

Rathbone Income Fund

Update August 2018

In February 2017, US giant Kraft Heinz launched, and then rapidly aborted, an aggressive bid for the Anglo-Dutch consumer staples business Unilever. The marauder was going to use the weapon of debt (Kraft Heinz typically operates with leverage (net debt) of up to four times earnings (EBITDA)) to facilitate its conquest. The value to the aggressor was obvious, as Unilever's cash flow would amply cover the cost of the very cheap borrowing Kraft Heinz could raise to pay for it – and more. In effect, Unilever's enviable cash flow would finance the demise of its own independence.

Although Kraft Heinz's volte-face was rapid (it bid on the Friday, backtracked on the Monday), Unilever's management had received a resounding shot across the bow. They acted with urgency and by May 2017, Unilever was expounding a new strategy. We own the shares and we have reaped the rewards, but we recognise that this episode shines a light on some far-reaching ideas.

In 1888, first ground was broken on the development of what was to become Port Sunlight, the model village that William Lever created to house the families of employees at his new soap factory. It was a remarkable exercise in social welfare, an allocation of capital that recognised all the stakeholders in his enterprise. He was investing not only in soap manufacture, but in housing, schools, hospitals and sporting facilities. Port Sunlight still exists to this day, nestling in the Wirral Peninsula, as a conservation site.

This philosophy seems to inform modern Unilever's business ethic, and the company's strategy still evokes the principles of long-term sustainability. Its sustainable living plan establishes how it juggles the three separate aims of business growth, reducing its environmental impact and being a decent member of society.

We ask the question, therefore: what happens when Unilever's philosophy collides with the profit-maximising, shareholder-fulfilling aggression of the highly geared Kraft Heinz bulldozer, ridden as it is by the private equity gorilla that is 3G? What happens to the modern day descendant of the company whose ethical, sustainable and holistic principles are epitomised by the Port Sunlight project? Is it possible to satisfy all stakeholders? When push comes to shove, can the boards of businesses ever pay more than lip service to sustainability if the demands of shareholders are to be satisfied? Conversely, will we as shareholders be content to forego maximum short-term gains for the longer-term good, not necessarily quantified in monetary terms? Or, if these are not mutually exclusive aims, is the endgame the realisation that financial returns for responsible companies will ultimately be stronger? This is, after all, an exercise in risk management.

We have already started to look into some of these questions, but we believe this is just the start of a very long road. Indeed, our initial interaction with companies is less likely to be based upon a robust set of questions, but rather an exploration of what the correct questions should be in the first place.

Metaphysical as it sounds, this is a crucial exercise. For a start, companies themselves are making statements of intent around the whole sustainability piece. In many cases the narrative has moved on from general reference to issues of sustainability to more actionable procedures, with three

particular topics outstanding recently: the need to reduce plastic packaging in the supply chain, the mitigation of overall water consumption and eliminating unnecessary energy consumption and converting to renewables. These actions all require investment; therefore, these actions all impact returns.

What the Kraft Heinz/Unilever interaction reveals, in its starkest form, is the contrast between the desire to maximise returns to shareholders today and a philosophy of looking toward the future. Between Kraft-Heinz's balance sheet engineering and rampant focus on cutting costs, and Unilever's aspiration to put its cash where it will do the most good and least harm, which harkens back to a utopian ideal cemented a century and a half previous. This interaction needs to be the core of our analysis.

When a finance director is looking to allocate capital, how do sustainability considerations impact on the decision-making process? What impact do these considerations have on internal rates of return and what tolerance is there if returns are dampened? On the other hand, is the nature of the change in attitude so fundamental that there would be a deleterious effect on returns if these considerations are not met? To what extent do external forces, such as increased regulation or evolving consumer attitudes, impact on future returns? If your core client base baulks at one-off plastic use having watched Blue Planet II, businesses had better calculate the future financial ramifications of continuing to serve up the polluting packaging versus effecting meaningful change.

At the moment there is no well-established methodology. The United Nations has established its 17 Sustainable Development Goals (SDGs), but it's up to individual businesses to elect how to reference them, if at all. An increasing number of businesses are aligning their practices to these goals without yet understanding how they truly impact upon their investment decisions. Although the SDGs are not necessarily compatible with the profit-maximising tenets of modern capitalism, they are nevertheless beginning to impact on behaviour. On one level, there are areas of structural change (e.g. in the reduction of plastic use) that are already influencing corporate behaviour, and these changes will also influence investor behaviour, as investors attempt to identify investable themes in pockets of industry ripe for attracting capital.

Indeed, the purpose of this letter is the beginning of a reflection on how these ideas influence the companies in which we invest for your fund. Anything that impacts the investment decisions of a business impacts our view of that business, as do other investors' expectations regarding the responsibilities of these businesses. It's only appropriate that we develop a methodology for examining these decisions. We are already embarking on additional interactions with the companies in which we invest, above and beyond our regular timetable.

It's interesting that one of the books long-listed for the FT Business Book of the Year 2018 is *The Value of Everything*, by Mariana Mazzucato. The book is a treatise on the economic notion of valuation, with the author arguing that the body corporate in developed economies is often an extractor of value rather than a creator. Ms Mazzucato posits that businesses are not actually investing, rather they are extracting value at an enormous scale, which is reflected in expanding degrees of financial inequality. This certainly rings true when one considers the sheer scope of cash returns to shareholders, especially in the form of share buybacks and special dividends over the last 10 to 15 years. If companies are doing this, they are not investing in their industries. The value extracted is shifting to shareholders. Value is not being created through industrial and economic growth.

This is a huge topic beyond the scope of this letter, but it does tie us back to our initial comparison. Do we want to invest in businesses that have a “sustainable” agenda in its broadest terms or are we happy to maximise short-term gains? Our philosophy has consistently been one of long-term capital returns, with an income target for the future, whether its provision of additional pension income, university fees, healthcare costs or something else. It’s a long-term vision. However, the investment zeitgeist of recent years has been in sharp contrast. Now, whether it be the evidence of greater sustainability concerns or the publication of such tomes as Ms Mazzucato’s book, change may be afoot. Our sense is that the tide is most certainly beginning to turn, and we would do well to organise our own processes accordingly.

Recent trades: Trading in August have been motivated by reflections on value. We have added to cheap shares, buying **Greene King** and **Micro Focus International**, whilst establishing a nascent position in **Jupiter Fund Management**. We have reduced holdings in stocks like **Astra Zeneca** and **Dechra Pharmaceuticals** where we deem the price risk to be too high, and have also trimmed **Rio Tinto**, on ongoing global trade concerns.

Companies seen this month: Senior, Hiscox and Hansteen Holdings.



Carl Stick
Fund Manager

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