HEPTAGON Capital

Future Trends Equity Fund

Q3 2022 Commentary

Fund Manager

Alex Gunz

Investment Objective

The Fund aims to deliver consistent and sustainable long-term returns by investing in a concentrated portfolio of global equities.

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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 Future Trends Fund has a very clear and distinct philosophy: we seek to identify and invest in a diverse range of businesses offering exposure to the key trends which we believe will help shape the future. Although the Fund outperformed in Q3 relative to its MSCI World benchmark, 2022 has clearly been a challenging year for equities. The Fund is down 29.3% since the start of January. Looking ahead, despite a likely still-difficult macro environment, we believe that the prospects for our businesses and the themes to which they are exposed remain highly compelling. Such conviction is reinforced by the fundamental analysis we have done.

Introduction

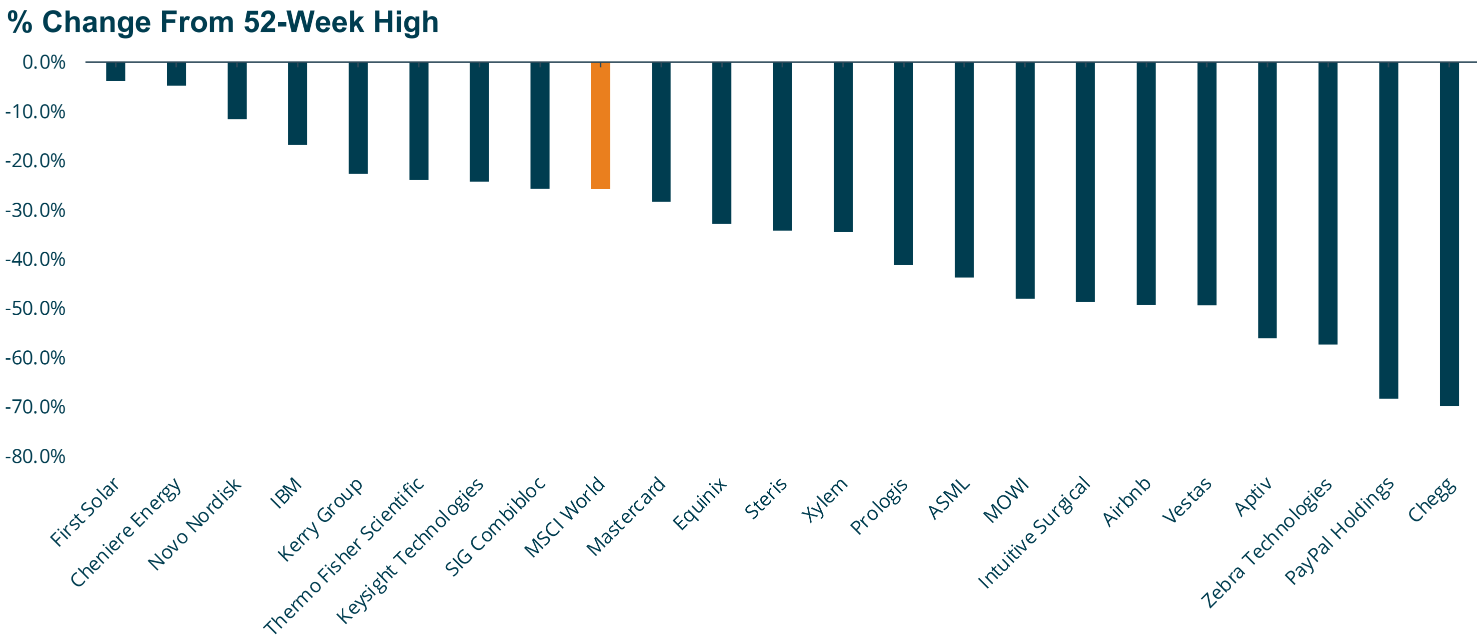
Investors would need to go back to the Great Financial Crisis of 2008/9 to find the last time when the MSCI World Index of global equities fell three consecutive quarters. This pattern has unfortunately been repeated in 2022 to-date. The reasons for the decline this time around have been well-documented elsewhere and all market participants are having to adjust to the reality of inflation, monetary tightening and the possible risk of a recession.

The Future Trends Fund has followed a similar pattern to the MSCI World and fallen in each of the three quarters of 2022, by 10.6%, 18.9% and 2.5% respectively. While there would be no way to characterise this decline as a 'good' performance, we note that **the Fund has performed *relatively* better than many other comparable growth or thematic oriented Funds**. Moreover, during the third quarter, the Fund's drop of 2.5% saw it *outperform relative to the MSCI World Index* for the first time this year. Whereas the Future Trends Fund was 700 basis points behind the MSCI World at the end of Q2, it is now lagging by 'only' 390 basis points.

We know we can't control the macro environment. Further, we recognise that investors' risk appetite levels will vary across the cycle. **Our job is stay disciplined and combine top-down and bottom-up analysis** in order to build the case for the businesses we own, with a *long-term* perspective in mind.

Drawdown creates opportunity

There have been few places for investors to hide in 2022. Several of our businesses are down over 50% year-to-date. When viewed through the lens of share price moves versus 52-week highs, the average business in the Future Trends Fund has experienced a 35.7% drawdown. The comparable figure for the MSCI World is 25.8%.



Sources: Heptagon Capital, Bloomberg

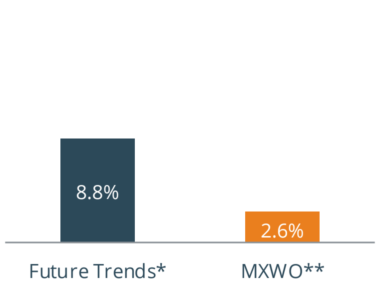
In the face of such moves, some soul-searching might naturally be called for; or, put more formally, we need to make **recourse to fundamental analysis**. Begin top-down. We have built a thematic library which dates back over a decade. Our contention has always been – and remains – that **we are still early in the innings with regard to the development of all the trends to which the Fund's businesses have exposure**.

Take renewable energy by way of example. The topic has moved to front of mind given the crossover between geopolitical and environmental priorities, accelerated by Russa's invasion of Ukraine. Almost every country in Europe has committed to new renewable energy targets. Meanwhile President Biden's Inflation Reduction Act calls for an acceleration of clean energy deployment in the US. The importance of energy independence may now be much better 'understood' than a year ago but consider that **less than 10% of all electricity generated globally currently comes from renewable sources**. In other words, this theme can run for a long time. We could make similar arguments for any other theme to which the Fund has exposure. For our latest real-time insights, interested parties should view our weekly Blog.

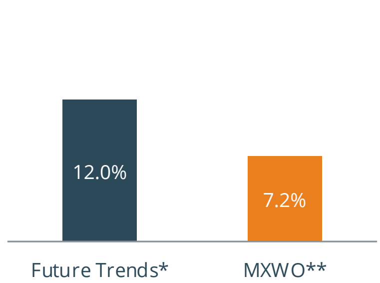
We also derive comfort from the bottom-up work that we do. We build financial models for every business we own, or consider investing in. We review these regularly and stress-test our assumptions. These are typically more conservative than consensus estimates sourced from Bloomberg. When we take the weighted average of our forecasts, **our businesses are set to outgrow the MSCI World by a factor of more than three on a three-year compound annual basis**. More importantly, our businesses are very effective at taking this growth and converting it into cash.

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

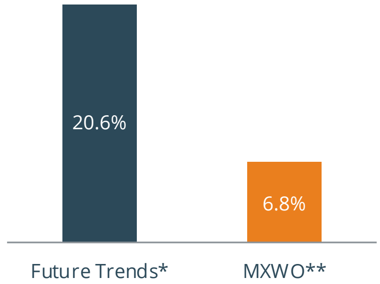
Revenue Growth (3Y CAGR) 2021-2024E



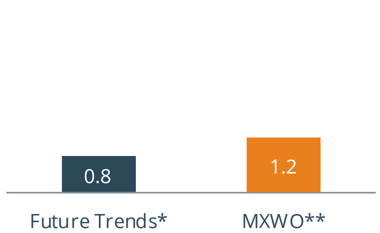
Earnings Growth (3Y CAGR) 2021-2024E



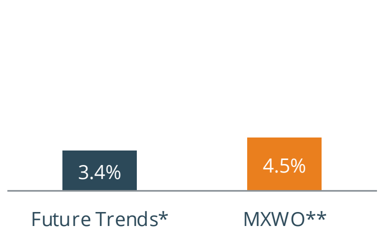
FCF Growth (3Y CAGR) 2021-2024E



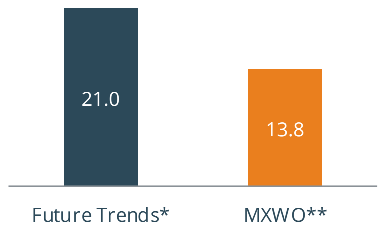
Net debt/EBITDA (x) 2021A



1Y forward FCF yield (%) 2022E



1Y forward P/E (x) 2022E



*Sources: MSCI, Bloomberg, Heptagon Capital. *Weighted average for the Fund. **MSCI World NR USD.*

Even if there is a broader downside risk to forecasting associated with a likely general deterioration of macroeconomic conditions, we believe that prospects for our businesses relative to those in the broader market will remain highly favourable. Investors (especially those with a longer-term mindset) are justified, in our view, in paying a premium for superior growth and free cashflow. For reference, when we conduct our valuation work on a bottom-up basis using discounted free cashflow analysis, **our average business is almost 50% undervalued at present.**

Beyond our modelling work, **engagement is also a key part of our process**. Much of our ongoing work is detailed in our regular quarterly sustainability reports. For the record, **year-to-date, we conducted 81 corporate meetings**, either in-person or virtually. Over the past quarter, we interacted with 16 businesses, 10 of which are (or were, in the case of Darktrace) Fund constituents.

Put another way, *despite* the current highly uncertain investment environment, there has been **no change in our investment process**. Each business we own within the Future Trends Fund remains subject to an ongoing, detailed due diligence process. This begins with a thorough understanding of the prospects for the theme to which the business is exposed and is complemented by ongoing interaction with company management and a consideration of financial and valuation prospects. Such an approach also explains why the Fund has low turnover.

Portfolio changes

Our strategy has always emphasised low turnover. When we add names to the Fund, it is to increase thematic diversification. Meanwhile, sell decisions are motivated typically by higher relative conviction in new names. **We made one portfolio addition and one (unrelated) exit in Q3.** For the record, the holding period for the businesses in which we invest is potentially indefinite. We have owned three businesses (Kerry Group, Mastercard, Novo Nordisk) since the Fund's inception. The average business within the Fund currently has been owned for 43 months.

Xylem became the newest investment in the Future Trends Fund, added to the portfolio in August 2022. Listed in the US with a market capitalisation of $16.6bn, Xylem is a leading pure-play water technology business that addresses the water cycle across its three business units (water infrastructure, applied water solutions, and measurement & control

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solutions).
With over a third of the world's population currently living under some form of water stress and this figure only likely to rise given increasing water demand, **there is a clear logic in improving the efficiency of water supply through intelligent innovation**. We first highlighted the importance of this future trend in June 2011 and made the specific case for digitalising the water sector in February 2022. Our dialogue with Xylem first began in 2016 and our more recent due diligence included a visit to the company's New York headquarters to meet with senior management, a trip to Xylem's UK research and development centre in Cambridge, England and a conversation with the procurement manager at one of Xylem's significant customers.

Xylem has a strong track record in terms of execution, evidenced by 7.7% annualised returns over the last five years. Last reported results from the business (in August 2022) saw Xylem beat consensus estimates and raise its guidance for 2022. The business is now calling for 8-10% organic revenue growth, up from 3-5% at the start of the year and prior (May 2022) guidance of 4-6%. Looking beyond this, we believe visibility is positive for Xylem given not only the strong secular trends driving the sector, but also supported by Xylem's current $3.3bn order backlog and its high percentage (c40%) of revenues which are recurring. Xylem is currently a 4.2% weight in the Future Trends Fund.

Our position in Xylem was primarily funded through **our decision to exit from Darktrace**. Although Darktrace was only added to the Fund in February, our sell after such a short period was motivated by positive M&A activity. As a reminder, Darktrace is a UK-listed cybersecurity business which provides advanced AI solutions to its customers. We have followed the theme of cybersecurity since we first began writing about future trends and remain of the view that data have no value unless secured, stored and analysed.

Darktrace constituted the third time we have had exposure to this theme in the Fund, having previously been investors in Sophos and Avast. In both these cases, the businesses also were on the receiving end of corporate interest from a larger acquirer (by Thoma Bravo in September 2019 and Norton Lifelock in August 2021, respectively). This time around, Thoma Bravo, a leading US private equity house, was also responsible for the interest in Darktrace. The company issued a press release on 15 August after the UK market had closed highlighting that it had been subject to a "preliminary approach." Darktrace shares closed 24.2% higher on the subsequent trading day.

We used this large move as an opportunity to lock in some profit on our investment in Darktrace. With hindsight, this proved to be the right decision as Darktrace announced on 8 September that its talks with Thoma Bravo had concluded unsuccessfully. The shares dropped on this day by 34.5% (although they admittedly gained 12.5% on 9 September). We subsequently sold our remaining stake. While we have always been impressed with the underlying technology offering of Darktrace, clearly Thoma Bravo would have been in a position to do substantially more due diligence than we would ever have been able to do on Darktrace. **Over the time we owned Darktrace, we made a 24.2% return**, which compares very favourably to the -11.1% move in the MSCI World Index.

Owning Xylem increases the thematic diversification of the Fund as well as improving its ESG credentials. We will, however, continue to review investment opportunities within the cybersecurity space.

Conclusion

In times of uncertainty, we believe it is important to remain focused on the bigger picture and not to lose sight of what matters. Thought of differently, it is a matter of **balancing short-term market concerns with the longer-term thematic opportunity**.

On one side, market sentiment is currently characterised by high levels of risk aversion, perhaps unsurprising in the context of tightening monetary conditions and the associated downside potential to consensus earnings estimates. Do not forget heightened levels of geopolitical uncertainty as an additional concern.

Consider now, the longer-term opportunity. **All the future trends in which we invest are still in an early innings**.

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Digitalisation and decarbonisation constitute secular tailwinds. Next, remember that all **our businesses have strong free cashflow generating potential**, which is underpinned by the deep moats they possess. The Fund is highly diversified both by theme and by geography. It also has **a track record of generating consistent returns since its inception** in 2016.

Thank you for your interest in and support of the Heptagon Future Trends Equity Fund.

Alexander Gunz, Fund Manager

Appendix: Q3 leaders and laggards

There have always been high levels of dispersion across the Future Trends Fund, reflecting the different themes to which the Fund is exposed. On a year-to-date basis, there is a 120 percentage point difference between our best and worst performers (Cheniere Energy and Zebra Technologies respectively). During the third quarter, the spread between our leader and our laggard was equivalent to 132 points.

At the top of the table were two of our three alternative energy plays. **First Solar** gained 94.1% during Q3, while **Cheniere Energy** added 24.7%. Both businesses continue to benefit from ongoing geopolitical dynamics and the prioritisation of energy independence, a theme we discussed in detail in March. As the largest US-listed producer of solar panels for industrial/ utility customers, with a highly differentiated proprietary technology, First Solar was a clear beneficiary of President Biden's Inflation Reduction Act, which passed in August.

Meanwhile, Cheniere continues to benefit from its position as the key player within the space of liquefying and then transporting natural gas. We believe LNG provides an interim solution in the transition from conventional fossil fuels to renewable sources. Cheniere began 2022 guiding $7.0-7.5bn of EBITDA. Current guidance calls for $9.8-10.3bn.

MOWI was the Fund's notable laggard in Q3, losing 38.2%. Much of this decline came on the penultimate day of the month, when the shares dropped 18.9% following a proposal from the Norwegian Government to implement a new resource tax on all salmon farmers. While this would clearly be negative for MOWI (and the industry as a whole), the proposal has yet to be passed into formal legislation and MOWI benefits from being a global business, with c50% of its revenues outside Norway. One likely consequence, should the tax become law, would be for MOWI to prioritise investment *outside* of Norway ahead of domestic projects. **Steris**, our play on healthcare sterilisation, was our other laggard, down 19.3% primarily on a rare miss to earnings, which led to lowered financial guidance.

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SFDR

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