud, despite the prevalence of application software start-ups that have specifically targeted Cloud offerings in recent years. Along similar lines Sage, at its recent results, noted that renewal rates have remained steady at 81%, and recurring revenues have moved from 67% to 70% of revenues. This is testament to the reluctance of Sage software users to switch provider - their software becomes a habitual, intricate part of the daily life of its users.

Again, like the consumer branded businesses, the scope for margin improvement thanks to operating leverage is clear. Incremental sales for digital business models come with low incremental costs. The big expenditures are in developing software applications, databases, content etc. Once these activities have been expensed, each incremental sale drops through to the bottom line. As Reed Elsevier move increasingly away from physical publishing (which now represents less than 20% of the overall business), they have managed to convert revenue growth of +3% into earnings growth of +11%. Pearson is not as far through the transition to digital services as Reed (with slightly over 50% of Pearson's sales now digital) and recent investments to accelerate the transition are weighing on profitability. The prize, however, remains huge – clear global leadership in digital education, a sector set for very significant demand growth over the next decade, but with a limited requirement for working capital investment or capital expenditure.

Healthcare

Our healthcare holdings (Glaxosmithkline, Johnson & Johnson, Astrazeneca and Smith & Nephew) represent 22% of the fund, and all have updated the market over the last month. The sector continues to appeal to us. Much has been made of the patent cliffs that pharmaceutical stocks have faced. However, several developments suggest that this drag will begin to wane over coming years.

First, despite high profiles patent expiries for the industry over the last ten years, fundamentals have remained surprisingly good and market shares have been fairly stable. This is a reminder of the high barriers to entry this industry enjoys, thanks to integrated knowledge bases, entrenched distribution networks and economies of scale. The most significant headwind the sector has faced over the last decade has been a valuation headwind not a fundamental one. Glaxo and J & J, for instance, have grown their earnings by an average of +3% and +9% a year over the last ten years, but their price-to-earnings (PE) multiples have fallen from over 30x ten years ago to 13x and 16x today. More generally, global pharmaceutical revenues grew from $400bn to $800bn from 2000 to 2010****. It seems a reasonable assumption that growth rates in the healthcare industry will remain positive: the shift to an increasingly ageing population continues, as does the resulting growth in arthritic hips, clouded lenses, furred-up arteries and more generally the age-determined conditions such as heart disease, stroke and cancer.

Second, in terms of Evenlode holdings, a significant patent cliff is now only left for AstraZeneca. Johnson & Johnson and Glaxo's drug pipelines are looking far more healthy than they did five years ago. Glaxo's internal rate of return from research has increased from 7.5% to 12.5% since 2009, and management are hoping to reach a 15% return in coming years. Here are two recent comments from Glaxo CEO Andrew Witty that give a sense of the renewed optimism:

'I've worked in this company since 1985. I don't think it's ever been more exciting from an R & D perspective. At every level we are seeing some very exciting stuff coming out of our R & D organisation'.

'In terms of pipeline it's starting to look really exciting. There is no question that in terms of both numbers and potential scale of opportunity we've never had a portfolio like this at GSK, and I'm not sure too many other companies have ever had it either'.

Third, the scientific shift from chemistry to biology in the world of drug discovery and development is beginning to have a positive impact on the industry's economics. In important areas such as cancer treatment, biological therapies represent the most significant conceptual advance of the last 30 years. They now represent an increasing proportion of pharmaceutical pipelines (50% of the molecules in AstraZeneca's pipeline, for instance, are biological therapies). These biologicals tend to have stronger, longer lasting patents, are less easily copied ('generisised') once patents expire, and they target a greater number of more specialised treatment areas (thus mitigating the 'all or nothing' risks of the blockbuster model).

In The Waiting Room

Having pointed out the positives in our healthcare holdings, their drawbacks should not be omitted from this discussion. As intangible asset businesses with high and consistent returns on equity they fit the bill in terms of our investment approach. Their high barriers to entry and relative stable market positions are also attractive. But they have a significant disadvantage when lined up against other intangible asset businesses in that their 'brands' have a more limited shelf-life, notwithstanding the shift to biological therapies. Once a drug's patent expires, pharmaceutical companies need to find a new replacement 'brand': unlike say, consumer staples businesses where brands such as Gillette and Johnnie Walker persist for decades with only a limited need to evolve the product over time. Also, whilst we expect industry growth to remain attractive, we are realistic about the growth potential of these already large businesses. However, in the current market we think their valuations more than compensate for these economic drawbacks.

To generalise, 'large and stable' (or more pejoratively 'dull and boring') is where we are seeing the most interest. The current bull market is leaving few stones unturned, and many of the more 'exciting' businesses in our investable universe have come to trade on valuations which we believe leave little room for disappointment. This month my colleague Ben Peters has written a piece *In The Waiting Room* which gives some perspective on our current positioning in the context of our investment process. His view is available here: *http://www.wiseinvestment.co.uk/2013/08/in-the-waiting-room/*

Please do get in touch if you have any questions, and enjoy the rest of the summer!

Hugh Yarrow
Investment Director
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Please note, these views represent the personal opinions of Hugh Yarrow as at 19 August 2013 and do not constitute investment advice.

*Organic, constant currency. Unilever and Reckitts figures are taken from half year results to June 2013, Procter & Gamble figures are taken from full year results to June 2013.
**IDC Digital Universe Study 2011 - http://www.emc.com/collateral/demos/microsites/emc-digital-universe-2011/index.htm
***SAP Sapphire Now conference 2012