HEPTAGON
Capital

Listed Private Assets Fund

Q3 2022 Commentary

Fund Manager

Arnaud Gandon

Investment Objective

The Fund aims to produce high single digit returns, from a combination of capital appreciation and income, with a targeted annual yield of 4-5%. The investment philosophy of the Fund is founded on the premise that exposure to private assets should earn a premium over listed equities and bonds over time.

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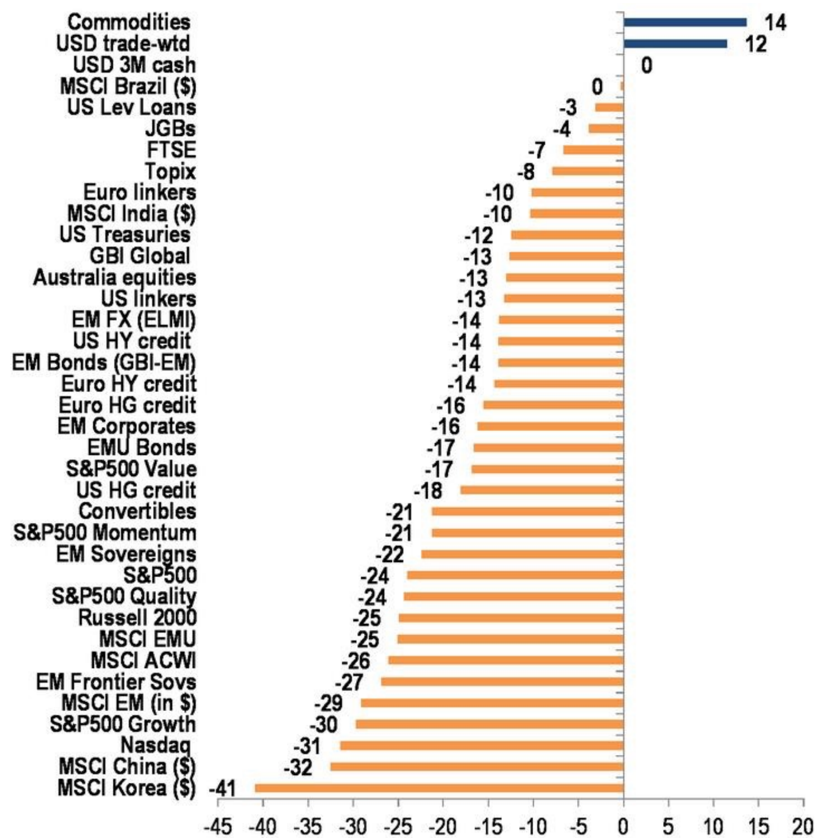
Opinions expressed whether in general or in both on the performance of individual investments and in a wider economic context represent the views of the contributor at the time of preparation.

The third quarter was undoubtedly a difficult one for all assets: the only game in town would have been to have long positions in the US Dollar. The year-to-date performance for major asset classes is no short of being the worst we have seen in our entire career, bar for a few weeks in the midst of the Covid-19 crisis in March of 2020.

Year to date returns

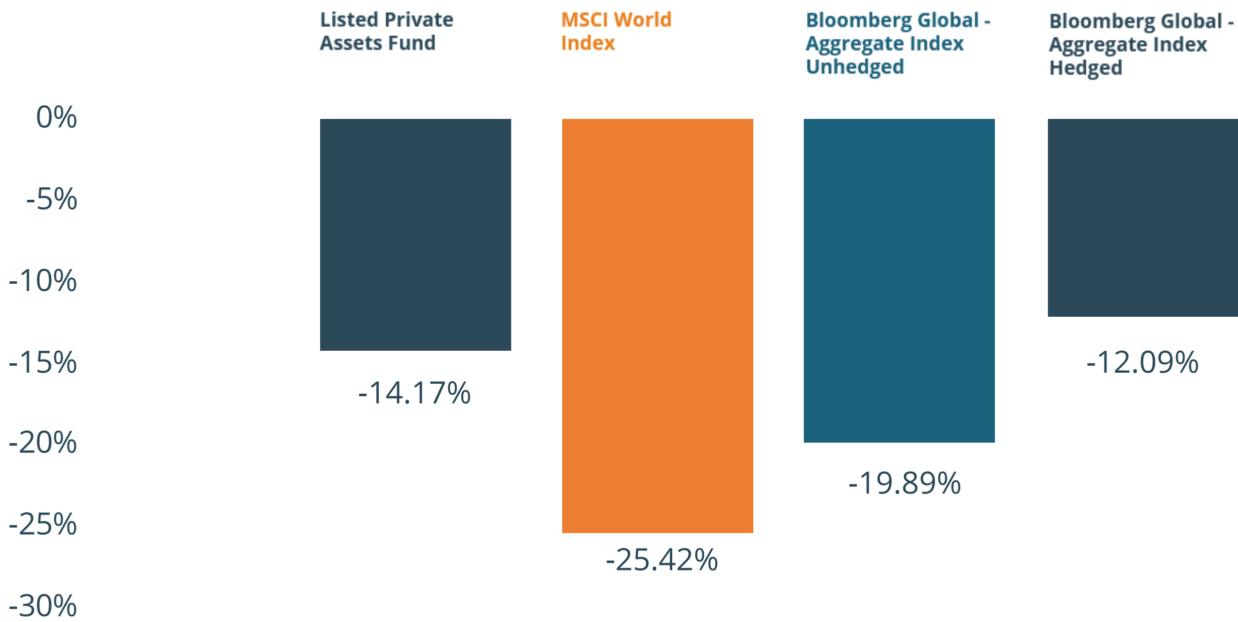


Source: Bloomberg, Heptagon Capital

It is in this context that the LPA strategy returned a negative -5.6% slightly ahead of both Global Equities and bonds for Q3. This brings the year-to-date return of the strategy to -14% which compares to -25% and -20% for Global Equities and Global Bond respectively.

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

2022 downside protection

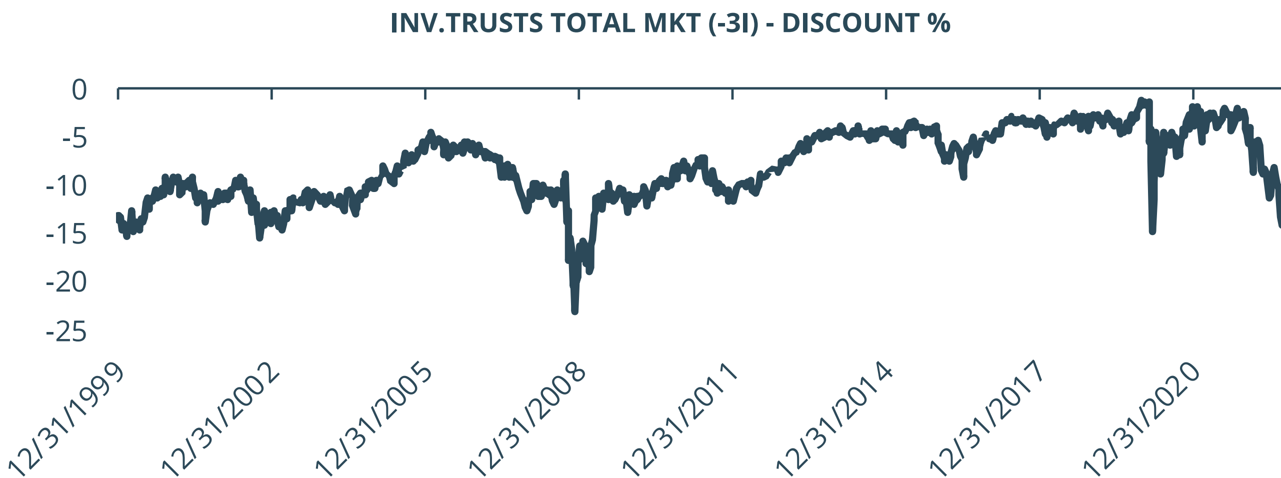


Source: Bloomberg

Our strategy performed reasonably well, at least on a relative basis, until the last two weeks of September when interest rate volatility increased dramatically in the United Kingdom because of the poorly received budget by the newly formed Conservative government. The volatility spooked the markets and the entire listed investment company universe we monitor corrected indiscriminately, regardless of the nature or geographic location of the underlying assets.

A concrete example of this market reaction was seen in the sharp correction of our holdings in Eurobox, a European-focussed logistics business which corrected -23% in September. Given that this company's large warehouses are in Europe and its cost of funding is in Euro, we view this price move as an overreaction and potential forced selling from institutional clients. This company has a strong balance sheet and plenty of capital flexibility. It has a low loan-to-value ratio of 28% and 73% of its Euro-denominated debt is fixed with a 5-year maturity tenor.

Looking across the portfolio, the majority of our companies have now moved to meaningful discounts to their net asset values as can be seen on the chart.



Source: J.P. Morgan

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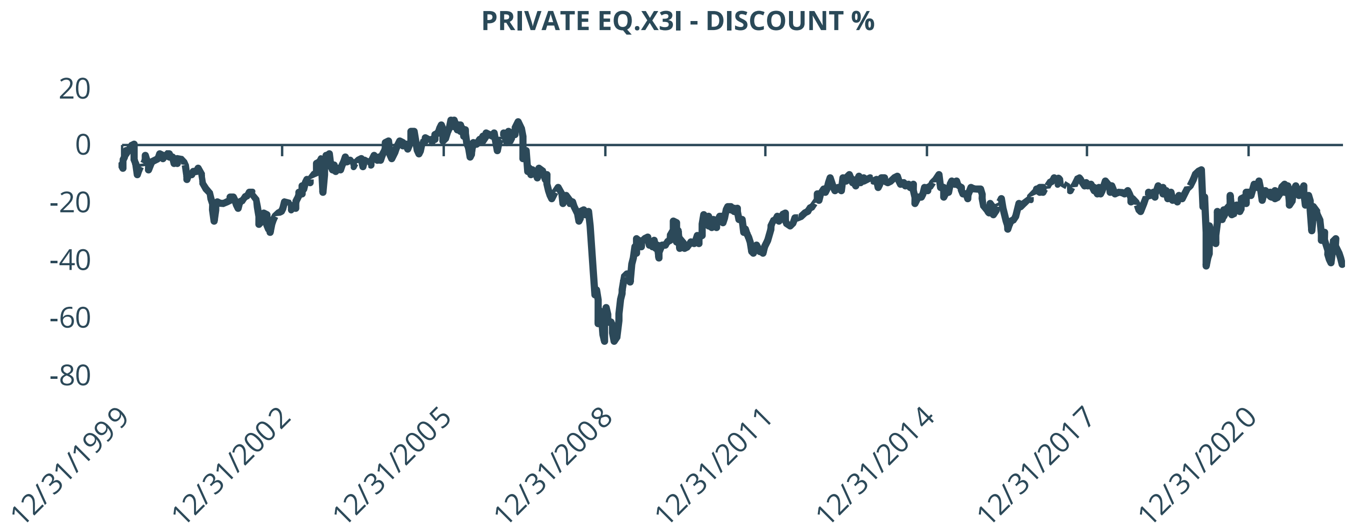
As always, the level of discount will vary depending on the underlying assets, with Private Equity and Venture Capital offering the largest discounts (in the range of 40% to 60%) while Private Debt is trading on an average of 10% to 20% discounts.



Source: J.P. Morgans

Of course, given the lagging nature of the net asset values we expect them to follow the discount downwards as they tend to follow the market. The name of the game is now to estimate the potential markdowns in NAVs and compare it to the current level of discounts. Using our framework, we now see a number of attractive opportunities that should underwrite the fund's returns for the next 2 to 3 years. It is also our experience that every time we have seen forced selling across some of our holdings, it has led to a good forward returns dynamic for the portfolio.

Looking across the portfolio, it is our view that the correction witnessed during the third quarter was primarily due to the following: 1) extreme rate volatility; 2) forced selling by large institutions; and 3) good old-fashioned fear leading to large discounts irrespective of net asset value performance by most assets. In fact, looking at our portfolio, earning and results reported during the quarter were well above trend for many of our holdings.

Take our position in 3i Infrastructure for example, it invests in companies that provide or maintain essential infrastructure, and therefore have a high degree of pricing power. In our view the management team has one of the most disciplined and talented within the European infrastructure space. It invests in a concentrated portfolio of 18 critical infrastructure businesses, typically taking a controlling stake and a seat on the company's board in order to actively engage and maximise returns for its shareholders.

On the debt side, the company does not face any material refinancing requirements until 2026 and the debt typically sits at the underlying companies' level rather than on its own balance sheet. The company has a good track record of delivering total returns in excess of its 10% return target since inception and management has re-iterated that its net asset value is on track to deliver its target - an expected 5% return for the first half of 2022.

In addition to this, the management's discount rate assumptions have always been on the conservative side, using 10% to value future cashflow thereby leaving plenty of margin of safety with respect to a potential increase in the risk-free rate.

Finally, the company has been traded on a double-digit premium to net asset value over the past few years and is now on offer at a 7% discount to our estimated NAV. Since our philosophy has always been to add to high quality asset at a discount, we brought this position from a small, less than 2% holding to a 6% holding.

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Our real estate exposure was the largest negative contributor to performance during Q3 as the sharp increase in risk-free rates moved the entire sector to a -25% discount. (CHART). Most of our holdings have reported solid earnings and increases to their net asset values for the first half of 2022. We are selectively adding to some of the beaten down names which we believe are pricing plenty of bad news already.

Tritax Big Box, which we have owned since inception, has been one of the names we have been adding to in September. Tritax owns and rent large industrial warehouses to support the growth of online retail in the United Kingdom. The portfolio consists of 28 sites with approximately 40m sq. ft of space valued at about £6bn. The company reported a +9% appreciation in its net asset value in the first half of 2022 with vacancy at 0% and 100% rent collection. Rent growth has also remained solid during H1.

Importantly, the company's balance sheet is strong with low LTVs (24%) and conservative financing leaving the management with plenty of flexibility to navigate the current challenging environment. 70% of its debt is at fixed rates with the remaining variable debt 100% hedged mitigating any earnings impact from rising interest rates with cost of borrowing 2.5%. There are no major maturities for 2.5yrs with £443m of undrawn financing commitments available to fund capex with disposals adding investment capacity. Our position in Tritax has gone from a 1% position at the very beginning of September to a 5% position today.

Within the debt segment of the portfolio, we have also added to holdings that have been sold aggressively, creating opportunities to earn a significantly higher level of yield for the portfolio. We re-initiated a position into a large US Agency Mortgage-Backed Securities REIT, Annaly Capital, on an 18% dividend yield. This segment of the real estate-backed debt sector has seen a significant increase in spreads as a function of US mortgage rate volatility.

This is a well-managed REIT with a long track record of delivering returns across the market cycle. The company has $4bn of cash and $2bn of unencumbered assets giving its balance sheet flexibility to weather the current storm. The current level of yield for this security is now higher than during the GFC and the Covid-19 crisis. We believe that for long term investors, given that agency paper (Freddie Mac & Fannie May) bears no credit risk, the current level of yield compensates holders for further possible negative outcomes.

Reflecting on the quarter, we find it hard to find any meaningful negative stock specific news for the majority of our holdings. The poor performance in September was a function of a "grey swan" or an event-driven shock related to the risk-free rate affecting our universe of companies. We continue to believe that asset-based cashflows with a high degree of inflation-linked revenues are well suited for the current environment.

We are certainly far too sceptical to be forecasting a market bottom in the weeks to come. We can however look at the shape of returns, discounts and NAVs during past recessions and find comfort that the current price levels should underwrite above-average returns on a 2-to-3-year horizon. We have now deployed all our cash and might look to recycle some names into highly discounted situations over the weeks to come.

We would like to thank our investors for their trust and patience.

Kind regards,

Arnaud Gandon, Portfolio Manager

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