HEPTAGON
Capital

Driehaus US Micro Cap Equity Fund

Q1 2023 Commentary

Fund Manager

Jeff James

Investment Objective

The investment objective of the Fund is to achieve long-term capital growth. The Fund's Sub-Investment Manager, Driehaus Capital Management LLC, is a privately-held boutique asset management firm located in Chicago, USA. The firm was founded in 1982 and has USD 13.4 billion of assets under management.

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Opinions expressed whether in general or in both on the performance of individual investments and in a wider economic context represent the views of the contributor at the time of preparation.

The **Driehaus US Micro Cap Equity Fund** (the "Fund") is a sub-fund of Heptagon Fund ICAV which is an open-ended umbrella type investment vehicle authorised pursuant to UCITS regulations. Heptagon Capital Limited ("Heptagon") is the Investment Manager and Driehaus Capital Management LLC ("Driehaus") is the Sub-Investment Manager meaning Driehaus exercises discretionary investment authority over the Fund. The Fund was launched on 7th December 2016 and had AUM of USD 628m as of 31st March 2023. During the first quarter of 2023, the Fund outperformed the Russell Micro Cap Growth Index TR USD (the "Index"), returning 1.9% (I USD share class) compared to 0.8% for the Index.

Market Overview

The March quarter saw gains for U.S. equities but there was a large dispersion by month, market cap as well as style and sectors.

- January was a strong month to start the year with the small cap indices leading the way as they appreciated nearly ten percent. Optimism about easing inflation, along with buoyant economic data encouraged risk taking and aggressive short covering.
- In February, equities pulled back as the better-than-expected economic data boosted January's inflation data (both Consumer Price Index (CPI) and Producer Price Index (PPI)) above expectations. While inflation continued to trend lower year-over-year since peaking in June, January inflation was discouraging as it supported the Federal Reserve's hawkish monetary policy.
- March was dominated by a series of regional bank failures, most notably Silicon Valley Bank, which quickly morphed into a banking crisis. Bank stocks and the financial sector were hard hit causing value to underperform sharply versus growth. The threat of contagion and rising uncertainty caused large caps and the tech sector to become safe havens as they outperformed as just 10 mega cap technology stocks drove 90% of the year-to-date gains for the S&P 500.

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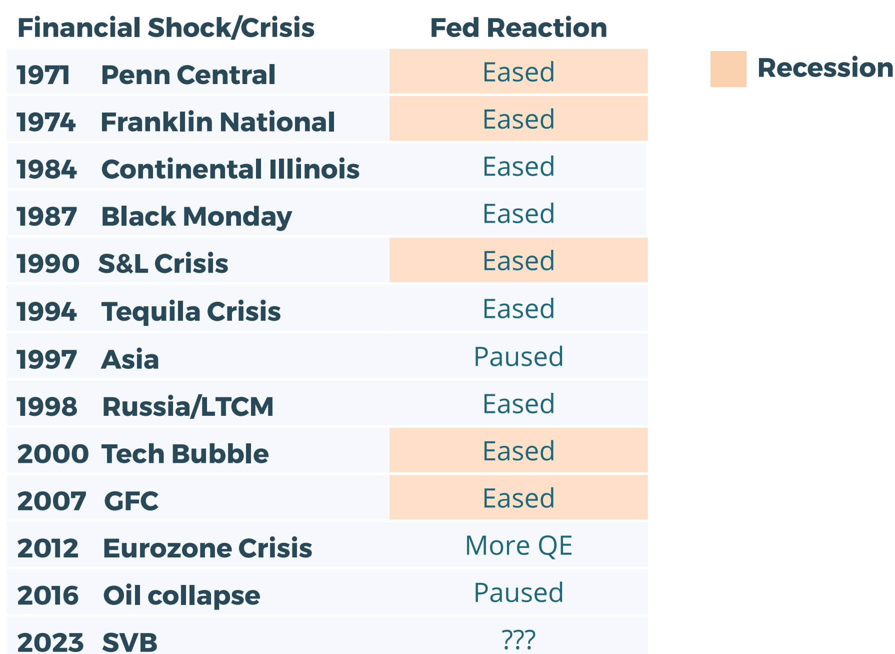
Silicon Valley Bank (SVB) and the regional bank crisis

Federal Reserve (Fed) rate tightening cycles historically result in a crisis or a shock. Such shocks typically cause the Fed to change its monetary policy and it either pauses or eases interest rate hikes. See a historical list below. This current crisis is hitting U.S. regional banks. SVB was the 16th largest bank in the U.S. and a key financial artery in the Silicon Valley ecosystem and it failed in a matter of days. The SVB collapse has been well documented, but it is important to stress that it had some unique characteristics. It had a concentrated exposure to VC/PE (venture capital and private equity) and their portfolio companies, namely early-stage technology and life science companies. SVB's concentrated deposit base resulted in an unusually high percentage of its deposits being uninsured (95% were above the Federal Deposit Insurance Corporation's (FDIC's) $250,000 guarantee). Ironically, banks were incentivised to hold safe treasury securities as they were considered very safe and highly liquid by regulators. As it faced heavy customer withdrawals it had to sell treasuries at a loss which caused further stress on its earnings. On March 9th, SVB saw nearly a quarter of its deposits leave in a classic run-on-the-bank situation. Facing suddenly mounting losses, further withdrawal requests and a complete loss of confidence, SVB was forced to close its doors the next day. Signature Bank collapsed two days later in a similar fashion, and contagion risk threatened other key regional banks. The loans and deposits of both failed banks were acquired later in the month by other competing banks. While no additional U.S. banks have yet suffered the same fate, the far larger Credit Suisse collapsed later in March and was rescued by Swiss regulators and its closest competitor UBS.



Financial Shock/Crisis		Fed Reaction
1971	Penn Central	Eased
1974	Franklin National	Eased
1984	Continental Illinois	Eased
1987	Black Monday	Eased
1990	S&L Crisis	Eased
1994	Tequila Crisis	Eased
1997	Asia	Paused
1998	Russia/LTCM	Eased
2000	Tech Bubble	Eased
2007	GFC	Eased
2012	Eurozone Crisis	More QE
2016	Oil collapse	Paused
2023	SVB	???

Source: Evercore ISI

Once SVB and Signature failed, the Fed and the FDIC quickly implemented some extraordinary measures, including the FDIC guaranteeing all deposits at the two banks. Then the Fed established the Bank Term Funding Program, an emergency liquidity facility to provide loans and funding to banks at very attractive terms. Thus far, these two measures have gone a long way to promote stability and restore confidence in the regional banks. Importantly and unlike during the 2008 Global Financial Crisis (GFC), these bank runs were not related to defaults or the credit quality of their loan books. The U.S. banking system is actually in far better shape in terms of reserves and other liquidity key metrics than it was during the GFC. One key silver lining to these events is that bond yields have declined substantially since early March.

The market continues to be very influenced by macro conditions versus the typical bottom-up characteristics that commonly dominate during a bull market. We have carefully looked at the market's tendencies over a handful of decades focusing on prior multiple cycles, inflationary periods, Fed tightening cycles and market bottoms. While history does not repeat itself exactly, it often consistently rhymes. Consider the following:

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Historical consistencies to be mindful of

- Fed rate hike cycles lead to a financial shock/crisis.
- Financial shocks do not end until the Fed has at least paused.
- The Fed had not hiked rates during a prior financial crisis, until it did last month.
- Financial shocks/crises are typically needed to trigger or tip the economy into a recession.
- Recessions typically begin at least one year before the yield curve inverts. The last six recessions started 17, 10, 18, 13, 22 and 6 months after the initial inversion of the yield curve.
- The yield curve (the 2 year – 10 year) inverted on April 1 of 2022.
- Equity markets bottom before aggregate earnings bottom.
- The equity market bottoms after the 2-year treasury yield peaks (in all 12 instances since 1962), as the 2-year treasury yield closely tracks the Fed Funds rate. Thus far 2-year treasury yields appear to have peaked when SVB collapsed.
- The 2-year treasury yield and the Fed Funds rate typically peak prior to or at the beginning of a recession.
- Equities bottom when inflation peaks. CPI did peak in June of last year. However, CPI typically peaks during a recession.
- The equity markets bottom during a recession not before.

The U.S. Economy and Inflation are both slowing

Economic growth in the first quarter remained non-recessionary with U.S. GDP expected to be in the 1.5 to 2% range. In many ways the economy has been resilient over the past year despite higher interest rates and tighter financial conditions. Equities have been resilient also. The large cap indices such as the S&P 500 and the NASDAQ 100 are holding up well. Large cap and small cap indices have consolidated for over nine months dating back to the June quarter of last year (when CPI peaked). However, market breadth and other technical indicators are far weaker than the widely followed indices are.

Looking forward, recent data suggest the economy is slowing. Labour market data (March Job Openings and Labor Turnover Survey (JOLTS) data showed the largest drop in job openings in years) and ISM manufacturing and services PMIs are both weakening (March ISM manufacturing dropped to 46.3). Loan officer surveys are pointing to reduced credit availability. Leading economic indicators (LEIs) and bond yields are also weakening.

While financial crises are unwelcome events, they are inevitable. They are also a part of the market's bottoming process. A true market bottom will depend on several key questions surrounding SVB, the regional bank crisis and the tremendous Fed tightening to date:

- To what extent will overall bank lending be impacted?
- Will another key area or industry be next to see severe stress? Will it be private companies reliant on non-bank financing or perhaps commercial real estate?
- Will the widely anticipated recession get pulled forward? Does it increase the chances of one occurring?
- Will it increase the severity of a potential recession? Will it be a mild recession as the consensus expects or perhaps a deeper one?
- Will the Fed be quick to respond to economic weakness or be slow to pivot?

Time will determine the answers to these questions. Overall, bank lending levels have been holding up thus far. However, regional Fed districts are beginning to report weakness. Specifically, the Dallas Fed is now reporting in its most recent bank conditions survey that bank lenders are "expecting a contraction in loan demand and business activity and an increase in non-performing loans over the next six months." Bank lending standards have been tightening and are expected to get more restrictive. Will these initial observations worsen?

The likelihood of a recession remains high as reliable historical indicators such as the inverted yield curve, steep Fed tightening, and declining LEIs all suggest an economic contraction will occur later this year. While it is possible we

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have seen rolling recessions across various industries already, it would be historically unique if a recession did not occur. Based on current conditions, we believe a mild recession is the most likely outcome. A hard landing or a severe recession likely requires a more widespread credit crisis, a severe geopolitical event or some other shock.

Inflation and the Fed

Outside of the bank crisis, market participants remain focused on inflation and the Fed. Monthly inflation data has been volatile versus consensus expectations, but we believe inflation will continue to ease. Some components of the official monthly CPI work on a lag (such as housing inputs and services), but most indicators of inflation continue to trend solidly lower. Further, the four key Covid-related drivers of inflation continue to ease or normalise:

- Money supply (M2)
- Excess saving
- Supply chain issues
- Labour shortages

The Fed is steadfast in its focus on additional rate hikes to tame inflation. However, weakening economic data, additional banking stress, and further proof of lower inflation will likely force the Federal Open Market Committee (FOMC) to pause additional rate increases.

Performance Review

For the March quarter, the Driehaus US Micro Cap Equity Fund outperformed its benchmark. The Fund appreciated 1.9% (I USD share class) net of fees, while the Russell Micro Cap Growth Index gained 0.8%. By comparison, the Russell Micro Cap Index fell 2.8%, the Russell 2000 appreciated 2.5%, and the S&P 500 rose 7.5%. It was a quarter where growth outperformed value, and large caps outgrew smaller caps. By month, the Fund trailed in January but outperformed in February and March.

By sector, the March quarter performance is summarised as follows:

Consumer Discretionary

After a challenging 2022 for the sector overall, consumer discretionary rebounded, and our holdings outperformed by 83 basis points on a relative basis. Our holdings gained 8.9% vs 6.5% for the Index. This strength was led by auto suppliers, hotels, restaurants, a fitness chain operator, and homebuilders. We increased our sector exposure from just under 8.3% to approximately 12%. This increase was partly due to the appreciation of existing positions on strong earnings reports and the initiation of new positions in leisure, specialty retail and homebuilding related companies. The leisure and retailer positions are stock specific in nature. Homebuilders are looking increasingly attractive as the shortage of homes nationwide continues. Mortgage rates appear to have peaked with interest rates overall, incrementally improving home affordability and re-accelerating orders for the builders.

Consumer Staples

Staples outperformed by 72 basis points. Our holdings rose 10.4% for the quarter outperforming the benchmark staples holdings, which declined 4.9%. The sector's outperformance came from a cosmetic/beauty supplier, which appreciated nearly 48% supported by another positive earnings surprise and large upward estimate revisions. A specialty beverage company gained over 36% also with strong earnings. These gains were offset by modest declines among our specialty food beverage holdings. We continue to maintain an overweight in the sector.

Financials

Financials outperformed by 27 basis points. Our holdings did decline 10.8% for the quarter versus the benchmark's financial holdings, which fell 5.8%. That outperformance strength came from being materially underweight banks. The portfolio does hold small weightings in two specialty banks that are growing and that have zero similarities with the stressed larger regional banks. We have been underweight banks on fundamentals concerns with the industry overall.

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Technology

Technology did generate 160 basis points in absolute performance, but it underperformed the Index by 28 basis points. The Strategy's tech holdings gained 6.5%, while the benchmark's tech holdings appreciated 8.2%. The underperformance was entirely driven by declines in the telecom equipment sub-industry. After sharply growing their backlogs, revenues, and earnings and thereby generating strong stock performance over the past two years, two portfolio companies saw a pause in demand and a sequential decline in their backlog. We believe over the intermediate term, strong demand will resume as the enormous federal programs kick in to further penetrate rural broadband access in the US.

Semiconductors saw robust performance, as our holdings appreciated 32.3% versus the 27% for the Index's semi positions. The strength was again due to an RFID chip supplier which beat earnings as it grows supply to catch up to its overwhelming demand. Also, a couple of semi cap equipment holdings continued to perform well as they benefit from increased spending and adoption of silicon carbide (SiC). As a specialised alternative to silicon, SiC is seeing strong adoption in specific applications in the automotive sector, especially within EVs (electric vehicles).

Software was mixed as several positions performed well as they exceeded expectations and continued to gain market share. However, one holding saw macro pressures within its customer's IT budgets causing that stock to underperform. Overall, valuations have stabilised within the industry, and we believe cloud/SaaS software remains a compelling long-term theme.

The portfolio's maintained a modest overweight to the tech sector, but that exposure declined 150 basis points during the quarter as the telecom equipment overweight was reduced due to weakness in that group; this was partially offset to increased exposure to semiconductors and fintech.

Healthcare

Healthcare underperformed by a narrow 6 basis points vs the benchmark. After the impressive performance in the September and December quarters for our holdings in the sector, the March quarter performance was more uneven. Healthcare holdings were down 0.64% versus down 0.32% for in the benchmark. Outperformance in biotech/pharma was offset by negative relative performance in healthcare services. Healthcare is the portfolio's largest absolute weight at 31.5% but is underweight by 360 basis points.

Biotech/Pharma holdings outperformed the benchmark by 72 basis points. The portfolio's absolute weighting rose by 140 basis points to finish the quarter at 21.4%, which is a small underweight of 110 basis points. We remain quite encouraged with clinical trial updates and outlooks for our therapeutic holdings. We anticipate 2023 will be a promising year for them as various clinical trials demonstrate successful outcomes.

Industrials

Industrials detracted 33 basis points in relative terms. Our holdings were down 1.1% vs positive 0.6% for the Index. We did not change our overall weight in the sector, but we maintain an overweight as we see attractive holdings and several strong end market themes within the sector.

After multiple decades of moving manufacturing and supply chains overseas that process is now being reversed. Due to headaches from the Covid-led supply chain disruptions and uncertain behavior by China, many companies are in the process of "reshoring" large parts of their manufacturing and supply chains back to the US. Additionally, multiple very large federal stimulus programs offer big opportunities for US companies. These include programs worth well over $1 trillion such as new infrastructure spending, the Inflation Reduction Act, Rural Broadband Spending programs and the Chips Act to name just a few.

We see attractive individual companies that should benefit, within the following sub-industries: engineering & construction, infrastructure, machinery, aerospace, building materials, consulting, distribution, and rental equipment.

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Energy

Energy continued to be very volatile, as the price of crude oil and natural gas were weak, pressuring the sector. The sector narrowly underperformed by 9 basis points. It was the market's best performing sector last year, but the worst performing sector for the March quarter. One bright spot was oil service companies with offshore and/or international exposures. For the quarter, we decreased exposure to the sector by 135 basis points as we reduced exposure to E&Ps, domestic focus oil service and LNG transport providers. We remain underweight the sector.

Outlook & Positioning

Market conditions remain challenging. Inflation, Fed tightening, higher interest rates and recession fears remain at the top of the market's mind. The key topic remains the direction of inflation and the Fed's continued policy response. Rapidly falling inflation, a soft economic landing and a Fed that responds to the data will be bullish developments. Stubbornly high inflation, a hard economic landing and a Fed policy mistake are the market's primary fears.

Current conditions are highly uncertain over the near-term, yet they offer tremendous opportunity looking out over the next 12 months and beyond. Positively, valuations have declined for our portfolio as we see many holdings trading at attractive discounts versus their own history. Micro/small cap stocks in general continue to trade at a deep discount versus large caps, the second largest discount in 40 years. Additionally, current small cap valuations are at levels similar to past recessions. While the odds of a recession have materially increased, this is a widely anticipated recession that the market has been discounting for over a year. Lastly, while history is clear that micro/small caps stocks underperform during bear markets (this one began in February of 2021), history is also clear that micro/small caps typically outperform during the first five years or more of a new market cycle.

In terms of portfolio positioning, we have an attractive mix of secular and cyclical growth holdings. By sector, healthcare is our largest absolute weight, followed by technology, industrials, consumer discretionary, consumer staples, financials, energy, and materials. On a relative basis, the Strategy is overweight industrials, consumer staples, technology, and consumer discretionary. The Strategy is underweight health care, financials, and energy.

Overall, we still see many dynamic investment opportunities. Fundamentally these holdings fit our investment philosophy well as they are companies exhibiting growth inflections, with important differentiation, market share gains, strong revenues and expanding profitability.

Top Contributors

Axcelis Technologies, Inc. (Ticker: ACLS-US). Axcelis Technologies, Inc. engages in the manufacture of ion implantation capital equipment for the semiconductor chip manufacturing industry. ACLS was a top contributor after it reported 4Q22 sales 12% higher than initial guidance and issued guidance for 1Q23 revenues to be 2% higher than expectations with better profitability metrics. ACLS saw burgeoning demand for ion implant tools in the emerging Silicon Carbide (SiC) power device market while demand conditions with its core customer base of trailing edge fabs remained steady. We took profits in the Strategy as the multiple expanded.

e.l.f. Beauty, Inc. (Ticker: ELF-US). e.l.f. Beauty, Inc. is a leading manufacturer of mass market and clean beauty products. The company was a top contributor during the quarter after reporting December 2022 results well above estimates and raising guidance above consensus expectations. Revenue growth accelerated significantly to +49% year over year and EPS guidance was increased fiscal year 2023 (March) EPS guidance was raised by 28%.

Top Detractors

Xometry, Inc. Class A (Ticker: XMTR-US). Xometry, Inc. reported December quarter 2022 results and guided 2023 performance below consensus estimates. Weaker results materialised as XMTR unexpectedly experienced deteriorating order trends from its largest customers halfway through the quarter. This behavior also resulted in weaker realised pricing. We believe this was primarily due to uncertainty related to the macro environment.

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Clearfield, Inc. (Ticker: CLFD-US). Clearfield, Inc. engages in the design and manufacture of fiber optic components/ protection. CLFD was a top detractor after reporting Fiscal 1Q23 sales 3% better than consensus estimates but guided Fiscal 2Q23 sales 22% below expectations. Guidance was negatively impacted by an inventory correction and push outs in deployment schedules with its core Tier - 2 customer base with weakness expected to persist through Fiscal 3Q2023. We eliminated the position from the Strategy as consensus estimates for sales and earnings remain in a downward trajectory with limited visibility into a recovery over the next 2-3 quarters.

Largest New Purchase[1]

FTAI Aviation Ltd. (Ticker: FTAI-US). FTAI Aviation Ltd. acquires, owns, sells, and leases aviation assets, primarily engines. During the pandemic, airlines burned through engine “green time” at record rates and raided many of their parked aircraft for parts. Additionally supply chain issues have impacted the timeline on which new aircraft can be delivered. As global air travel demand returns to pre-pandemic levels, we expect leased aircraft and engine demand to increase which will be positive for the company. We initiated a position during 1Q23.

Largest Full Sale[2]

Clearfield, Inc. (Ticker: CLFD-US). Clearfield, Inc. engages in the design and manufacture of fiber optic components/ protection. CLFD was a top sell after reporting Fiscal 1Q23 sales 3% better than consensus estimates but guided Fiscal 2Q23 sales 22% below expectations. Guidance was negatively impacted by an inventory correction and push outs in deployment schedules with its core Tier - 2 customer base with weakness expected to persist through Fiscal 3Q2023. We eliminated the position from the Strategy as consensus estimates for sales and earnings remain in a downward trajectory with limited visibility into a recovery over the next 2-3 quarters.

[1]*Defined as the Fund’s largest position as of the end of the quarter that was not held at the start of the quarter*

[2]*Defined as the Fund’s largest position at the start of the quarter that was not held at the end of the quarter*

Sincerely,
Heptagon Capital and Driehaus Capital Management

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Sector performance attribution- Q1 2023

	Driehaus Micro Cap Growth Composite (Port) (%)		Russell Microcap® Growth Index (Bench) (%)		Attribution Analysis (%)		
GICS Sector	Port Avg. Weight	Port Contrib To Return	Bench Avg. weight	Bench Contrib To Return	Allocation Effect	Selection + Interaction	Total Effect
Comm. Services	2.76	0.38	1.90	-0.04	-0.08	0.61	0.53
Consumer Discretionary	10.70	0.57	9.13	0.47	0.05	0.27	0.32
Consumer Staples	8.98	0.87	2.87	-0.11	-0.34	1.06	0.72
Energy	3.64	-0.56	6.47	-0.41	0.15	-0.23	-0.08
Financials	1.89	-0.21	6.91	-0.50	0.37	-0.09	0.28
Health Care	31.03	-0.45	35.38	0.06	0.04	-0.11	-0.06
Industrials	17.54	-0.18	12.87	0.05	-0.02	-0.30	-0.32
Information Technology	20.69	1.60	18.55	1.38	0.14	-0.42	-0.28
Materials	1.96	0.13	2.96	0.00	0.01	0.19	0.21
Real Estate	0.00	0.00	1.67	-0.14	0.16	0.00	0.16
Utilities	0.00	0.00	1.28	0.04	-0.03	0.00	-0.03
Cash	0.81	0.00	0.00	0.00	-0.10	0.00	-0.10
Other*	0.00	-0.29	0.00	0.00	-0.30	0.00	-0.30
Total	**100.00**	**1.86**	**100.00**	**0.81**	**0.06**	**0.99**	**1.05**

Sources: Driehaus Capital Management LLC, Factset Research Systems, Inc., eVestment Alliance
**Other refers to securities not recognised by Factset.*
Data as of 31 March 2023

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Annualized Total Returns as of 31st March 2023, gross of fees

	Q1 23	YTD	1-Year	3-Year	5-Year	10-Year
Driehaus Micro Cap Growth Composite	2.1%	2.1%	-12.9%	29.1%	17.5%	18.5%
Russell Micro Cap Growth Index TR	0.8%	0.8%	-18.0%	10.9%	1.0%	5.8%

Source: Driehaus Capital Management, Bloomberg

Driehaus manages the Irish regulated Driehaus US Micro Cap Equity UCITS Fund according to the same investment principals, philosophy and execution of approach as it manages the Driehaus Micro Cap Growth Composite, however it should be noted that due to different regulation, fees, taxes, charges and other expenses there can be variances between the investment returns demonstrated by each portfolio. The Driehaus Micro Cap Growth Composite is provided in the table above to show a longer track record for the underlying strategy.

The views expressed represent the opinions of Driehaus Capital Management, as 31st March 2023, are not intended as a forecast or guarantee of future results, and are subject to change without notice.

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The Fund is subject to special risk considerations including geographic concentration risk, portfolio concentration risk and operational risk. The investment return and principal value of an investment will fluctuate so that the investor's shares, when redeemed, may be worth more or less than their original cost. Any investor should consider the investment objectives, risks and charges and expenses of the fund carefully before investing. Where an investment is denominated in a currency other than the investor's currency, changes in rates of exchange may have an adverse effect on the value, price of, or income derived from the investment.

SFDR

The Fund takes sustainability risks into account within the investment process, and this is disclosed in accordance with Article 6 requirements of the Sustainable Finance Disclosure Regulation ('SFDR') in the Fund's Prospectus. However, the Fund does not have as its objective sustainable investment and does not promote environmental or social characteristics for the purposes of the SFDR. Sustainability risks may occur in a manner that is not anticipated by the Sub-Investment Manager, there may be a sudden, material negative impact on the value of an investment and hence the returns of the Fund. As a result of the assessment of the impact of sustainability risks on the returns of the Fund, the Sub-Investment Manager aims to identified that the Fund may be exposed to sustainability risks and will aim to mitigate those risks.

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