Evenlode Investment View

Wise Funds

NOVEMBER 2012 – NOTES FROM THE FRONT LINE

Markets weren't sure what to do ahead of the US election, but since the month end they have moved downward, in a volatile fashion. One might have thought the re-election of Obama, and the corresponding likelihood of a continuation in loose monetary and fiscal conditions, would have been received well by markets (at least in the short-term). However, thoughts have turned to the coming problem of the US 'fiscal cliff' – the potential impact on the US economy of a looming reversal of various tax cuts and spending programmes that are due to expire in 2013.

On a more optimistic note, leading economic indicators – globally – have been turning up in recent weeks, as falling inflationary pressures begin to make life easier for consumers and businesses again. So we have a situation, similar to that in the second half of 2011, where short-term cyclical positives are pushing in one direction and on-going structural negatives are pushing in another. These cross currents make it harder than ever to make bold predictions on the economic front.

Meanwhile, back in the more mundane world of company fundamentals, most of the fund's largest holdings have updated investors over the last few weeks, and we have been busy digesting them. In general these results, in stark contrast to the feast/famine mentality of Mr Market, have been reassuring and steady (or you might say dull and boring!) Below is an update on three key areas for the Evenlode fund – global brands, professional information and healthcare.

Global Brands

For the global branded businesses we hold (Unilever, Reckitts, P & G et al) a strong regional pattern has emerged this year – the US is OK but tough, Europe is difficult, China is slowing, and growth elsewhere is generally good, but very mixed. In the context of this patchy operating backdrop, geographical diversity is proving a valuable asset.

Our three largest consumer staples holdings (representing more than 20% of the fund) all reported results last month and total growth in sales for the year so far, as well as growth in emerging market sales, are summarised below*:

Stock	Growth Rate 2012	EM Growth Rate 2012
Unilever	+7%	+12%
Reckitt Benckiser	+4%	+10%
Procter & Gamble	+2%	+7%

Unilever have talked for some time about the importance of the 'Next 13' group of emerging nations that along with the BRIC nations will be crucial in driving long-term growth (these include Indonesia, Philippines, Nigeria, South Africa, Argentina, Egypt, Mexico, Vietnam, Pakistan, Bangladesh, Turkey, Thailand and Poland). This broad diversity helps explain the continuation of robust growth for Unilever et al, despite the recent slowdown in BRIC (and particularly Chinese) economic growth.

It's not just about sales growth from these newer markets either – it's now about operating leverage too. This month Procter & Gamble said they expect profit from their top ten emerging markets to increase by +35% for the year as margin begin to improve. Procter owns an excellent portfolio of brands, with Gillette and Pampers in particular being two of the most appealing repeat-purchase franchises in the world. After significant investment in developing markets in recent years, the profit-related benefits of expansion are only just beginning.

More than 55% of Unilever's sales now come from emerging markets. For P & G and Reckitt, it's approximately 40% (and Reckitt have a publicly stated target of surpassing the 50% mark by 2015). These percentages have been steadily growing over the last few years.

In this context, it's worth noting the value that both Mr Market and private buyers are willing to attribute to the pure, emerging market businesses in this sector. Unilever's Indonesian and Indian subsidiaries, for instance, trade on 30x and 27x EV/EBITDA* respectively. BAT's Indian associate trades on 20x, and Diageo recently bought a minority stake in Indian business United Spirits Group for 20x. There is, of course, an element of takeover premium (potential or actual) built into these valuations but even so, the valuations of Unilever, P & G and Reckitt (all trading at 10-11x EV/EBITDA**) look extremely pedestrian in contrast. And spare a thought for the developed market businesses – having more mature businesses in your portfolio does have plenty of advantages (years of accumulated expertise and knowledge, aspirational brands with great heritage, strong cash flows that can help accelerate investment into faster growing markets, etc., etc.)

Professional Information

Another important theme in the Evenlode portfolio is the management and organisation of information for businesses. Examples in the fund include Reed, Experian, Sage, Microsoft, ITE Group and Euromoney. Although some are classed as 'media' stocks, some as 'support service' stocks and some as 'software' stocks, in my view these businesses share several key dynamics.

Services include credit checks for loan applications, software that manage consumer purchases online, digital marketing, data analytics for insurance companies, the analysis of public records for police forces, trade exhibitions, accounting software, and cloud computing services. All the above provide critical functions for businesses and institutions, helping to improve performance and/or efficiency. As Eric Engstrom, the chief executive of Reed Elsevier, recently put it '*the solutions we provide often cost less than 1% of a customer's cost base but can have a significant impact on the other 99%*'. Most of these solutions also relate to digital information. The need for businesses to manage, store, secure and analyse digital data is growing fast (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.***)

These critical services are not easy for new entrants to replicate. They all require an embedded, trusting relationship with customers, and most of them require some sort of intangible asset with significant complexity (databases, networks of information, sophisticated analysis, software etc.) Consider the following statistics, for instance:

1) Reed's Risk Analytics business has the most comprehensive public record database in the US, containing more than 30 billion records. As Reed management recently put it, 'public records is kind of a euphemism – we have more information than the public records do'.
2) Reed's Elsevier business receives 1 million article submissions a year, of which 300,000 are published.
3) Experian maintains 19 consumer credit databases globally with information on 740 million individuals, and 14 business credit databases, with information on 70 million businesses.
4) Renewal rates for stands at trade exhibitions typically run at 75% or more.
5) Renewal rates for Sage's software subscriptions run at more than 80%.

Another benefit for all these assets is that, being intangible, they are able to create incremental growth with a low investment requirement. Cash generation for these businesses is correspondingly high.

Reed and Experian have both updated the market over the last month and underlying growth for 2012 have been healthy so far (+4% and +14% respectively). Experian's performance has resulted in a rising valuation and we have reduced our exposure accordingly. However, Reed Elsevier looks very interesting. After a long time out of favour, the shares remain on an attractive valuation and the company remains a top ten holding. In my view Reed's portfolio of professional media assets should be able to grow steadily over the medium term – particularly given that 80% of Reed's sales now come from digital services.

Healthcare

While the global brands and professional media assets held in the portfolio are in something of a sweet spot, our healthcare holdings have been out of fashion this year, as illustrated by share price falls for GlaxoSmithKline and Smith & Nephew in particular. This has partly been due to investor psychology (their perceived 'defensive' qualities did them no favours as Mr Market looked to take on more risk over the summer). However, these businesses are also at the sharp end of European (and to some extent US) austerity programmes, as governments look to get better value for money from medical suppliers. As a result they are operating in slower growth markets than existed prior to the recession of 2008/9.

However, these are businesses with considerable investment attractions. They all possess a network of intangible assets (distribution networks, research capabilities, patents etc.) that allow them – even in the currently difficult circumstances – to generate high and returns on invested capital, high cash-flows and growing dividends (witness, for instance, Smith & Nephew's recent +50% rebasing of its interim dividend).

And the medium-term opportunity looks good. The global pharmaceutical market is expected to grow from $950m this year to $1.2 trillion by 2016 due to both the demographic effect in developed nations and continued strong

Wise Funds

growth in developing markets. Even now, fundamentals are by no means universally bad. Johnson & Johnson's pharmaceutical division, for instance, grew sales by +11% in the third quarter, the 10th quarter of consecutive growth, thanks to a significant improvement in J & J's research and development productivity.

It has become increasingly clear to the management of healthcare companies that chucking a wall of money at R & D is not a sustainable business model. The focus is turning instead to capital allocation and productivity. As Pascal Soriot, Astrazeneca's new CEO said recently:

"Scientific leadership is not about spending lots of money, it's about being productive. My priority is to build an R & D organisation that is one of the best and most productive in the industry. I'll only start increasing R & D investment when productivity has improved."

Glaxosmithkline were in a similar position to Astrazeneca a few years ago, with a product pipeline that needed to be filled. But new management's focus on capital allocation and productivity has meant that products are surviving better to market and the cost per product is falling. 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. This focus on productivity has had a very positive impact on Glaxo's pipeline, Consider this comment from CEO Andrew Witty on a recent conference call.

"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. That's a key piece of our optimism for the next few years, built on top of what we increasingly think is, except Europe, an extremely solid set of platforms in our growth businesses and an extremely solid and stable American business."

I believe that GSK is at an inflection point – the headwinds of the patent cliff that the business has been through over the last few years are beginning to wane, while the tailwinds from their strong pipeline should start to show themselves towards the end of 2013. Some patience may be required given the current uncertainties in Europe but in the meantime, a well-covered 5.7% yield growing at +6-7% means we get paid to wait. Similar arguments apply for our other healthcare holdings. Desirable economics and medium-term growth potential are being masked by tough industry headwinds.

Watching and Waiting

"All men's miseries derive from not being able to sit in a quiet room alone"
Blaise Pascal

There are some very high quality businesses in the current portfolio. All of them are asset-light business models that generate high returns on capital without needing much debt. Most of them are also globally diverse franchises that pass the 'toothpaste test' –selling products and services that are used by millions of customers on a daily basis. At current forward cash returns, these businesses should in my view produce attractive long-term returns on both a relative and absolute basis.

Market volatility has been picking up over the last few weeks. If this trend continues, it will create new opportunities. We are working hard, as always, to not only follow the companies we hold in the fund (32 currently), but also to closely follow those companies that we would include in the fund at more attractive valuations and dividend yields (of which there are just over fifty). We watch and wait with interest….

Hugh Yarrow
18th November 2012

Please note, these views represent the personal opinions of Hugh Yarrow as at 18 October 2012 and do not constitute investment advice.

*Source: Oriel Securities
**Source: Cannacord Genuity Quest
***IDC Digital Universe Study 2011 - http://www.emc.com/collateral/demos/microsites/emc-digital-universe-2011/index.htm