Evenlode Investment View

May 2014 – On The River Bank

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It might not feel like it but we are not far off the half way point for 2014. The overall stock market has made fairly pedestrian progress since the start of the year, up +2.1% year-to-date as I write, but there have been plenty of cross-currents under the stock market's surface. In the first quarter, worries were focused on a slowdown in emerging markets and the sharp depreciation of emerging market currencies. More recently, the shares of many UK small and medium sized companies have started to underperform. As a result value is beginning to steadily seep back into several of the smaller franchises in our investable universe, not least into some of the stocks we have sold over the last eighteen months. So far these doors have only opened a crack, but we are watching developments closely, aware that value *might* reappear again quickly in some of our favourite names. If this is the case we will be ready to shift the portfolio accordingly.

For now (regular readers can yawn here) the fund remains almost exclusively exposed to large, asset-light compounding businesses in sectors such as healthcare, consumer branded goods, media and technology. Below is a whistle-stop tour through these key sectors for the fund, and my thoughts on recent developments.

Healthcare

It must be a bull market! The year began with a volley of deal-making activity and this upswing in animal spirits has continued over the last month, not least in the healthcare sector with several huge takeover bids and deals announced. This included Pfizer's £70bn approach for Astrazeneca (which at the time of writing hangs in the balance) and *on the same day*, somewhat bizarrely, Glaxosmithkline and Novartis announcing a massive three way asset swap.

Glaxo and Novartis are both holdings in Evenlode, with Glaxo a particularly important holding for the fund currently. This deal looks well thought through to us by both parties. From Glaxo's perspective, it is a clear signal from chief executive Andrew Witty and his team, if one were needed, that their priority is sensible capital allocation rather than ego-driven empire building (not an unknown characteristic in the executive world!). Glaxo will sell its cancer portfolio to Novartis, in return for certain vaccine and consumer healthcare assets and a slug of cash, which will be returned to Glaxo shareholders as a £4bn special dividend next year (representing approximately 5% of the company's current value). Nearly three-quarters of the new-look Glaxo will consist of durable, market leading franchises in vaccines, consumer healthcare, respiratory therapies, and HIV therapies. Glaxo's consumer healthcare business will be the world's largest over-the-counter healthcare business which has a reassuring repeat-purchase resilience to it (think Aquafresh, Panadol, Sensodyne, Tums, Zovirax and even Horlicks!). So does Glaxo's vaccine franchise - a business with more than 50% share of this steadily growing global market*. In the current investment environment, where decent cash-flow streams have become more difficult to find at reasonable prices, we think Glaxo stands out.

Turning to Astrazeneca, it is nice to see this stalwart of the portfolio having a few months in the sun (whether or not the Pfizer deal ends up happening). It has been a holding in the Evenlode portfolio since 2009** and although unfashionable for most of this period has still been able to compound total returns at an annualised +18% versus +11% for the UK market. Our investment in Astra has always been based on the premise that a combination of internal drug development, in-licensing and bolt-on acquisitions would slowly refill Astra's product pipeline and ultimately provide the business with replacement cash-flows for their established products that are coming off-patent. It has been good to see steady progress on this pipeline rebuild, particularly since the arrival of Pascal Soriot as chief executive. Conservative assumptions for Astra's future cash-flow potential suggest good forward cash returns for Astra shareholders at current levels. On our estimates, however, Pfizer's latest bid is well pitched, at approximately fair value.

As a bookend to this discussion on pharmaceuticals, I think it is just worth reiterating three key planks to our positive view on the investment merits of this sector which I outlined last summer:

1) The industry enjoys high barriers to entry thanks to strong intangible assets which include integrated knowledge bases, entrenched distribution networks and economies of scale.
2) The most significant headwind the sector has faced over the last decade has been a valuation headwind

not a fundamental one. 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.
3) 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 portion 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).

Elsewhere in the healthcare sector Smith & Nephew, another Evenlode holding, has performed well over the last few weeks thanks to a deal between two of its competitors, Zimmer and Biomet. The high valuation multiple for this deal led to a strong rally in Smith & Nephew shares. We have been using this strength to start reducing the holding on valuation grounds. As a result, it is no longer a top ten holding.

Consumer Branded Goods

We don't want to manage our business on the basis of one month or even by quarters. In the grand scheme of things these things will even out over time.

Rahesh Kapoor, Reckitt Chief Executive (in response to analyst questions on how trading had been in March relative to January and February).

The consumer branded goods stocks have been plodding on through adversity this year, facing several headwinds including the recent strength of sterling which is having a significant translation impact on overseas earnings. Furthermore, demand has slowed in developing markets (though growth rates remain attractive) but developed markets have yet to see much pick-up despite an improvement in economic leading indicators. Unilever's management summed this up in reference to the US economy:

There are certainly positive signs in the economy itself. But for most ordinary people, it still feels like a recession, and the gap between the low and high incomes continues to grow. There are some signs of improvement in our markets, but they are tentative signs and they're still very, very muted at this point in time.

We view these headwinds as part of the *Sturm and Drang* that patient long-term investors need to sit out. It is the grand sweep of long-term growth and the massive brand strength and diversification of these businesses that keeps us interested. Unilever's products are sold in more than 8 million outlets around the world, and they plan to add another 300,000 to this during the course of 2014. The average spend per capita on repeat-purchase branded goods in emerging markets is between a tenth and a twentieth of the level in the developed world - as consumption rises in these regions over the next ten or twenty years cash generation will too.

Take two, somewhat randomly chosen brand examples - Corona and KY Jelly. These are two very different brands (though perhaps consumption of one leads to use of the other?!) that two Evenlode businesses (AB-Inbev and Reckitts) have recently added to their portfolios. Will the global population be consuming more of these brands in ten years time and will they retain their pricing power? It seems likely to us that the answer to both of these questions will be yes.

Having said all this we remain, as always, valuation minded, and some stocks in this sector have had a very strong bounce back since the lows of January/February. So, for instance, we are pegging our exposure to Unilever back (which peaked at 9.5% in February) to slightly lower levels.

Media and Technology

These holdings broadly deal in the provision of information content and the analysis of information and data. Both our media and technology holdings are undergoing transitions. In technology holdings such as Sage, Microsoft and SAP's case it is the transition from on-premise software to online (i.e. cloud) software. This shift is happening at different speeds depending on the type of company and the sector they are in. In my view it will take more than five years (possibly more than a decade) until this trend is fully played out. While this shift comes with some disruption and new competition (as I mentioned last month) it also comes with some benefits. Look, for instance, at the way Microsoft Office 365, the new subscription model for Word, Excel etc, has been taking off. In the short-term it means a little less upfront revenue, but in the long-term it means a higher quality earnings stream and a stickier customer base. Similarly, Sage have approximately two million customers that currently pay them recurring revenues (subscription, maintenance and support), making up nearly two-third of Sage's revenue. But there are another *four million* customers that have bought from Sage in the past, and in many cases still use Sage software - but from whom Sage do not currently receive revenue. The opportunity to bring these customers back into the fold is significant. As Sage put it at recent results *this is a big opportunity for us and we are pretty much unique in Europe in terms of the size of our installed customer base versus our direct competitors*. So there are opportunities as well as threats that come from being the incumbent industry supplier.

In the case of media holdings such as Reed and Pearson a somewhat analogous transition is happening - in this case from physical publishing to digital content and services. Reed's business is now less than 20% physical publishing. Pearson is less far through the journey with 40% exposure to print, though this compares with 60% five years ago and they are targeting less than 30% exposure in 2015. While many investors are very negative on Pearson, we are prepared to give this educational franchise the benefit of the doubt. So far the signs are encouraging that the shift to digital services has not come at the expense of pricing power. The number of textbooks sold by Pearson in the US last year fell -8% but the number of MyLab subscriptions (a digital service they offer) rose. And crucially, overall revenue per college enrolment remained stable (in fact it rose slightly to +1%). If Pearson can continue to migrate on the basis of these economics they will emerge with a resilient business model in the brave new digital world. And as with the software companies, this new world has some economic advantages - higher recurring revenues, a lower marginal cost of sales and less need for holding inventory. Just over 50% of Reed Elsevier's revenues now come from subscription. And in the five years to 2015, Pearson will have halved their global warehousing capacity and significantly reduced working capital requirements. To summarise, these complex transitions are not without risk, but there are counterbalancing factors that shouldn't be forgotten.

On The River Bank

You may have noticed that, after nearly five years in business, Evenlode now has a logo (don't all get too excited at once!). Ben and I have chosen an Otter (Eddy the Otter). Otters are curious, active hunters, and still live and fish on the banks of our local river, the Evenlode (which joins the Isis at Oxford and then flows on into the Thames). Ben and I continue to stalk along our metaphorical river bank, albeit looking at fewer compelling opportunities in the current market than we saw back at the fund's launch in 2009.

Hugh Yarrow
Investment Director
May 2014

Please note, these views represent the personal opinions of Hugh Yarrow as at 21 May 2014 and do not constitute investment advice.

*Glaxo has also dominated the respiratory therapies industry for the past 30 years and looks set to for at least the next decade thanks to its current portfolio, and is the number 2 globally in HIV therapies.
**Our initial purchase price for Astrazeneca was £28 and we have held it at various different weightings since then. It is currently a little over 3% of the fund - we actually reduced our exposure in the first quarter on valuation grounds (hindsight is the perfect science!). Incidentally, we have analysed the proposed Pfizer/Astra deal in some detail and, we were somewhat surprised to find that it looks like a *reasonably* sensible move from Pfizer (not always the case for multinational mega-mergers). So perhaps this is a sign that we are not too far into the silly season on the deal-making front?
***_The Rise and Fall of Modern Medicine_, Dr James Le Fanu, Abacus (2011)