HEPTAGON Capital

Heptagon Kettle Hill US L/S Equity Fund

Q3 2022 Commentary

Fund Manager

Andrew Kurita

Investment Objective

The Fund aims to achieve long-term capital growth through investing primarily in US small-capitalization stocks. The Fund's Sub-Investment Manager, Kettle Hill Capital Management, is a long/short equity fund manager, established by Andrew Kurita in 2003 and is in New York, USA.

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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 **Heptagon Kettle Hill US L/S 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 Kettle Hill Capital Management, LLC ("Kettle Hill") is the Sub-Investment Manager, meaning Kettle Hill exercises discretionary investment authority over the Fund.

The Fund was launched on October 5, 2017 and had AUM of USD 106m as of September 30, 2022. Since launch to the end of Q3 2022, the Fund has returned 3.6% (Z USD share class) compared to 2.7% for the HFRX Equity Hedge Index, on an annualised basis. During the third quarter of 2022, the Fund returned 2.1% compared to -0.1% for the HFRX Equity Hedge Index.

For the quarter ended September 30, 2022, Kettle Hill Partners, LP had a gain of 1.9%, net of all fees. Longs subtracted 0.1%, and shorts contributed 2.0%. Ending exposure was 106% gross and 33% net, 70% gross long and -36% gross short, resulting in a long/short ratio of 1.92:1.

3Q22 Review

We generated a gain in a quarter when the broad markets declined. The long book was almost flat while the short book contributed 2.04%. Our results were led by positive returns on both the long and short side in technology. Over the course of the quarter, we benefitted from the proactive trading of some individual stocks as well as dynamic management of the portfolio's overall exposures. For example, we thought positioning and overall market sentiment was overly pessimistic in July and overly optimistic in the middle of August. Thus, we were able to opportunistically make tactical shifts to try to take advantage of these shifting views and market conditions. We believe that market uncertainty is creating great opportunity; there are many stocks with dislocated valuations. We'll continue to work hard in an attempt to capitalize on this moment. The more detailed discussion below on some of our winners and losers may provide additional insight into the dislocations and volatility impacting the markets and stocks.

Past performance is no guide to future performance, and the value of investments and income from them can fall as well as rise

3Q22 Winners and Losers

Best-Performing Long—Everbridge, Inc. (EVBG)

The best-performing long in the period was Everbridge, an enterprise software company focused on critical event response for governments and enterprises. The stock was a high-flyer last year until they reported disappointing results due to a shortfall in the company's European mass-alert business. The company went from hyper growth to medium growth, yet, as per our research, the stock trades at a seemingly distressed level for a software company. We believe there is growing demand for the company's products in the current environment as it is becoming more necessary for organizations to be alert and respond to critical events in real time. In our opinion, the market's sell-off in growth companies gave us an opportunity to own what we perceive to be a high-quality recurring revenue business with high freecash-flow margins, at a steeply discounted price. The stock was oversold along with the broader market in the second quarter. It rebounded in the third quarter given the appointment of its new CEO with a track record of fixing and selling software companies. We believe the stock has significant upside from current levels.

Worst-Performing Long—Citigroup Inc. (C)

The worst-performing long in the period was Citigroup. We like the new CEO and the efforts to exit low-return and higher-risk international businesses. The net result should be lower-risk, higher return on equity and a higher valuation. The stock was trading at a fraction of book value with a mid-single-digit P/E ratio. In our opinion, the company's progress was underappreciated, the strategic plan was strong and the steep valuation discount to its peers could be closed. The company announced higher-than-expected expenses to effect this transformation, concurrent with a sharp market sell-off. As a result, we incurred a loss on the position and sold it for a loss as part of our risk-management discipline.

Best-Performing Short—Lam Research Corporation (LRCX)

The best-performing short in the period was Lam Research Corporation, a semiconductor capital equipment company with significant exposure to memory chip manufacturing equipment. The company is an industry leader and has great margins, so why would we short it? Memory semiconductors (DRAM and flash) are deeply cyclical businesses, and sales of the capital equipment to produce it are even more cyclical. In prior cycles, technology investors have often overvalued these companies by placing peak multiples on peak earnings. We believed the stock was overbought and overvalued based on strong sales in the prior twelve months. It was our belief that memory capex was about to plummet due to an impending glut of chip inventory. One of their larger customers missed earnings, citing slowing demand, yet the stock was initially slow to respond on the downside. As the stock declined, we took profits on a portion of the position.

Worst-Performing Short—DICK'S Sporting Goods, Inc. (DKS)

The worst-performing short in the period was Dick's Sporting Goods. We believed the pandemic created unsustainably high margins for most retailers. Retailers slashed inventory orders early in the pandemic, only to see sales rebound more sharply than anticipated. That allowed them to reduce discounts, sharply increasing their margins. Retailers place orders twelve months in advance; it was our belief they would over-order when demand would likely falter due to decreased stimulus and higher inflation. This was a commonly held thesis, and Dick's was able to outperform in a period when most investors thought they might do poorly. Considering new data, we re-evaluated our thesis and covered for a loss.

Investment Outlook

The current macroeconomic environment is toxic. The reversal of globalization, the weaponization of trade policy and the restriction of immigration could create sustainably higher rates of inflation in the future. We think that the Fed was late to raise rates, and now it seems they are raising too aggressively. It appears the Fed is trying to kill demand to reduce inflation; this will cause a lot of pain and doesn't address the core issue. We believe that the sustainable solution to solving inflation is increasing the supply of the inputs of production and increasing labour supply. Increasing immigration and offshoring are politically untenable. The era of easy monetary policy and globalization may be over, and we may have to adjust to managing money in a very different environment than any active participant has ever experienced. We will therefore proceed cautiously.

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Unsettled markets typically experience prolonged levels of high volatility. It is our view that this creates trading opportunities in individual stocks and in managing overall levels of gross and net exposure in the portfolio. We aim to thrive on stocks with asymmetrical risk-reward profiles. The outlook is unclear, yet we believe the opportunity set is robust and just as compelling as what existed in prior crisis years. Many stocks appear to have already fully discounted a deep recession, and we are attempting to identify the companies that will emerge from this period stronger, with higher levels of revenues and profit.

Our objective is to stress test every position in the book based on internal methodologies, with the aim of building models to project earnings in the most difficult economic scenarios. Therefore, we are avoiding cyclicals and targeting companies with potentially recession-proof revenues and stock prices that have been dislocated from our assessment of durable franchise value. We are long recurring revenue software companies with good growth prospects trading at valuations that, in our opinion, are well below private market valuations. Although we are generally avoiding cyclical companies, we are buying consumer stocks that are trading at levels last seen in early 2020, that trade at mid-single-digit P/E multiples on our conservative estimates of normalized earnings. Cancer immunotherapy may be on the verge of a breakthrough in the next few years. The stocks in this group have been crushed and trade at levels where we think failure is priced in, whereas success could produce large upside. This basket of stocks only represents a small portion of our capital given the associated risks with drug development.

We are short companies with high levels of international exposure due to the potential for much weaker economies and foreign exchange translation risks. Our software longs are hedged by software shorts we believe to have decelerating fundamentals with no valuation support. Inventory is building in the global economy, and we are short stocks related to the supply chain that could suffer earnings shortfalls as abnormally high levels of demand for goods abates. Lastly, high levels of home improvement spending and construction will probably decline as interest rates and inflation of building supply materials render most projects unfeasible.

Conclusion

We think that we tend to do better than many others in difficult environments, and we are excited about our current positions and future investments in the pipeline. We believe we have protected capital relatively well this year, and, as we have done in the past, we are prepared to deploy that capital into in what we judge to be superior risk-rewards with clear eyes and calm minds.

Sincerely,
Heptagon Capital and Kettle Hill Management

The views expressed represent the opinions of Kettle Hill Capital Management, as of 30th September 2022, are not intended as a forecast or guarantee of future results, and are subject to change without notice.

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Annualized Total Returns as of 30th September 2022, net of fees

	Q3 22	YTD	1-Year	3-Year	5-Year	10-Year
Kettle Hill Partners, LP	1.9%	-6.6%	-7.7%	5.2%	3.5%	5.2%
HFRX Equity Hedge Index	-0.1%	-4.8%	-2.3%	4.7%	2.8%	3.2%

Source: Kettle Hill, Morningstar

Kettle Hill manages the Irish regulated Heptagon Kettle Hill US L/S Equity UCITS Fund according to the same investment principals, philosophy and execution of approach as it manages Kettle Hill Partners, LP, a Delaware Limited Partnership available for U.S. accredited investors that launched in June 2003. 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. Kettle Hill Partners, LP performance is provided in the table above to show a longer track record for the underlying strategy.

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Risk Warnings

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.

Authorised & Regulated by the Financial Conduct Authority (FRN: 403304)

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For all definitions of the financial terms used within this document, please refer to the glossary on our website:
https://www.heptagon-capital.com/glossary

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