Evenlode Investment View

September 2014 – Some Long-Term Themes

EVENLODE
INVESTMENTS FOR LIFE

My Lord, but the market for noise is a lucrative one these days
David Rosenberg

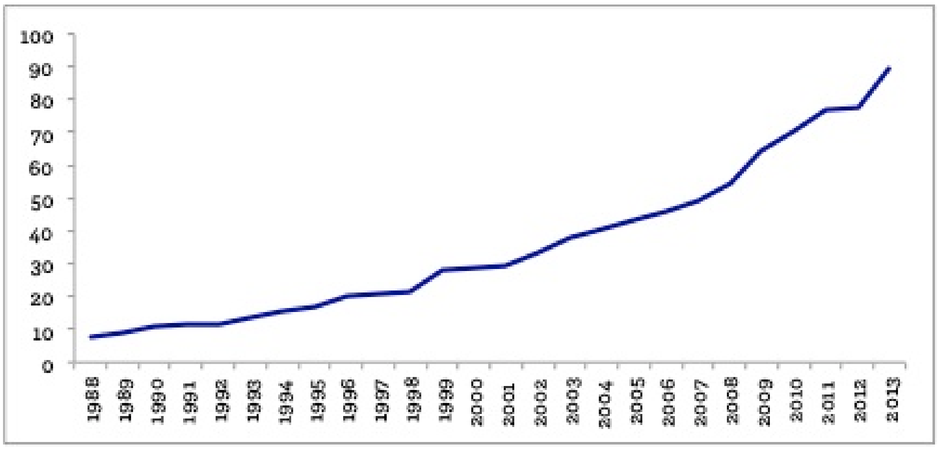
There's been no shortage of big picture uncertainties (both geopolitical and economic) to worry about this year: a very cold winter in the US; the threat of war with Russia and ISIS; China's dramatic slowdown; a more general slowdown in emerging markets; volatility in currency markets; a European economy flirting with recession and deflation; falling commodity prices; an uncertain monetary policy environment; the Scottish Referendum and its implications on UK politics over coming months and years.

The more these big picture uncertainties hang over financial markets, the more 'noise' they create. Share prices wobble around, opinions quickly change, trends don't last. Stocks act more as paper conduits for people's angst than as fractional shares in real businesses. Take our largest holding, Unilever, possessor of one of the most stable profitability profiles in the UK market. In the last couple of years, Unilever has been described by the investment community as all of the following things:

1) A 'value' stock
2) A 'quality' stock
3) A 'growth' stock
4) A 'defensive' stock (good)
5) An 'expensive defensive' (bad)
6) An 'inflation linked bond' (good)
7) A 'bond proxy' (bad)
8) A megacap (boring because small and mid caps are where the excitement is)
9) A megacap (good place to hide because small and mid caps are now underperforming)
10) A great way of getting emerging market exposure
11) A stock to avoid due to its emerging market exposure
12) One to buy ahead of next quarter's strong sales number
13) One to sell ahead of next quarter's weak sales number
14) A stock to avoid due to the impact of a strengthening pound on its global earnings.
15) A way to play the possibility of a 'yes' vote in the Scottish Referendum due to the impact of a weakening pound on its global earnings.

Not bad multi-tasking for a global portfolio of tea bags, ice cream, soap, shampoo and deodorant!

The stock itself, of course, never knows who owns it, or what the people who are buying (or selling it) are thinking. Over the long-term, the micro-economics of this business (strong brands, pricing power, repeat-purchase goods, economic resilience, high profitability, slow-moving and consolidated industry structure, global diversification) have helped it grind out a quietly rising stream of dividends – *through all the noise*. The chart below shows Unilever's dividend progression since 1988 (pence per share), as far back as the Factset machine will let us go:



Despite this track record of dividend growth over the years (+10% p.a. since 1988), the stock still trades today on an attractive starting dividend yield of 3.7%.

Some Long-Term Themes

As I have said before, we think *micro-economics* and *valuation* are the most important ingredients for our investment approach. We like to find quality companies capable of long-term dividend growth (such as Unilever) and buy them when they are attractively valued. *Quality and value are our belt and braces.* We don't think spending lots of time worrying about what interest rates will do next month is particularly helpful.

It's worth stressing though, that whilst we try our best to tune out the short-term noise, we definitely don't ignore bigger picture considerations. We pay close attention to them - structural growth can be very helpful in augmenting long-run dividend growth. This month I'd like to lay out a few thoughts we have on this front. Below are some broad long-term themes that feature heavily in the Evenlode portfolio, and that I believe should work as a useful tailwind over the next decade. I have also included some stock examples from our investable universe (stocks in italics are current holdings). These companies give investors an asset-light, cash generative exposure to the areas mentioned. Think of them, in very simplistic terms, as royalty streams on these themes - they have an ability to benefit from (and invest in) this future growth while continuing to generate strong excess cash flow.

Pharmaceuticals and Consumer Healthcare

In my view a combination of innovation, demographics, and increasing emerging market healthcare spend will provide a backdrop of good growth for both pharmaceutical and consumer healthcare markets over the next few years. In the pharmaceutical sector, recent developments in biotechnology (such as immuno-oncology) look particularly interesting and are helpful for the industry's over-arching economics. These biologicals tend to have stronger, longer lasting patents, are less easily copied ('generisised') once patents expire, and target a greater number of more specialised treatment areas (thus mitigating the 'all or nothing' risks of the blockbuster model).

Stock Examples: *Glaxosmithkline, Astrazeneca, Reckitts, Johnson & Johnson, Novartis*, Smith & Nephew, Sanofi, Roche.

Digital Information and Software Analytics

There is an exponential amount of data being created - the digital universe is more than doubling in size every two years (current size: 4.4 trillion gigabytes!)*. As an increasing number of physical objects join the internet, this is creating even more data. Managing this information and using it to gain useful insights and improve productivity is becoming increasingly important for businesses, institutions and consumers. It can deliver real value and cost efficiency. Gartner predict that by 2020 more than 75% of employees in a typical business will have access to analytics software**. Today the figure is less than 10%. Media companies, software companies and technology consultants have plenty of opportunity to help their customers navigate and capitalise on this data explosion.

Stock Examples: *Sage, Pearson, Reed Elsevier, Microsoft, Informa, SAP, IBM,* Accenture, Experian, Euromoney, EMIS, Fidessa, Wolters Kluwer, Daily Mail, Axel Springer.

A Growing Global Middle Class

Only 30% of the world's population earns more than $10 a day. Over time, this number will increase and with it global demand for all the little luxuries we take for granted in the developed world. This won't happen in a straight line, as the recent emerging market slowdown quite clearly demonstrates. But we think a growing global middle class will provide a long runway for many companies with the asset-light business models we look for (e.g. consumer goods and financial services).

Stock Examples: *Unilever, Diageo, Reckitts, Procter & Gamble, BATs, Anheuser-Busch, SABMiller, Jardine Lloyd Thomson, Domino Printing, Ashmore Group,* PZ Cussons, Intercontinental Hotels Group, Nichols, Nestle, Philip Morris International, Colgate, Coca-Cola.

More From Less - Energy and Infrastructure
Baseline expectations for standard of living are on the up globally - whether that be in terms of access to energy, power, water, shelter, transport, connectivity or manufactured goods. This trend is being accentuated by an increasing rate of urbanisation. But the world's resource base is finite, environmental degradation is becoming an increasing problem, and geopolitics refuses to go away. These considerations create an interesting set of challenges that will require the world's population to get 'more from less' over coming years. The last decade's infrastructure development was led by China's cement, iron ore, copper and coal binge. But infrastructure will need to grow increasingly 'clever' over coming years and energy self-sufficiency will be a priority. Shale gas, solar, nuclear, LNG, resource efficiency, intelligent networks, sensors, the internet of things, production efficiency and lean manufacturing will all play their part. We like business-to-business franchises such as engineering consultancies and niche engineers that help their customers increase efficiency and find better solutions to this set of challenges (i.e. get more for less).

Stock Examples: *Amec, Spectris, Smiths Group,* Halma, WS Atkins, IMI, Renishaw, Rotork, Kone, Spirax-Sarco, Weir Group, IBM, Accenture.

A Last Word On Industry Consolidation

There is a caveat to all of the above - areas of growth tend to attract capital. Just look at the railway stocks of the 19th Century or the internet stocks of the 1990s. The more exciting the 'theme', the more capital is likely to be thrown at it - and as the old saying goes, *capital is the enemy of return on capital.* We like some protection from this trap. We tend to find it in mature, consolidated industries with useful barriers to entry. Companies in these industries have a good chance of converting demand growth into healthy profitability, cash generation and therefore dividend growth. New entrants just find it far harder to get in on the action.

On this subject, an old and resilient industry that fits this bill is beer - and it's been in the headlines recently as it it heads towards another round of consolidation. SABMiller's approach to Heineken and subsequent rejection has sparked further rumours that SAB itself is vulnerable to a takeover approach from AB Inbev. A history of acquisitions in the sector is a reminder of what scarce, irreplaceable assets beer brands are***. However much capital you chuck at it, you can't just create a Budweiser, a Corona, a Peroni or a CR Snow (SAB's Chinese brand - now the biggest selling beer in the world) from scratch. Established brands therefore don't tend to change hands cheaply. SAB's share price has headed sharply higher in sympathy with these considerations (and we have reduced our holding in Evenlode as a result)****. Perhaps in hindsight we'll look back and conclude we should just have run with this holding, but a valuation discipline is integral to our approach. We'd revise Mae West's one liner a little - too much of a good thing can be wonderful, but only *at the right price*.

Hugh Yarrow
Investment Director
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Please note, these views represent the personal opinions of Hugh Yarrow as at 22nd September 2014 and do not constitute investment advice.

*EMC/IDC Digital Universe 2014
**SAP Sapphire conference 2013
***AB Inbev, paid more than 15x Enterprise Value to Earnings Before Interest and Tax (EV/EBITDA) for Mexico's Grupo Modelo (owner of the Corona brand) in 2011. Hindsight suggests this wasn't such a bad deal - they are reaping the benefits now. AB Inbev's Mexican EBITDA increased by +35% in the latest quarter (Q2 2014).
****As AB Inbev shareholders too, we have analysed a potential SAB acquisition in detail, merging our financial models for both companies and making some conservative assumptions on synergy benefits. We believe that an acquisition in the range of £42-£45 would provide the best of both worlds - realising decent value for SAB as a standalone entity, whilst also giving AB Inbev the chance to enhance shareholder value (though this deal would come with a fair slug of execution risk, just as Inbev's huge acquisition of Budweiser did in 2008).