HEPTAGON
Capital

Future Trends: Quarterly Update

Q2 2021

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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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. The strategy has delivered consistent outperformance since inception in January 2016, gaining 151.5% versus a 113.9% return for our MSCI World Index benchmark. The past quarter saw the Fund enjoy an 8.1% increase, once again ahead of its benchmark. We added one new business (Covetrus) to the Fund over this period. More broadly, our focus remains unchanged and we believe that prospects for our businesses look more attractive than ever.

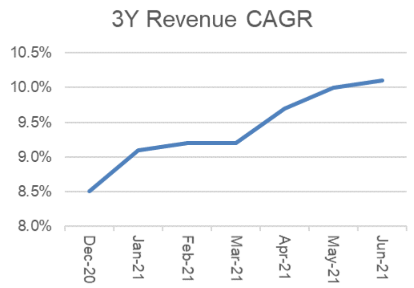
Half-time report

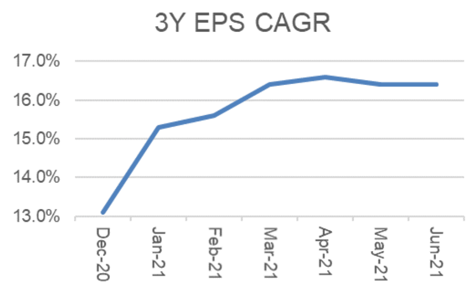
With the European Football Championships at their climax, sporting analogies are an obvious place with which to begin. All games – football included – comprise a combination of skill and luck. There are factors you can control (for example, your choice of players) and others you can't (the opposition, the referee, the quality of the pitch etc.). The same may be true of investing. Our metaphorical team – the businesses in which the Future Trends Fund is invested – is made up of clear leaders who meet the strict set of criteria we rigorously apply and that have remained unchanged since the Fund's inception.

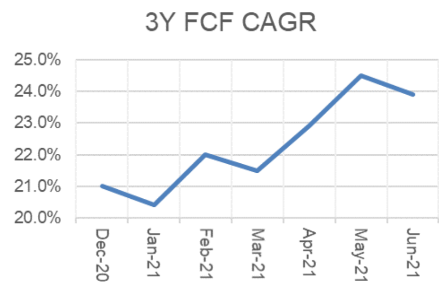
It is this discipline, we believe, that has allowed the Future Trends Fund to deliver consistent outperformance since its inception. To return to football, trophies are not won over just one game. While it was disappointing to see the Fund underperform in the first quarter of 2021 (-1.3% vs 4.9% for the MSCI World), we understand the reasons why – primarily external factors; in particular, the abrupt rise in bond yields and corresponding reflation trade – we were encouraged by the Fund's return to form in Q2. During this quarter, our 8.1% gain was ahead of the MSCI World's 7.7% return. **In 16 of the 22 quarters since the launch of the Fund, it has beaten its benchmark,** which speaks to our long-term record of success.

As of 30 June 2021, the Fund had gained 6.8%, leaving it 630 basis points behind its benchmark. With half of the year remaining, we are confident that the Fund can improve from current levels, especially since **the conviction in what we are doing has remained undiminished; if anything it has improved**. This belief is formed as a function of a combination of both quantitative and qualitative factors. Take the former and consider the charts below. Revenue growth, earnings and free cashflow prospects for the Fund (taking a weighted average of our own estimates) have clearly increased since the start of the year. We also note that the rate of improvement in forecasts for the businesses within the Fund has been *faster* than that of the MSCI World.

Future Trends YTD estimates revisions (weighted average for Fund)







Source: Heptagon Capital, Bloomberg

At the same time, **valuation prospects for the Fund also look more compelling**. The Fund's forward P/E multiple is *lower* now than at the start of the year, equivalent to 28.8x, versus 30.0x as of 31 December 2020. We would expect the Fund to trade at a premium to the MSCI World given its superior growth and cash-generating prospects as well as the healthier balance sheets of our businesses (current net debt/EBITDA for the Fund is 1.2x, versus the MSCI World Index's ratio of 1.9x). However, the Fund's P/E premium relative to the market has *narrowed*, from 10.2 percentage points at the start of the year to 9.2 points as of 30 June (all market data per Bloomberg). Further, on an absolute basis, using discounted free cashflow analysis, our businesses now offer an average of 22.2% upside to what we currently consider fair value, versus an 18.2% average at the end of last year.

From a qualitative point of view, if you want to get an impression to how exciting the future can be, then listen to the experts. We are experiencing **"a digital tsunami"** as **"data is being created, moved, analysed and stored at an unprecedented rate,"** in the words of Charles Meyers, the Chief Executive of Equinix. He was speaking at the company's Investor Day in June, its first since 2018. We have been making a similar contention since the very first thematic piece of work we published in March 2011 and updated almost a decade later, in October 2020. To hear the reiteration of this thesis from the head of the world's largest operator of data centres and their interconnecting ecosystem is, therefore, highly encouraging.

The other important point made by Equinix's CEO at the event is that **"disruption finds its way to every corner of the economy."** This, again, is highly consistent with the meta-thesis that has driven our investment approach towards future trends since inception. If we accept that global population growth will increase stress on already scarce resources (land, water, food, energy etc.), then we need technology as an enabler to help resolve this conundrum. Digitalisation and automation can deliver clear efficiency gains both to consumers and producers.

Against this background, it is no surprise that some of the best businesses in the world (in our view) are seizing upon this opportunity and investing appropriately. In the past quarter, we also heard Karsten Munk Knudsen, the Chief Financial Officer of Novo Nordisk, and Kevin Clark, the Chief Executive of Aptiv (among many others), speak. Both addressed this topic explicitly. The former said on that **"we will spend significantly more on R&D [research and development] in the years to come"** because "it's the right thing to do." Novo, the largest producer of insulin for treating diabetes, already spends over 12% of its revenues on R&D, well ahead of its peers. However, there is a clear logic in growing investment, given the large unmet need (some 40% of those who have diabetes are undiagnosed, per Novo). Novo's approach embraces working more with partners at universities, analysing bigger sets of data for more insights and leveraging its expertise into medical adjacencies such as Parkinson's and Alzheimer's diseases.

We heard a similar message from Aptiv. Kevin Clark noted that **"the long-awaited inflection point for electric vehicles has arrived."** Given that lithium-ion battery prices have fallen by over 90% in the last 30 years owing to technology improvements, this statement makes sense. For every doubling in EV (electric vehicle) capacity, prices have fallen by around 20% (all data here). EVs represent a logical and sustainable solution to transportation challenges and their growing presence will also clearly help reduce levels of greenhouse gas emissions. It is no surprise then that EV penetration forecasts – as a percentage of total vehicles – have increased over tenfold in the last five years. By 2030, Aptiv believes over one-in-four vehicles will be electric. Aptiv's ongoing investment in R&D (equivalent to ~8% of revenues) is helping to improve how EVs operate with increasing efficiency.

Interaction with management is a crucial part of our investment process, as the above examples indicate. Beyond more general investor presentations, **during the second quarter of 2021, we did 28 virtual meetings including with 16 of our current 23 investments in the Fund.** We had one-on-one calls with C-level management and/or Senior Investor Relations at ASML, Avast, Covetrus, Kerry Group, MOWI, Prologis and Zebra as well as being privileged to join a roundtable hosted by the Chief Executive of IBM, along with four other investors. The remaining calls were either in a small group format and/or with prospect/peer businesses).

We also continue to add to our library of proprietary work, which represents one *of the key differentiators in our investment process*. Over the past quarter, we published two new thematic pieces (on micromobility and the pet economy) as well as adding 13 posts to our Blog on topics as diverse as food innovation, plastic waste, and space. Even if not all our work results in immediate actionable investment ideas, our growing body of knowledge allows us to follow trends/ businesses from an early stage. This means – just as in football – that they can move from the metaphorical youth academy (start-up phase) to the substitutes bench (for our Fund) and eventually potentially into the winning team.

Case study: the pet economy and Covetrus

The purchase of a pet dog by your Fund Manager during lockdown focused our attention on the importance of the pet economy. Admittedly, it was a topic on which we had been planning on doing work for some time, given the attractions of the industry (predictable revenue streams) and its growth prospects (primarily from premiumisation and digitalisation). Against this background, we published our 71st piece of thematic work – on this topic – in May. The note coincided with our investment in Covetrus (funded primarily through cash within the Fund), although prior to our investment, we had done detailed due diligence and internal research on the business.

In terms of the bigger picture, **globally, 38% of households have dogs and 31% cats** (based on a 17-country survey by GFK). In the United States, the world's largest market for pets, household ownership reaches 67%, with dogs outpacing cats (32% vs 21%, per the American Pet Products Association, or APPA). The Argentineans are the world's biggest lovers of dogs – they inhabit 66% of households – while the Russians favour cats most highly (present in 57% of households, per the GFK survey).

Unsurprisingly, then, **the pet economy is a large market, worth $210bn** (per Global Market Insights). The US market alone is worth ~$100bn (per the APPA). **In the past decade, the market globally has expanded at a faster pace than world GDP** (66% vs 43%, per another study, by Euromonitor) and is set to experience high single-digit growth over the medium-term, based on most consultants' forecasts. Anyone who owns a new cat or dog can expect to have that animal for at least ten years, implying a 'long-tail' of predictable demand. Pets clearly have their own dietary, healthcare and other supply needs, *distinct from* humans. At the same time, many of the same drivers that support (human) consumer discretionary behaviour also play to the world of pets: wellness, convenience and personalisation.

Pet owners clearly want to give their pets the best life possible. 75% of those interviewed said that taking care of their pet's health was *as important* as their own, a conviction reinforced by the fact that 90% of dog owners and 86% of cat owners consider their animals as part of the family (data from IDEXX and Packaged Facts respectively). Correspondingly, **the disposable income owners are willing to allocate to their pets is increasing. Longer pet lives also imply more product innovation, primarily to address hitherto unmet needs** (not to mention illnesses). 69% of pet parents say that they are now spending more on pet products than they used to, while 85% stated that they were willing to pay more for pet foods that were healthier for their animals (per Packaged Facts). A separate study highlighted that 69% of Millennials give their pets natural or organic food, with a similar percentage also purchasing products that had a low carbon footprint and/or sustainable packaging (per First Insight Research).

Furthermore, just as consumers are increasingly digitally connected, so they are seeking similar smart devices for their pets. Pet safety and security are the two biggest concerns animal owners say they want to solve. Related, is the deployment of pet-tech to ensure that animals feel less lonely when their owners are absent. Solutions include pet cameras, trackers and GPS collars as well as automated feeding devices. Over 10% of US households have adopted some form of pet-tech.

As with most humankind use cases, **digitalising the animal world shifts the industry paradigm from a reactive stance to a proactive stance with higher overall engagement levels**. Pet owners naturally want to transact online, whether it is purchasing food or dealing with their vet. More broadly, **the application of technology to the pet sector creates a scenario where everyone wins,** particularly in the context of animal healthcare. Think of it as improving outcomes for all stakeholders: better business and clinical results for veterinarians, increased growth for product manufacturers and more convenience (as well as better care) for animal owners. Telemedicine and DNA sequencing constitute obvious use cases.

With multiple demand drivers, it seems there is little not to like about the pet economy opportunity. One charge often levelled at the industry is that animal owners typically use discretionary income to purchase services or products for their pets and hence economic concerns may cause some owners to forgo or defer visits to veterinary practices or, in extreme cases, even cease to continue owning a pet. The good news is that data from previous recessions (particularly during the credit crisis – see information on the Bureau of Labour Statistics website) is that **pet expenditure remains one of the most resilient categories across the economic cycle.** A July 2020 survey by IDEXX found that pet owners said that, were household income to decline, then they would forgo eating out (90% of respondents), personal grooming services (85%) and video streaming services (77%) in order to cover pet expenses.

We were attracted to Covetrus owing to its unique and differentiated business model. The company listed in February 2019, following the decision by Henry Schein to spin out its veterinary distribution business and then merge it (on listing) with Vets First Choice, a software business owned by private equity. Covetrus is currently capitalised at ~$3.6bn. It is the global market leader in veterinary distribution (28% share) and ranks number-one in US prescription management and software services, with ~60% share in the latter segment. Management has a clear business plan to increase product cross-sell and full platform adoption. Those customers who already buy a full suite of Covetrus services generate five times more in annual sales than distribution-only clients. Positive mix effects (more proprietary products and more software) should boost margin, while better working capital management implies an acceleration in free cashflow generation.

We have had five interactions with the team at Covetrus in the past three months including spending time twice with senior management (via online video calls). In addition, we have participated in discussions with the business over how it can improve its ESG strategy. Covetrus is already moving in the right direction, with high levels of workforce and Board diversity: 50% of employees are female as is 40% of the Board. The company has also undertaken a number of environmental initiatives including conserving energy at its facilities, minimising waste, increasing recycling and eliminating single-use plastics. Further, Covetrus has a long track record of charitable giving; to rescue/shelter services for animals as well as academic research. Also of note, in August, we will be meeting face-to-face with the head of Covetrus' UK business at their regional headquarters.

Second quarter performance

Future Trends gained 8.1% during the second quarter of 2021. This compared to a 7.7% rise in the MSCI World. Given that the Fund underperformed in Q1 (only its sixth quarter of underperformance since inception – see the table below), on a year-to-date basis, Future Trends is up 6.8%, versus 13.1% for the MSCI World. As far as the second quarter was concerned, June's 4.8% increase (340 basis points ahead of the benchmark) more than compensated for the 1.1% decline experienced in May (when the benchmark) rose, while April's 4.4% return was broadly in-line with the benchmark.

Period	Future Trends	MSCI World	Relative
Q1 16*	3.8%	6.1%	-2.3%
Q2 16	-2.4%	1.0%	-3.4%
Q3 16	10.4%	4.6%	+5.8%
Q4 16	-6.9%	1.9%	-8.7%
Q1 17	10.8%	6.4%	+4.5%
Q2 17	12.0%	4.0%	+7.9%
Q3 17	7.5%	4.8%	+2.7%
Q4 17	6.2%	5.5%	+0.7%
Q1 18	0.0%	-1.3%	+1.3%
Q2 18	2.7%	1.7%	+1.0%
Q3 18	5.4%	5.0%	+0.4%
Q4 18	-14.5%	-13.4%	-1.1%
Q1 19	16.1%	12.5%	+3.6%
Q2 19	5.8%	4.0%	+1.8%
Q3 19	-1.2%	0.5%	-1.7%
Q4 19	9.5%	8.6%	+1.0%
Q1 20	-16.6%	-21.1%	+4.5%
Q2 20	24.0%	19.4%	+4.6%
Q3 20	8.3%	7.9%	+0.4%
Q4 20	15.9%	14.0%	+1.9%
Q1 21	-1.3%	4.9%	-6.2%
Q2 21	8.1%	7.7%	+0.4%
From launch	**151.5%**	**113.9%**	+37.6%

**From Fund launch to end of quarter (12/1/16-31/3/16)*

Source: Heptagon Capital, Bloomberg. As of 31 March 2021. All figures shown are net of fees for the C USD share class.

As ever, there was significant dispersion across the portfolio, with the gap between our leading and lagging businesses equivalent to ~35 percentage points over the quarter (on a year-to-date basis, this figure grows to ~65 points). During Q2, we were pleased to see that **13 of our 23 businesses beat the benchmark**, with our best performer gaining close on 25% and our laggard losing less than 10%.

Our three best performers from the past quarter were Intuitive Surgical, Novo Nordisk and PayPal, gaining 24.5%, 22.3% and 20.0% respectively. The businesses offer exposure to different themes, but all benefited from strong upgrades to earnings estimates as a result of positively revised (or, in the case of Intuitive, reinstated – post-COVID) financial guidance. We continue to see the runway ahead for more automated surgery, the greater treatment of diabetes and related illnesses, and the digitalisation of payments as being significant.

On the downside, Vestas (wind turbines) and Daifuku (factory automation) both lost ~6% of their value in the quarter. Covetrus had fallen by 7.3% relative to the time of our initial purchase despite the fact that it raised financial guidance when it released results in May, spoke positively at an investor conference in June and announced a small (accretive) acquisition.

Some of the moves in Vestas and Daifuku needs to be seen in the context of the ~114% and ~92% gains enjoyed by these businesses respectively in 2020. Financial guidance from both businesses has been relatively conservative in respect of the current year, but we see medium-term prospects in each case as highly compelling. The logic for further deployment of alternative energy and industry 4.0 solutions is evident in our view.

Throughout the past quarter (and indeed since the inception of the Fund), **we have continued to be opportunistic**. While our general approach is one of low turnover, we have used periods of share price weakness to add to positions in which we have conviction. We added to Vestas in February/March when the shares had fallen by ~30% from their 2020 high and we have continued to keep our current position weight in Covetrus constant (at ~2.5%) despite recent declines. We also added to Thermo Fisher and First Solar on weakness in the past quarter, while taking some small profit in First Solar right at the end of the period (the business had gained 18.9% in June). In general, we aim to keep a cash level of ~3% in the Fund in order for us to remain nimble.

Conclusion

The approach we continue to take in managing assets within the Future Trends Fund emphasises a focus on the long-term. Although we have not discussed in detail in this report, sustainability considerations are also paramount (and further details on our commitments to ESG can be found here). Beyond the ongoing thematic work we continue to do, where we see long runways ahead for all the trends in which we are invested, we derive reassurance from the fact that **our businesses have above-average growth prospects, markedly higher free cashflow-generating potential and more robust balance sheets relative to the overall market**. We believe it is important to remain pragmatic and opportunistic, constantly reviewing what we believe to be our winning team of businesses.

Alex Gunz, Fund Manager

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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

This Fund has been classified as an Article 8 for the purposes of the EU’s Sustainable Finance Disclosure Regulation (‘SFDR’). The Fund promotes environmental and/or social characteristics but does not have sustainable investment as its primary objective. It might invest partially in assets that have a sustainable objective, for instance assets that are qualified as sustainable according to EU classifications but does not place significantly higher importance on the environmental objective of each underlying investment. Please see prospectus for further information on the Funds environmental and/or social characteristics and relevant sustainability risks and principal adverse impacts which may impact the Fund’s performance.

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