HEPTAGON Capital

European Focus Fund: Monthly Commentary

April 2021

Where earnings lead stocks follow

April was a good month for stock markets and for the Heptagon European Focus Equity Fund in particular. The Portfolio appreciated by +4.62% vs. +2.07% of the MSCI Europe NR (EUR) index, reflecting an outperformance of +255bps. While the Fund was still lagging the benchmark in the year to the end of April (+7.78% vs. +10.59% respectively, i.e. -281bps), we are hopeful that sales and profit upgrades following the very solid 1Q21 reporting season in April will turn this around.

13 out of the 21 Portfolio holdings (with a combined 45% weighting in the Fund) announced either sales or results statements during April. *First*, we are pleased that every company that published figures beat market expectations. *Secondly*, like-for-like (LfL) sales growth rates were generally higher (and often considerably more so) compared to what the market was expecting. *Thirdly*, the management teams of the different companies came across as much more upbeat in April than during the year-end reporting season in January-March. Based on our analysis of the 1Q21 statements, we construe that the sales and earnings outlook for the Portfolio – and more broadly speaking for quality-growth businesses in general – appear to be better than a few months ago. Against this backdrop, we also draw the conclusion that: (*i*) our Portfolio companies have recovered what they lost during the first lockdown about a year ago and; (*ii*) most of them are back on their growth trendline, which indicates a *V-shaped* recovery in terms of their sales and profit profiles. Again, it goes to show that the investment community generally underestimates companies' ability to adjust to changes in business conditions – normally when moving from a recessionary to a booming economic environment or vice versa – or as in the current case, by converting their operations and business models to a digital format and by embracing e-commerce.

Mark Twain said: '*It is difficult to make predictions, particularly about the future*' and this holds true in 2021. In our view, investors and analysts (and perhaps even companies) have been almost dumbfounded by the sharp uptick in LfL sales growth because they may not have appreciated just how sudden and deep the drawdown was in 2020 and/or haven't fully grasped just how swiftly business volumes bounced back. When we look at how LfL revenue growth of the Portfolio companies progressed quarter-by-quarter over the past 1-2 years (based on the weightings as of 30 April 2021), we get the following numbers.

Portfolio LfL sales growth (year-over-year)	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20	1Q21
Portfolio's weighted LfL revenue growth rate	**6.2%**	**5.5%**	**7.1%**	**8.2%**	**0.5%**	**-2.3%**	**7.2%**	**6.2%**	**18.1%**
EUR/USD-rate	*1.135*	*1.125*	*1.100*	*1.113*	*1.103*	*1.109*	*1.181*	*1.196*	*1.199*
FX difference year-over-year	7.8%	3.4%	5.4%	2.0%	2.8%	1.4%	-7.4%	-7.5%	-8.7%
Est. revenue growth with 50% USD-exposure	**10.1%**	**7.2%**	**9.9%**	**9.2%**	**1.9%**	**-1.6%**	**3.5%**	**2.4%**	**13.8%**

Source: Company reports, Bloomberg, Heptagon

During April, some Portfolio companies delivered growth rates which were completely 'off the charts' in 1Q21. For example, ASML showed revenue growth of +79% in 1Q21 (+96% vs. 1Q19), Eurofins Scientific +41% (+51% vs 1Q19), Hermès +38% (+29% vs. 1Q19) and Zalando, which pre-announced the 1Q21 sales number in April, +45% (+61% vs

1Q19). This is even more impressive when considering that the USD has remained weak against the EUR over the past two years.

A different way to look at the Portfolio's '*sales and earnings power*' is at what levels they were in absolute terms in 1Q21 compared with 1Q20 and 1Q19 (i.e. in comparison with a pre-pandemic environment). Again, this makes for pleasant reading as far as European Focus is concerned. Based on the Portfolio weightings by the end of April, the Portfolio's absolute level of sales was 6% higher in 1Q21 compared to 1Q20 and 9% higher compared to 1Q19. This implies that the 'base' from where the Portfolio companies can continue to draw revenues and generate profits (and cashflows) has also increased against the pre-pandemic environment because of market share gains. When looking at profits in 1Q21, EBITDA of the Portfolio was 9% higher vs. 1Q20 and 10% higher vs. 1Q19 and the corresponding levels for EBIT were 10% and 9% higher respectively. In summary, the Portfolio appears to be in excellent shape in this (probable) 'late-stage' pandemic environment.

From a qualitative point of view, we were positively surprised by the commentaries of most management teams. More often than not, their tone of voice conveyed optimism in terms of the business outlook and the state of the consumer. Invariably, all the managers anticipate economies to open up and to gather more momentum as vaccine rollouts continue to gain further traction and lockdown restrictions are eased. We construe that the US economy is currently bouncing back (underpinned by rising consumer confidence, solid PMI data and President Biden's massive $1.9tn stimulus package). Apart from the rapid escalation of COVID-19 cases in India, the rest of the Asia-Pacific region currently appears to be gaining economic momentum. As far as Europe is concerned, the UK seems to be moving ahead due to the successful vaccination program and recent comments from Germany indicate a sudden upswing in the vaccine rollout which should improve confidence and eventually economic recovery momentum. Net-net, we anticipate Continental Europe will continue to reopen and gain confidence and momentum during 2Q21 and the remainder of 2021.

What does this mean for corporate sales and profit profiles? Assuming that companies are correct in their assessment that business volumes will continue to improve, it looks as though the Portfolio's base numbers for comparison will be even more attractive in 2Q21 than they what were in 1Q21. We believe that the easiest way to illustrate our thinking is by looking at it this way. Assume that business activity will be at least as strong in 2Q21 as it was in 1Q21 due to improving macro-economic conditions. Apply the LfL revenue growth of +18.1% of 1Q21 and change the base number for comparison from +0.5% as it was in 1Q20 to -2.3% as it was in 2Q20. This implies that the Portfolio will show more than 20% LfL sales growth in 2Q21 (and more than 12% LfL sales growth in comparison with 2Q19).

When looking further out to the end of FY21 for sales, EBITDA and EBIT, our analysis indicates that the Portfolio continues to be in good health as the Fund's revenue base should be 8% higher vs. FY20 and 6% higher vs. FY19. When looking at profits, the Portfolio's EBITDA should be 7% higher in FY21 vs. FY20 and 6% higher vs. FY19; the corresponding levels for EBIT are 8% and 5% higher respectively.

Even when stripping out the obvious pandemic-winners (Zalando, Eurofins Scientific and ASML – their combined Portfolio weighting is around 18%). The rest of the Portfolio still sits in the +2% to +7% range on all three metrics (sales, EBITDA and EBIT) irrespective if comparisons are made against FY20 or FY19. This implies that the Portfolio has a broad base from where the companies' revenues and profits can continue to compound. Assuming that our mantra still holds true: '*Where earnings lead stocks follow*', we look forward to the next few quarters with confidence.

Christian Diebitsch, Fund Manager

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