European Focus Fund: Monthly Commentary

August 2021

Fund Manager

Christian Diebitsch

Investment Objective

The Fund aims to deliver long-term capital appreciation by investing in European equities. The Fund employs a high conviction, bottom-up, low turnover, research driven strategy with a focus on companies that exhibit sustainable long- term growth.

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Superior sales and earning power should continue to lead to strong investment returns

Following on from most other months in 2021, European equities registered another strong period in August. The MSCI Europe NR (EUR) index advanced by +1.97%, reflecting a YTD gain of +19.81%. Meanwhile, the Heptagon European Focus Equity Fund continued to outperform its benchmark showing an advance of 3.45% (i.e. +148bps above the benchmark) in August and thus registering a gain of 28.19% in the YTD (i.e. +838bps above the benchmark).

What has driven this strong performance is solid like-for-like revenue growth of the Portfolio companies and – we believe – the combined sales and earnings power of the Portfolio which has led to continuous estimate upgrades by consensus. Against this backdrop, we also construe that the price dynamics of equities are gradually being restored to what must be characterised as '*normal*', i.e. to an environment without central bank intervention through QE-strategies and similar. In short, we believe market participants are now factoring in a return to an investment climate where central bank stimuli will gradually be tapered. This should underpin an environment where top-quality companies are valued on their superior attributes, such as barriers to entry, global footprints, balance sheet strength, consistent cashflow generation etc.; i.e. consistent with the businesses that are held in European Focus.

The tables on the following page illustrate this point. We have indexed the sales and profit streams from FY19, i.e. before the pandemic, and applied the consensus growth rates of the companies in the Portfolio and for Europe (i.e. the MSCI Europe index) for FY20 and onwards. The FY20 column shows that while the Portfolio's combined sales grew by +2.0%, the MSCI Europe index saw the region's combined sales fall by -19.0%. In a similar fashion, the Portfolio's combined EBITDA and EBIT rose by +9.1% and +11.6% respectively in FY20, while the MSCI Europe index registered combined EBITDA and EBIT decreases of -21.2% and -38.3% respectively.

Expected sales and profit growth of European Focus and the MSCI by consensus

HEFEF	FY19	FY20	FY21e	FY22e	MSCI	FY19	FY20	FY21e	FY22e
Sales	—	2.0%	15.3%	8.3%	**Sales**	—	-19.0%	8.8%	4.4%
EBITDA	—	9.1%	26.4%	9.4%	**EBITDA**	—	-21.2%	36.4%	5.0%
EBIT	—	11.6%	63.8%	10.7%	**EBIT**	—	-38.3%	98.1%	4.6%

HEFEF	FY19	FY20	FY21e	FY22e	MSCI	FY19	FY20	FY21e	FY22e
Sales	100	102.0	117.6	127.4	**Sales**	100	81.0	88.1	92.0
EBITDA	100	109.1	137.8	150.9	**EBITDA**	100	78.8	107.5	112.9
EBIT	100	111.6	182.7	202.2	**EBIT**	100	61.7	122.2	127.9

Note: estimates as at 31 August 2021
Source: Bloomberg consensus and Heptagon Capital

Moving on to what is likely to be seen as the start of the pandemic recovery in FY21, the Portfolio as well as the broader market should benefit from easy base-numbers for comparison. Against that backdrop, the Portfolio should see stronger growth in sales than the market, according to consensus (+15.3% vs. +8.8% respectively). Although the EBITDA and EBIT growth rates of the MSCI are higher than those of the Portfolio for FY21, due to the sharp drawdown in FY20, the earnings power of the market still substantially lags that of the Portfolio. This point is illustrated in the second table, where the combined '*implicit*' EBITDA of the Portfolio is estimated at 137.8 vs. only 107.5 of the market for FY21 with the corresponding numbers for EBIT at 182.7 of the Portfolio vs. 122.2 of the market. In other words, even if the market is expected to generate higher profit growth than the Portfolio this year, the earnings power of the Portfolio is still vastly superior compared to that of the market (as measured by EBITDA and EBIT). We construe that this point is reflected in the strong YTD performance of the Portfolio compared with the benchmark index.

As the above tables show, the '*power of compounding*' sales and profits becomes even more relevant when looking at the prospects for FY22. While consensus forecasts the combined sales of the Portfolio to grow by a further +8.3% in FY22, i.e. putting the base for generating revenues at 127.4 vs. the pre-pandemic level, consensus forecasts the combined sales of the market (i.e. the MSCI index) to grow by only +4.4%, which puts its base for generating revenues at only 92.0 vs. the pre-pandemic level. Hence, even in FY22, consensus is still forecasting the base for generating sales in Europe to be 8 percentage points below the pre-pandemic level. Applying the same line of reasoning to EBIT, the earnings power of European Focus is expected to have more than doubled to 202.2, while the corresponding EBIT-level of the MSCI is expected to remain at 127.9. Against this backdrop, we see it as entirely logical that top-quality businesses should continue to be valued at premium-levels compared with the broader market.

What further confirms our confidence in the above analysis is comparing consensus expected growth rates from 31 August with those from 30 June, i.e. immediately before the 2Q21 reporting season. The tables on the following page show how the FY21 estimates for the Portfolio have been consistently raised. When looking at the European market, consensus estimated sales growth for FY21 has been revised down to +8.8% (from +10.8%), while EBITDA and EBIT have been raised. The FY21 consensus estimate for EBIT growth of the market has been raised substantially +98.1% (from +46.5%). However, the financial sector has around 15% weighting in European indices and we note that banks have been releasing significant loan-loss provisions which were made during the pandemic in FY20.

Expected growth rates as at 31 August 2021

HEFEF	FY20	FY21e	FY22e	MSCI	FY20	FY21e	FY22e
Sales	2.0%	15.3%	8.3%	**Sales**	-19.0%	8.8%	4.4%
EBITDA	9.1%	26.4%	9.4%	**EBITDA**	-21.2%	36.4%	5.0%
EBIT	11.6%	63.8%	10.7%	**EBIT**	-38.3%	98.1%	4.6%

Source: Bloomberg and Heptagon Capital

Expected growth rates as at 30 June 2021

HEFEF	FY20	FY21e	FY22e	MSCI	FY20	FY21e	FY22e
Sales	2.0%	12.9%	8.1%	**Sales**	-18.4%	10.8%	4.3%
EBITDA	9.4%	20.9%	9.9%	**EBITDA**	-21.1%	26.7%	5.8%
EBIT	13.4%	57.5%	11.2%	**EBIT**	-38.2%	46.5%	6.0%

Source: Bloomberg and Heptagon Capital

When looking at the individual stock price performances during August, we are pleased to note that some of our largest positions, which made up 25% of the combined Portfolio by the end of August, generated the strongest performance that month. **Eurofins Scientific**, advanced by +19.1%, **ASML** rose by +10.2%, **Lonza** increased by +9.9% and **Novo Nordisk** appreciated by 8.2%. Meanwhile, the weakest in August, which made up 17% of the Portfolio, were: **Coloplast** (down -4.9%), **Hermès** (down -3.5%), **Diageo** (down -2.1%) and **SGS** (down -1.9%). We made one Portfolio change during August; we divested our smallest position in the Fund, **Serco**. This means that European Focus consisted of 20 companies by the end of August.

We believe it is a *fool's game* trying to predict exchange rates. However, given the Fed's commentary following the FOMC meeting (27-28 July) and the recent remarks made by Chairman Jerome Powell during the Jackson Hole conference (26-28 August) on the timing of the Bank's commencement of tapering and ultimately starting to raise interest rates, we believe the current '*direction of travel*' speaks for a stronger USD vs. EUR. This should help to bolster sales and earnings growth for an export-dependent region such as Europe. Consequently, with regards to the Heptagon European Focus Equity Fund, we look forward to the coming months with confidence.

Christian Diebitsch, Fund Manager

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

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