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GLOBAL FUNDAMENTAL

INCOME FUND | MONTHLY SUMMARY | OCTOBER 2023

Past performance does not predict future returns

Summary

The Liontrust Income Fund seeks to offer attractive total returns to its investors while delivering dividend income above the FTSE All Share Index. September (+28bps) was a subdued month as rising sovereign bond yields around the world saw choppy equity markets.

Performance year-to-date (YTD) has been satisfactory on an absolute basis, delivering a total return of 4.54%, and relative to our benchmark (+22bps). YTD the fund is in the second quartile of the IA UK Equity Income comparator group.

The top contributor to performance in September was **Computacenter** (+37bps), the global provider of IT equipment and managed services, which reported strong results. **Shell** (+23bps) also performed strongly as oil prices climbed towards $100/bbl.

The biggest detractor from September's performance was **Kitwave** (-38bps) which, absent any news flow, continued to drift lower following a strong run. Homewares retailer **Dunelm** (-37bps) saw some pressure after its results, although with no material changes to estimates and the company demonstrating ongoing market outperformance, we remain sanguine. Other notable detractors were **Ashtead** (-34bps) with the market rotating out of construction exposed stocks as interest rates rise and **Pets at Home** (-37bps), as discussed in more detail in our company profile below.

Dividend paying companies with Competitive Power: **Pets at Home**

Pets at Home

Year-to-date our c.3% position in Pets at Home (PETS) has made a neutral contribution to fund performance (-2bps).

We are a truly nation of animal lovers. Various estimates suggest a population of c.10-12 million dogs plus a similar number of cats in the UK. That's c.20-25 million pets in the context of around 28 million households (although some families will own multiple pets). And pets truly rule their roosts – a recent survey into consumer spending intentions suggested people would prioritise spending on their pets over groceries, holidays, exercise, health and wellness, and even products for their babies and children! The 'humanisation' of pets is real…

PETS is the market leader in the £7.2 billion UK pet care industry. It is a business our animal-loving readers may be familiar with (hopefully as happy customers). For those less familiar, PETS operates a unique integrated pet care model with co-located retail (457 stores), vet practices and grooming salons, plus a well-established online offer. This creates a platform to meet all of a pet owner's needs and, we believe, a superior operating model which both single vertical specialists and generalist retailers dabbling in pet products would struggle to recreate. It enables cross-sell opportunities across the businesses, increasing PETS' share of customer wallet and driving loyalty.

A remarkable c.7.7 million customers are signed up to its VIP loyalty scheme, which provides a rich pool of data with which to manage the business. Its offer is resonating with customers, with market share having increased from 18% in FY17a to 24% in FY23a. Better still c.35-40% of all new pets in the UK are being signed up to its Puppy & Kitten Club scheme.

Our investment philosophy is that 'quality dividend investing works best' and we apply a systematic framework to understand and identify quality. In our view PETS is a competitively advantaged market share winner operating in an attractive, structurally growing market. It demonstrates the five building blocks we look for across our portfolio holdings.

1. It generates strong **returns on invested capital** (ROIC), achieving c.23% in FY23a (post-tax, leases capitalised), a number which has pleasingly trended higher over recent years. These returns create distributable cashflows for reinvestment into organic growth opportunities – PETS has achieved a 5 and 10-year EPS compound annual growth rate (CAGR) of c.11% and c.13%, respectively, alongside shareholder returns.

The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested. Please refer to the Key Risks for more information.

PETS retail business is c.10x bigger than its nearest specialist competitors. This gives it significant purchasing power with suppliers and has enabled it to launch own-brands, which account for c.30% of food and c.50% of accessory sales

2. As dividend-focused investors we want **clean, cash generative financial models**. PETS reports very straightforward accounts with few adjustments to earnings. Free cash flow to net profit conversion has been c.90-95% over recent years.

3. PETS operates with a **prudent balance sheet**, with a net cash position of c.£55 million at FY23a. Treating capitalised leases as debt (a can of worms for another time!) its IFRS 16 net debt / EBITDA ratio is a conservative c.1.5x. It has no pension deficit to service or material provisions booked.

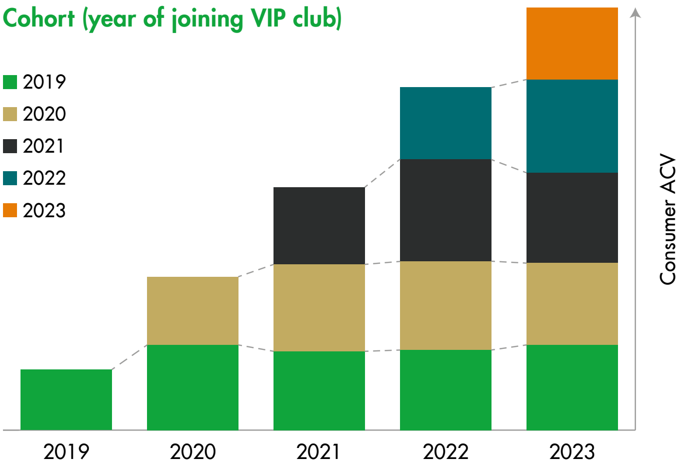
4. Pet care is a fundamentally **attractive underlying market**. Spend tends to be resilient, growing c.5% over the 2008-09 recession against a UK economy which shrank by c.-3.5%. The UK pet population has typically grown by c.1-2% per annum, but saw an >10% boost during the Covid pandemic as working habits changed. Cats and dogs have life expectancy of c.10-15 years and owners generally spend more as their pets get older, for instance on more complex veterinary procedures or advanced nutrition. For PETS this means once it has won a customer it tends to translate to predictable, annuity-like revenue streams.

5. We look for **skilled, motivated management**. We recently met CEO Lyssa McGowan (appointed June 2022) and were impressed by the strategic vision around use of digital channels to build deeper, more profitable customer relationships, while retaining focus on the nuts and bolts of retail and PETS' value for money proposition. Mike Iddon (CFO) has been with PETS since 2016 and we like both his returns focus and the cleanliness of financial reporting.

The future is the only thing that matters in investing and, as with all our investments, we apply a *Competitive Powers* framework to ensure we are comfortable that PETS' superior financial performance can sustain over time. As a reminder, Powers are strategic traits that underpin potential for a company to generate persistently attractive returns. They have dual attributes – benefits to the company, manifest through pricing power or lower costs; and barriers to competitors, who would ordinarily attempt to arbitrage away supernormal financial returns (for further discussion see here). We believe PETS has two of the seven Competitive Powers – Switching Costs and Scale Economies, which we think will underpin its continued profitable growth.

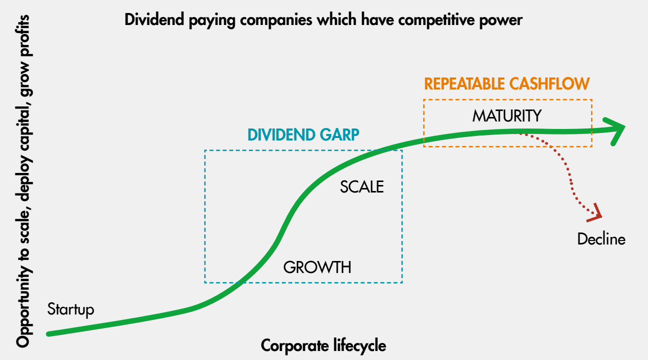
- **Scale Economies:** PETS retail business is c.10x bigger than its nearest specialist competitors. This gives it significant purchasing power with suppliers and has enabled it to launch own-brands, which account for c.30% of food and c.50% of accessory sales. These come with c.15% higher margins than branded goods while being c.25-30% cheaper for customers. This scale is shared with the consumer – a recent pricing study by Jefferies found PETS pricing to be on average c.3% cheaper vs. online competitors and >10% cheaper than brick-and-mortar-based peers. Other benefits of scale are its ability to amortise investment costs (e.g. in its new app) across the biggest pool of customers, or to run national (including TV) brand marketing campaigns. All this makes PETS a difficult business for smaller players or new entrants to compete against.

- **Switching Costs:** PETS unique pet care platform – a blend of products, services and advice, connected across both physical stores and digital channels – makes it attractive to customers and is allowing it to win more than its fair share of new pet owners. Once won, switching by veterinary customers is relatively unusual. Similar to a human switching their doctor, the loss of a personal, trusted relationship and friction involved in transferring medical records creates stickiness. On top of this, PETS has c.1.6 million customers signed up to recurring subscriptions, a number which is continuing to grow. All this translates to exceptional levels of customer loyalty. The cohort chart below, taken from a recent company presentation, illustrates this clearly with customers spending more in years three and beyond than in year one.



Source: Pets at Home Group plc (Pets at Home) Full Year Results, 25 May 2023

PETS sits within the Dividend GARP portion of portfolio, formed of companies in the growth phase of the corporate S-Curve. Our hypothesis with this group of stocks is that 'when underpinned by competitive power, value-added growth can persist for longer than may be priced in.' They generally pay a dividend, though still with plenty of runway to reinvest their cashflows and grow their businesses, we expect returns to be driven primarily by compound profit (and ultimately dividend) growth.



Dividend GARP: 'When underpinned by Competitive Power, value-added growth can persist for longer than may be priced in.'

Repeatable Cashflow: 'Cashflows underpinned by Competitive Power are durable, yet sometimes undervalued.'

PETS offers a prospective dividend yield of 4.1% (FY1-2e) and we believe its *Competitive Powers*, aligned with attractive market structure, will allow it to continue delivering double-digit growth in earnings, cashflow and dividends over the medium term, consistent with management targets.

The stock sold off during September on reports the UK Competition and Markets Authority (CMA) had initiated a market review into the UK veterinary sector. For context, PETS' Vet Group segment accounts for c.34% of total profit. The CMA has noted private equity owned vehicles have been consolidating the industry in recent years – independent practices accounted for 89% of the UK veterinary industry in 2013, which fell to approximately 45% by 2021. Its focus appears to be on pricing and price transparency; and the potential conflict of interest in vets referring customers to providers owned by the same group, for services such as diagnostics tests and specialist hospital treatments. It is expected to report its findings in early 2024. While remaining mindful, our sense is that PETS is not in the CMA's crosshairs. On pricing, we note a recent study by Liberum showing PETS pricing for vet services is among the cheapest in the industry, whereas the large private equity owned practices were at the upper end. And the issue of diagnostics seems less relevant to PETS given it primarily offers first opinion services, with diagnostics and more complex hospital treatments referred outside the group on an arm's length basis. For these reasons we have been prepared to disagree with the market in the face of a falling stock price, maintaining our holding at prior levels.

PETS offers a prospective dividend yield of 4.1% (FY1-2e) and we believe its *Competitive Powers*, aligned with attractive market structure, will allow it to continue delivering double-digit growth in earnings, cashflow and dividends over the medium term, consistent with management targets. The stock trades on a blended forward P/E of 14.7x (FY1-2e) vs. its own 5-yr average of c.19x and is on a prospective FCF yield of 6.3%. Should the stock hold its current multiple, which is undemanding given its defensive growth and returns profile, we see a prospective annualised shareholder return in the 'mid-high teens'. Any re-rating to historical levels could accelerate returns.

Fund performance year-to-date has been satisfactory. We are, though, focused on the more substantial opportunity that exists to grow our investors' wealth and dividend income over the long-term (and indeed our own, as substantial investors in the strategy). We remain confident that our process, identifying dividend paying companies with Competitive Powers, gives us a framework to capture superior risk adjusted returns. As ever, we thank you for your interest and continued support.

Discrete performance

To previous quarter 12 months ending (%)	Sep-23	Sep-22	Sep-21	Sep-20	Sep-19
Liontrust Income C Acc GBP	14.1	-2.9	20.7	-12.1	5.0
FTSE All-Share	13.8	-4.0	27.9	-16.6	2.7
IA UK Equity Income	13.6	-8.5	32.7	-17.2	-0.2
Quartile	2	1	4	1	1

Source: FE Analytics, as at 30.09.23. Liontrust Income Fund, primary share class performance, C Accumulation GBP, total return (net of fees, interest/income reinvested) versus FTSE All-Share and IA UK Equity Income comparator benchmarks. Quartiles and rankings, as at 30.09.23, generated on 09.10.23.

Key Risks and Disclaimer

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

Overseas investments may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of the Fund. Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result. The creditworthiness of a bond issuer may also affect that bond's value. Bonds that produce a higher level of income usually also carry greater risk as such bond issuers may have difficulty in paying their debts. The value of a bond would be significantly affected if the issuer either refused to pay or was unable to pay. This Fund may have a concentrated portfolio, i.e. hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the Fund's value than if it held a larger number of investments. The Fund may encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings. Outside of normal conditions, the Fund may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash. Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

In reference to any component (where applicable) of a fund's investment process that uses external ESG data, there may be limitations to the availability, completeness or accuracy of ESG information from third-party providers, or inconsistencies in the consideration of ESG factors across different third-party data providers, given the evolving nature of ESG.

The level of income is not guaranteed. The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

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