Evans and Partners International Fund

EVANS & PARTNERS

DECEMBER 2018 QUARTER REPORT

For fund investor use only. The views expressed herein are part of a wider portfolio investment strategy and should not be considered in isolation.

PERFORMANCE TO 31 DECEMBER 2018

	3 MONTHS	6 MONTHS	1 YEAR	2 YEARS (P.A.)	3 YEARS (P.A.)	SINCE INCEPTION (P.A.)
Portfolio return (AUD)	-6.9%	0.9%	7.6%	8.2%	9.5%	11.1%
MSCI AC World Accum Index ex-Aust (AUD)	-10.4%	-4.5%	0.7%	7.6%	7.8%	10.1%
Excess return	**3.5%**	**5.3%**	**6.9%**	**0.6%**	**1.7%**	**1.0%**

Performance is net of investment management fees. Inception date is 18th February 2014. Numbers may not sum due to rounding. Since inception return is annualized and assumes reinvestment of distributions. Past performance should not be taken as an indication of future performance.

BOB DESMOND
Head of International Equities

ADAM CHANDLER
Portfolio Manager

CONTRIBUTION TO PORTFOLIO RETURN – DEC 2018 (%)

TOP 5		BOTTOM 5	
Sika	0.04	Alphabet	-0.86
Equifax	-0.02	Visa	-0.80
RELX Group	-0.06	adidas	-0.71
3M	-0.15	Nordson	-0.68
Ecolab	-0.19	Accenture	-0.62

Numbers represent contribution in percentages of each stock to the percentage change in portfolio value.

SECURITIES MOVEMENTS FOR THE MONTH OF DECEMBER

Bought in	Aon, adidas, Sika, Equifax
Sold out	Ecolab, 3M
Increased holding	Ross Stores, Visa
Decreased holding	Accenture, CDW, Experian, RELX

HOLDINGS AS AT 31 DECEMBER 2018

	REGION	SECTOR
Illinois Tool Works	US	Industrials
Nordson	US	Industrials
Sika	CH	Industrials
TE Connectivity	US	Industrials
Compass Group	UK	Business Services
RELX Group	UK	Business Services
Accenture	US	Technology
Alphabet	US	Technology
CDW	US	Technology
Aon	US	Financial Services
Equifax	US	Financial Services
Experian	UK	Financial Services
Visa	US	Financial Services
adidas	DE	Consumer
Ross Stores	US	Consumer

MARKET COMMENTARY

International equity markets fell by 10.4% over the December quarter (all figures are in AUD unless noted otherwise), driven by mounting concerns over global trade (US and China specifically), peak profit margins, rising interest rates in the US and slowing global economic growth. The Australia equity market declined 7.5% over the same period, outperforming international equities.

The US equity market decreased 11.4% over the quarter, reversing third quarter gains, after posting its worst December since 1931. A solid earnings reporting season was overshadowed by generally more subdued forward-looking commentary by corporate management. Further, trade tariffs continue to create uncertainty, and the potential for an economic slowdown weighed on sentiment. Early in the quarter, the Federal Reserve Chairman, Jerome Powell, spooked markets when he commented that the target federal funds rate remained “a long way” below neutral, stoking fears that the Fed would tighten rates more than had previously been expected. In December, the Federal Reserve raised the Fed funds rate by 25 basis points (bps), as expected, but clarified that future increases may be at a slower pace. The more dovish stance was welcomed by the market.

In Europe, forward-looking indicators deteriorated over the quarter, driven by a downturn in the manufacturing sector and political uncertainty. This contributed to European equity markets declining 10.3%. New orders declined, in part, due to lower demand from China and a fall in local business confidence across the region. Further, the European Central Bank’s (ECB’s) quantitative easing (QE) program came to an “official” end in December. The end of QE is a form of tightening but does not represent a complete withdrawal from asset purchases by the ECB, as proceeds from maturing bonds will continue to be reinvested and the official interest rate remains at zero. UK equities continued to slump (-9.3%) as the uncertainty around Brexit negotiations weighed on consumer and business confidence.

Emerging markets fared better than developed markets, decreasing 4.9%. Brazil bucked the trend, rallying 16.6%, driven by the election of the pro-business Jair Bolsonaro in October. Numerous economic indicators in China were negative – industrial production and retail sales slowed more than expected and auto sales fell sharply. Policy easing has yet to filter into the economy or change sentiment. The negative data, together with concerns around a trade deal being reached with the US, resulted in the Chinese market extending its decline (-8.3%) over the quarter.

The performance of all sectors, excluding Utilities which increased 3.6% over the quarter, was negative. Defensive sectors (Utilities, Real Estate, Consumer Staples and Communication) fared the best as investors sought safe havens. Notably, the Energy sector dropped 18.0%, as the oil price collapsed (Brent Crude decreased 35.0%), driven by increased US shale oil production and concerns around global growth. Information Technology reversed third quarter gains, retreating 14.8%, and Industrials declined 13.2%.

PORTFOLIO CONSTRUCTION CONSIDERATIONS

Following on from the September quarter, where we made no changes, the December quarter was highly active – at least by our traditionally low turnover standards. Our prior research and a volatile market presented numerous opportunities, allowing new positions to be purchased at a significant discount to intrinsic value, which we believe have resulted in an overall upgrade to the portfolio from both a quality and valuation perspective. We initiated four new portfolio positions: **adidas**, **Aon, Equifax** and **Sika**, and we exited two positions: **3M** and **Ecolab**. We also used the sell-off in December as an opportunity to top-up certain existing holdings. While portfolio changes are outlined below, more interested investors may refer to our published research on the new portfolio companies and the recent portfolio changes updates for more detail.

PORTFOLIO PERFORMANCE

The Evans and Partners International Fund declined by 6.9% for the quarter, outperforming the benchmark by 3.5%, which fell by 10.4% for the period.

Key contributors to performance for the quarter were **Sika**, **RELX** and **3M**:

- **Sika** – the company was added to the portfolio in October and announced strong third quarter results with organic growth increasing 7.4%, an acceleration from 1H18 (+6.8%), with growth across all regions. Sika’s geographic breadth, with operations in 101 countries, continued to deliver balanced growth despite the global economic volatility. China delivered solid growth, increasing 9.5% year to date, bucking the economic trend. Management indicated that the momentum in third quarter has continued into the fourth quarter. Raw materials have been a headwind for the company, however they expect to recover the input cost through price increases. We expect double digit top-line growth for FY18, driven by solid organic growth complemented by bolt on acquisitions.
- **RELX** – during the fourth quarter the company provided a reassuring trading update, delivering 4% organic growth for the first nine months of the year. The best performing division was Risk & Business Analytics, where growth increased 8%. In addition, management confirmed their full year outlook of underlying revenue and earnings growth.
- **3M** – despite a disappointing third quarter result in late October, with organic growth of 1.3% and a 4.0% cut to expected FY18 earnings, 3M’s share price rallied over the following month. The company is typically viewed as a defensive industrial and a preferred place to hide within the sector during periods of slower economic growth. With the weaker outlook and the share price above our valuation, we took the opportunity to exit the position during November.

Notable detractors from the portfolio were **Alphabet**, **Visa** and **adidas**:

- **Alphabet** – is one of the much spoken about “FANG “stocks and was swept up by the broader market and tech sector sell-off during the quarter. For Q3 the company reported 22% topline growth (19% for the core advertising business), an impressive result but slightly below expectations. Further, operating expenses increased 26% and capex 102% as the management continued to invest to widen Alphabet’s moat. Despite the slight miss relative to consensus expectations, we believe the underlying quality of the business remains exceptional and the valuation is undemanding.
- **Visa** – heading in to the quarter Visa’s share price was up approximately 32% year to date (in local currency). While the company announced a solid set of results during the fourth quarter this was insufficient to offset broader market concerns. Operationally Visa continued to execute very well, delivering double digit payments volume growth and

mid-teen EPS growth for the third quarter. We expect the company will continue to grow EPS at approximately 15% per annum over the medium-term.

- **adidas** – reported solid fiscal 3Q18 results. Constant currency revenue growth was 8% and NPAT growth was 19%. China was a standout, growing 26% during the quarter. Revenue growth guidance was reduced to 8-9%, compared with prior guidance of 10%, which saw some short-term share price pressure. We remain comfortable that through product innovation and their distribution strategy, adidas can continue to deliver high-single digit top-line growth.

PORTFOLIO CHANGES – STOCKS ADDED TO THE PORTFOLIO

adidas – Founded in 1949, adidas is one of the world's most recognised brands and the second largest sporting goods company. Through brand appeal, innovation and quality, the company has been able to grow sales and EPS at an average of 9% and 11% p.a. respectively over the last 10 years. Its multi-brand strategy (i.e. adidas, Originals, NEO) has been key to the outstanding growth in recent years, allowing the company to reach a much wider consumer base, while keeping sport at its core.

The company has a well-defined strategy and financial targets out to 2020 which imply ~13% annual profit after tax growth from 2018-20. These targets are conservative in our view (EAPe ~5% ahead) and we see room for further improvement past 2020 from ongoing initiatives such as direct-to-consumer, speed-to-market and product innovation. 100% of management's long-term incentives are subject to achieving 2020 targets.

At the time of initiating the position, adidas traded on 23x our one-year forward EPS, in line with its average premium to the S&P 500. Value is more evident relative to its key peer, Nike, with adidas trading at a ~20% discount vs the ~10% historical average discount. With similar strategies and growth prospects, we see potential for a relative re-rate on the back of consistent execution, with a valuation of EUR260 per share.

Aon – is a global leader around the advice of insurance, retirement and health benefits. It is important to note that Aon acts as a broker/advisor and takes no underwriting risk. Their business model benefits from high switching costs, largely recurring revenues and customer retention in their core insurance business is approximately 90%.

With high margins and limited capital needs, the company generates prodigious amounts of free cash flow. Management have been excellent stewards of capital. They have divested slower growing, capital intensive businesses like underwriting and benefits outsourcing, and focused on higher margin, capital light businesses. Management have a disciplined focus on organic revenue growth, free cash flow and return on invested capital.

Over the medium term, we expect Aon to deliver organic revenue growth of 4% p.a., and with margin improvements and good capital allocation, we expect the company will deliver double-digit EPS growth.

At the time of purchase the business was trading at 17.3x next twelve-month earnings and a 7% discount to our valuation of USD$166. We believe this is a reasonable price for a business with a track record of double-digit earnings growth, a strong balance sheet, solid cash flow, a capital light business model and margins north of 20%.

Equifax – is one of the big three credit reporting bureaus, operating in a stable oligopoly with high barriers to entry. The credit bureaus are deeply integrated within the lending ecosystem and the industry is currently benefiting from strong end-market growth; with client demand for data and analytics (for example to originate new business and more accurately assess loans) as well as for more efficient and automated processes to reduce costs. Historically consistent top line growth, expanding margins and strong free cashflow generation highlight the underlying quality of Equifax's data assets. However, the company's data breach in 2017 led to a lower short-term revenue and earnings growth profile, and a valuation de-rating. Since the breach Equifax has appointed a new CEO, made well-credentialed IT hires, changed reporting lines and revised management incentives. Significant financial resources have been allocated to improving IT systems and security. Importantly, Equifax has been able to maintain its existing client base with no meaningful market share shifts – outside of the consumer business – underlining the resilient characteristics of its operating model.

While elevated IT investments will continue, we believe Equifax has now completed the bulk of its repositioning and over the cycle, 6% to 8% p.a. top-line growth and low double-digit EPS growth is achievable.

While 2019 will likely be a transition year, the market's impatience regarding a quick turn-around created an attractive entry opportunity, with the company trading at 16.0x next twelve-month earnings, and a 21% discount to our assessment of intrinsic value (USD$120 per share) at the time of our purchase. By comparison, Equifax's key competitors are trading at 21x to 22x earnings.

Sika – Sika is a leading global construction chemicals company founded in 1910. Over time, Sika has earned builders' trust through their reliability, product quality, innovation and their direct, consultant sales force. With an average gross margin of 54%, Sika's products are not your typical construction products and are backed by decades of R&D and patent protected. Their products have a low cost-to-value ratio; typically representing 1-4% of project cost, yet they are key to enhancing and preserving the structural integrity of the underlying asset. With a presence in over 100 countries and an equal revenue split between new build and refurbishment, Sika has been able to deliver consistent results through the cycle. The last decade has seen Sika deliver organic growth of 5% p.a. and mid-teen earnings per share growth.

Sika's product portfolio serves the construction process from foundation to roof. Their portfolio breadth uniquely positions them to capture growth from mega trends such as urbanisation, improved building techniques and standards in emerging markets, and rising safety and environmental standards and improved project efficiency in developed markets.

Sika's entrepreneurial culture, decentralised operating structure and strong R&D capabilities have allowed them to respond to demand in local markets with agility and become the supplier of choice.

Over the next three years we are forecasting 9% sales growth (5% organic) p.a. and 220 bps of margin expansion, to result in 18% EPS growth p.a. Sika trades at 21x our next twelve months earnings, a reasonable valuation given: 1) the excellent management team and culture; 2) proven business model with earnings durability; and 3) long term structural tailwinds. We have an estimated intrinsic value of CHF 149.

PORTFOLIO CHANGES – STOCKS REMOVED FROM THE PORTFOLIO

3M and Ecolab – we exited both investments on valuation grounds. 3M was trading at 20x our next twelve months earnings forecast, a 25% premium to the market, and Ecolab was at 26x our next twelve months earnings forecasts, a 54% premium to the market. In our view absolute and relative valuations for both companies had reached elevated levels with little scope for further upward earnings revisions or multiple expansion, hence we exited the positions. For both companies our view on the quality of the business and the management teams remain unchanged.

COMPOSITION OF PORTFOLIO PERFORMANCE

	3 MONTHS	6 MONTHS	1 YEAR	2 YEARS (P.A.)	3 YEARS (P.A.)	SINCE INCEPTION (P.A.)
Local currency impact	-9.1%	-3.1%	-1.6%	5.4%	9.7%	7.2%
+/- currency impact on return	2.3%	4.0%	9.3%	2.8%	-0.2%	3.9%
Portfolio return (AUD)	**-6.9%**	**0.9%**	**7.6%**	**8.2%**	**9.5%**	**11.1%**

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PORTFOLIO CHARACTERISTICS – 3 YEARS TO DECEMBER 2018

	3 MONTHS
Standard deviation	11.0%
Realised beta	0.98
Tracking error	6.2%
Upside capture ratio	1.02
Downside capture ratio	0.89

FUND NAME	EVANS AND PARTNERS INTERNATIONAL FUND
APIR Code	ETL0390AU
ARSN	166 708 792
Responsible Entity	Equity Trustees
Number of stocks	10–15
Maximum cash weighting	10%
Maximum single stock weighting	10%
Currency exposure	Unhedged
Benchmark	MSCI All Countries World Accum Index ex-Australia (AS)
Minimum Investment	$20,000
Distribution Frequency	Bi-annually
Investment Management fee	1.25% incl. GST
Buy/sell spread	0.10%–0.10%
Fund Inception	18th February 2014

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