HEPTAGON
Capital

European Focus Fund: Monthly Commentary

March 2021

European Focus stands strong in a post COVID-19 environment

The early part of March reflected deliberation for European equities; whether to look beyond the likely cyclical re-opening boast, or whether the slow inoculation rollout and the tussle for vaccines would lead to a third wave of the virus. While a sector breakdown for the month gives an inconclusive picture in our view, we construe that investors ultimately decided to look beyond the re-opening boast. Defensive income stocks in the consumer staples and communication services rose by 9% in March, while consumer discretionary shares rose by 8%. Meanwhile, traditional cyclical recovery stocks, such as those in the energy and materials sectors (which performed well in February), did not keep up with the broader market as they only advanced by +1% and +4% respectively in March. A closer look at the discretionary sector, however, shows that the German automotive stocks had an extremely strong month following Volkswagen's remark (16th March) that it would take on Tesla's dominance in the electric vehicle space. This prompted the VW (preference) share to advance by +38%, Porsche by +36% and BMW by +24%. The Heptagon European Focus Fund does not invest in this sub-sector and struggled to keep up with the broader market. The Fund's NAV increased by +4.11% in March vs. the benchmark MSCI Europe NR (EUR) index, which rose by +6.47%, reflecting a shortfall to the index of -236bps.

March marked the end of the FY20 reporting season. On a positive note, all Portfolio companies in European Focus either matched or beat market expectations. The main differentiating factors as to whether stocks outperformed or underperformed following the publications of their statements related to managements' guidance and the magnitude of changes to consensus sales and profit revisions. Two topics (on which we have commented previously) were on top of companies' agendas during the many results webcasts. *First*, companies' progress in converting their businesses to the digital world and how to best offer their products and services online. *Secondly*, ESG (and climate change in particular) was highly topical and several companies announced that they had directly linked their management's compensation to measurable ESG-targets.

Leaving the year-end reporting season, we believe it is important to analyse the Portfolio companies' revenue and profit streams in order to get an idea of the magnitude of changes that lies ahead. Based on the individual stock weightings as of 31st March, the Portfolio companies' combined revenues increased by +2.2% in FY20 (vs. -17.2% of the MSCI index), while EBITDA rose by +9.8% (vs. -22.2% of the MSCI index) and EBIT by +14.4% (vs. -34.3% of the MSCI index). In short, the Portfolio's sales and profit bases grew while those of the market declined.

Equally important when looking ahead, the market's revision changes for the Portfolio companies' sales, EBITDA and EBIT streams from the end of Dec-20 to the end of Mar-21 are encouraging. We are pleased to report that the consensus changes to the Portfolio's FY21 estimates are broadly unchanged. *First*, we regard this as very good news for an export-driven Portfolio like European Focus, given that the USD is some -9% weaker against the EUR in 1Q21 year-over-year (we guesstimate that around 50% of companies' invoicing is denominated in USD). *Secondly*, we also regard the unchanged estimate outlook as impressive considering that businesses across most of Europe were severely constrained in 1Q21 because of COVID-19 restrictions. When looking at revision changes for FY22 from the end of Dec-20 to the end of Mar-21, we note that there have been upgrades to Portfolio companies' estimates in the range of +1 to +2%.

Over the past few months, a number of market commentators have remarked on a shift in the price dynamics of equities where traditional value-driven shares in the energy, materials and financial sectors have been bolstered on-and-off by expectations of rising inflation and this has pushed bond yields higher. Since this has a direct effect on the valuation of companies in growth industries, such as those in the technology sector, we believe it is worthwhile to take a step back and consider what the wider implications are. *First*, if one believes that technology will have a smaller role to play after economies eventually open up in a post-COVID-19 environment, rotation to value-driven stocks makes sense. *Secondly*, other growth sectors which have been subject to profit-taking – like those in the TIC-segment (testing/inspection/certification) – are also unlikely to have a smaller role to play in a post-COVID-19 environment given that the demand for '*testing*' in a wider sense should be more commonplace. Against this backdrop, we believe the current revival of value-stocks will be transitory.

Over the years ahead, a number of traditional businesses, such as energy, metals/mining and general industry, will have to re-engineer their activities to comply with considerably tighter environmental restrictions while other industries, like those in oil and fossil exploration, will need to entirely convert their activities to become sustainable (such as in the renewable field). These industries will need to re-allocate valuable management time to re-design their business strategies, which not only takes time away from focusing on growing their core activities but will also require additional capital to build up scale. This leads us to the important conclusion that businesses that have stood the test of time should have higher odds to perform well in the long run. Our analysis shows that the average age of a Portfolio company in European Focus goes back to 1934 (oldest: Hermès/1837 – youngest: Zalando/2008). Thus, irrespective of COVID-19 and/or other ESG-related matters, the probability is high that most Portfolio companies will continue to be around for the foreseeable future since they are: (*i*) ESG-friendly and; (*ii*) have established significant barriers to entry by having a core focus and pricing-power, driven by doing something extremely well for a long time.

In regard to the current issue on whether higher bond yields will be a constraint only to growth companies' valuation, we believe a more relevant question is if higher bond yields will affect businesses' profitability (for example, if companies have sought government support during the pandemic or will require debt-relief). On this note, we are pleased to report that the balance sheet strength of an average Portfolio company in European Focus is healthier now than a year ago.

Following the FY20 reporting season, our analysis shows that based on the consensus FY21 estimates for EBITDA, the Portfolio's net interest-bearing debt to EBITDA at the end of Dec-20 stood at 0.5x (end Dec-19: 0.8x) excluding lease-debt obligations. The corresponding figure including lease-debt obligations was 0.8x (end Dec-19: 1.3x). Hence, there has been a marked improvement in the average Portfolio company's capitalisation during the past year. Moreover, these strong Portfolio metrics compare extremely favourably with the average net debt to EBITDA of the European market, which sits in the range of 3.0-3.5x.

Moreover, the duration of debt of an average Portfolio company in European Focus has improved further in 2020. Our analysis shows that short-term debt (excluding lease-debt obligations) stood at only 24% at the end of Dec-20 (end Dec-19: 28%), while the corresponding short-term debt (including lease-debt obligations) stood at 21% (end Dec-19: 23%). As and when investors start to consider what implications higher bond yields will have on companies' business performance – and not just in the context of the higher discount rates for valuing growth companies – we are confident that this factor will be regarded as an impediment to many industries. This should play into a further strengthening of the Heptagon European Focus Fund.

Christian Diebitsch, Fund Manager

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