HEPTAGON Capital

Future Trends: Quarterly Update

Q3 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 generated consistent outperformance since inception in January 2016, delivering 17.4% annualised returns versus 14.2% for its MSCI World benchmark. On a year-to-date basis, the Fund has added 6.2%, with a decline of 0.6% recorded in the past quarter. Despite this move, our focus remains unchanged. We believe that prospects for our businesses look more attractive than ever: both growth forecasts and valuation metrics point to clear improvement.

Unravelling the opportunity

The wonderful thing about managing an equity strategy called Future Trends is that it necessarily forces you into thinking about the long-term. Of course, this does not mean that the very near-term can be ignored; just that much of it is noise. It was disappointing that the Fund just failed to beat its benchmark in the third quarter of this year (it underperformed by 57 basis points), particularly since it had been ahead of the MSCI World Index throughout the period but for the final trading week of the period. However, within this abrupt unravelling comes opportunity: put simply, **the case for the trends in which we invest remains as strong as ever, while prospects for businesses have continued only to improve**.

To understand this assertion in better detail, consider the information shared with the investment community by the Fund's two largest businesses in the past month (coincidentally, both closed the quarter with exactly the same weighting, of 5.93%). Both **ASML** and **Thermo Fisher** hosted events in September. In each case, management provided a financial framework and detailed guidance through to 2025. That *any* business is able to provide a 5-year outlook given present global macro uncertainties speaks highly to its confidence and positioning in our view.

Begin with ASML. As we have said regularly, **the future can't happen without ASML**. The business – the world's largest producer of machines that make semiconductor chips – has been a Future Trends holding since 2017. Management reminded investors that almost everyone connected with the industry continued to "**structurally under-estimate semiconductor growth.**" Against this background, management now sees an *acceleration* in the rate of its future growth prospects relative to when it last updated investors on this topic in 2018. Implied guidance assumes 15%+ revenue growth through to 2025 and 10%+ through to 2030, with the business expanding margins *at the same time*.

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

Next, take the case for Thermo Fisher. It is perhaps easiest to think of this business as being to the life sciences industry what Amazon is to the online retail sector. In other words, **Thermo has the world's largest supply globally of medical equipment diagnostics and services.** Inevitably the business has been a beneficiary of the pandemic, but the most important take-away we drew from its September investor event was that Thermo is now calling for 7-9% organic growth over the next five years, a 200 basis point upgrade relative to its previous guidance, equivalent to market outgrowth (on its assumptions) of up to 500 basis points annually. This growth guidance is the most positive Thermo has issued in a decade, despite the business being roughly three times bigger in revenue terms than it was in 2010.

It seems clear then that **the case for ASML and Thermo has got stronger in the past month**. However, while Thermo rose 3.0% in September, ASML dropped by 8.3% (compounded by a 12.3% decline in the last week). This obviously had an impact on near-term Fund performance, although we would clearly wish to highlight that ASML remains the Fund's best-performer on a year-to-date basis – up 62.5% – while Thermo has gained 22.7%, well ahead of the MSCI World (up 13.0%).

Our approach has always espoused **pan-thematic diversification.** Indeed, ASML comprises the 'chips' in our 'cloud-to-wind and fish-to-chips' mantra. Vestas (the world's last producer of wind turbines) currently sits third in terms of Fund weighting, while our play, MOWI ('fish') also sits in our top-five. Prologis – our favoured play on online society – completes the top-five, while IBM (the 'cloud' part of our equation) currently occupies a top-ten position in the Fund.

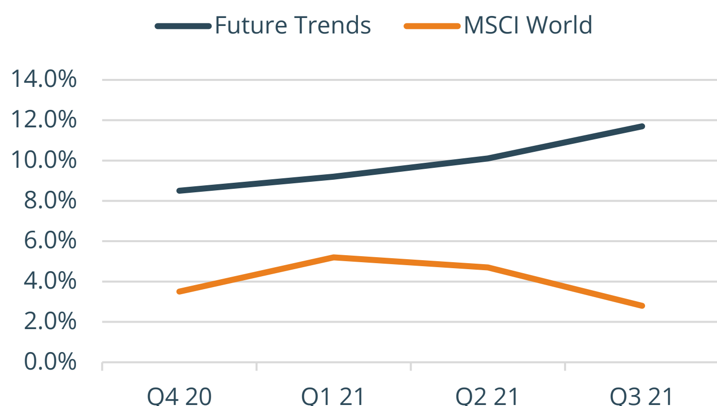
We believe it is this diversification that will continue to help drive outperformance over the long-term. We are not beholden to any specific trend. Further, as many of the trends in which we do invest overlap, they become mutually reinforcing and hence self-sustaining for a longer period of time. Importantly, it also means that when we come to think about valuation, our approach sits very firmly in the **growth at the right price** camp.

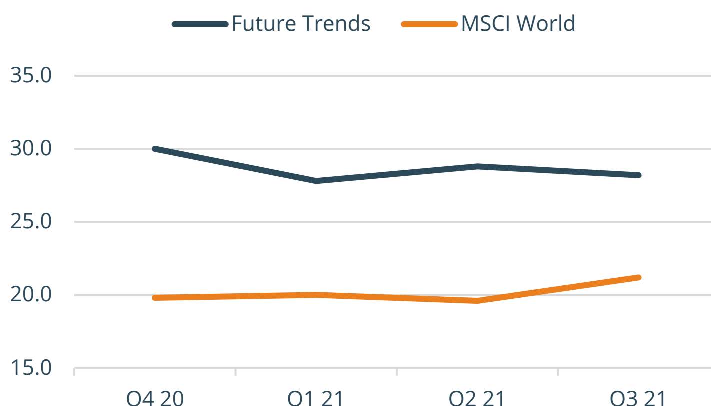
Put another way, with a Fund such as Future Trends **investors are paying a premium for growth in a world where growth is scarce**. However, it is a premium justified also for **the Fund's free cashflow generating abilities and the balance sheet health of our businesses**. Further, the premium has narrowed since the start of the year while **the absolute valuation potential for our business has improved**.

The charts below provide the best visual demonstration of the above contention. We build our own financial forecasts for each of the businesses we invest in and the figures below constitute the weighted average for the 23 investments across the Fund. It is also worth bearing in mind that our estimates tend be *more conservative* than street consensus estimates (per Bloomberg).

Revenue growth prospects for the Fund have improved since the start of the year at the same time that growth forecasts for the MSCI World (and global GDP) have decelerated. We are also very pleased that our businesses are able to translate their superior revenue growth into free cashflow generation. Asset-light business models and high operating leverage help. Further, our businesses have average net debt/EBITDA of 1.2x versus a level of 1.6x for the MSCI World.

Future Trends YTD estimate revisions (weighted average for Fund)





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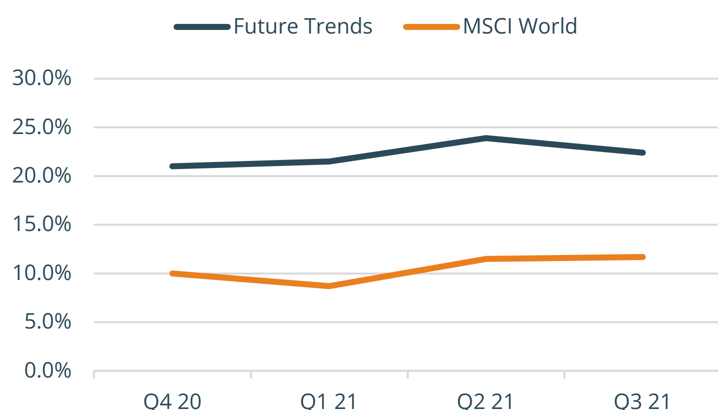

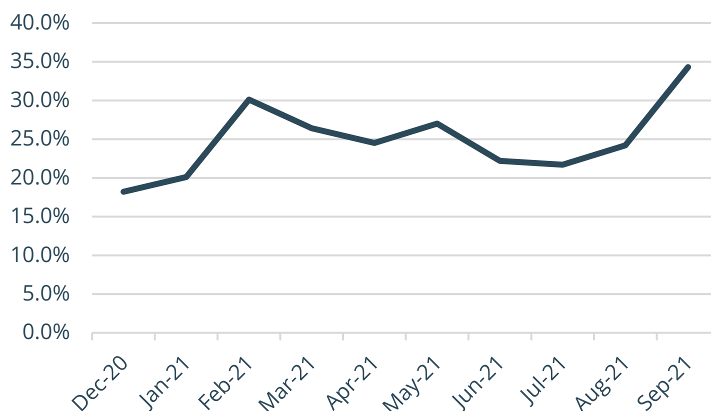

Needless to say, superior growth and cash generation argues for a valuation premium. However, **the premium that the Future Trends Fund commands relative to the MSCI World has narrowed** as 2021 has developed. At the end of December last year, the Fund traded at over a 10-point premium relative to the global market. This has now shrunk to 7 points. At the same time, when we consider the absolute valuation upside embedded within our forecasts, the weighted average discount to fair value (on a discounted free cashflow basis using 10-year modelling assumptions) is now over 30%. By contrast, at the start of the year it was less than 20%. All the above developments are perhaps best explained by the fact that **our businesses have benefited from a better pace of upgrades to estimates relative to the broader market**.

Throughout 2021 (and indeed the life of the Fund), we have sought to retain discipline. Think of it, as we said earlier, as **growth at the right price, *not* growth at any price**. When investing in the future, it is important to separate hype from reality and to apply appropriate guardrails vis-à-vis valuation. This explains why we seek generally to avoid loss-making businesses and 'concept' stories. Just as ASML and Thermo Fisher represented interesting case studies earlier in this report, now let us compare and contrast **our investment in Airbnb** and our recent work on the metaverse.

Airbnb became the newest investment in the Fund in August. It is also a great case study in the patience we embed into our investment process. Beyond having been a regular user of the company's services for some time. We first did thematic work on the case for the business when we wrote about the sharing economy in 2016. We followed Airbnb from the time when it was private, first built a financial model in late 2019 prior to its IPO, and initiated dialogue with management in early 2021.

What has impressed us most about the business is that it has emerged from the pandemic stronger than it had been previously. In other words, last year's crisis forced Airbnb to cut costs and refine its search engine in order to be more flexible and adapt better to the revised operating environment. It's quite notable how consensus estimates have correspondingly had to react. The street began 2021 assuming that Airbnb would generate $37.7m of EBITDA this year. The current estimate (per Bloomberg) is for $1.16bn. Airbnb is set to turn free cashflow positive soon and subsequent rapid free cashflow generation – with the potential to reinvest some of this back into the business and further strengthen its competitive moat – should provide additional ballast for the investment case.

The question we are asked with most regularity about Airbnb is how we justify its valuation. On a 10-year discounted free cashflow model, we see the shares comfortably above $200 (they are currently trading at ~$167). However, the more important point is that we believe investors are wholly justified in paying 6.1x sales and 28.2x EBITDA (using our own 2022 estimates) given the growth prospects we expect the business to enjoy. We are forecasting compound annual revenue growth of 35.9% for the next three years during which time Airbnb's EBITDA margin should improve by over 30 percentage points.

Our investment in Airbnb was funded through the sale of our position in Avast. In July, Avast announced that it was in advanced discussions with its larger listed US rival, NortonLifeLock, regarding a possible merger. The deal was formally announced at the start of August. This constitutes **the third time that an investment within the Fund has been on the receiving end of positive M&A** (the other two examples were ARM in 2016 and Sophos in 2019). In each case, the business in question was UK-listed, perhaps indicative of the country's relatively flexible takeover protocols. From our perspective, we were pleased with the 40%+ return we had made on our investment in Avast. We remain on the lookout for other businesses to give us exposure to the theme of cybersecurity again.

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To return to the idea of patience, the case study of cybersecurity is an instructive one. Our first theme piece ever written, on data in 2011, argued that **data have no value unless it is stored, secured and analysed**. We then wrote specifically on cybersecurity in 2014 and again in 2017. However, we did *not* make a direct investment in the area until 2017 (Sophos), followed by Avast in 2020. **It is easier to identify trends than it is to find businesses which meet our criteria**. As a reminder, we look only for pure-play businesses (deriving over 75% of their revenues from the theme in question, market leaders and proven out-innovators).

This observation provides a neat segue into **the topic of the metaverse**. Many have suggested that the metaverse currently stands where the consumer internet did 20 years ago; with huge but unproven potential. An increasing number of companies have begun to reference the term metaverse in their commentaries and some new business models seeking directly to exploit the trend have already begun to emerge. It was to this end that we published our 73rd piece of thematic work on the topic in September.

Rather than repeating the full arguments embedded in the piece (interested readers who missed the original can click on the link above), it is best to summarise the metaverse as being thought of as a digital mirror to the physical world; or a collective shared space. Consumer versions/ interpretations of this could be thought of as Fortnite, Minecraft and Roblox. Within these environments, users can meet not only to game, but also to shop, attend events such as concerts and be educated. Some believe that if we are now accustomed to Teams/ Zoom for work, it is only just a small conceptual step from here to a virtual metaverse office. From our perspective, we see the clear potential, but believe **the concept is still in 'hype phase' currently** with few plausible investment opportunities. We would prefer to be patient.

Our work into understanding the future better remains unceasing. In the past quarter, we published 11 Blog pieces on a range of diverse topics. These included visiting one of the largest producers of plant-based protein in the UK and attending our first real-world industry conference (on the pet economy) in 18 months. Ongoing interaction with management is also absolutely crucial. **During the third quarter, we did 13 meetings including 9 of our current 23 investments in the Fund**.

We had one-on-one meetings with C-level management and/or Senior Investor Relations at Airbnb, Aptiv, Chegg, Covetrus, Keysight and Orpea. Our Orpea meeting took place face-to-face in Paris, the first time we had done such an event in over a year. In addition, over the past quarter we participated virtually in small group calls with teams at First Solar, Kerry and MOWI as well as engaging in dialogue with several peer/ prospect businesses.

Conclusion

As should hopefully be evident, 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. Thank you for your interest in and support of the Heptagon Future Trends Equity Fund.

Alex Gunz, Fund Manager

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Appendix: Third quarter performance

Future Trends lost 0.6% during the third quarter, which compares to a flat performance from its MSCI World benchmark. As discussed earlier on in this commentary, the majority of the underperformance came in the last week of the quarter and from the decline in ASML in particular. For the record, July saw the Fund gain 2.8% (100 basis points ahead of benchmark) while August saw the Fund add 2.0% (the MSCI World added 2.4%). September's 5.1% drop was worse than the 4.2% fall recorded by the MSCI.

As ever, there was **significant dispersion across the Fund**, with a 50 percentage-point gap recorded between our best and worst performers (on a year-to-date basis, this gap extends to 100 points). Roughly half our businesses outpaced the MSCI World in the third quarter. We were also particularly pleased to note that our newest investment (Airbnb), where we first invested on 10 August, has gained 13.0% since then – well ahead of the world market – and was the Fund's best performer in September.

To return to the third quarter, **Novo Nordisk was the Fund's best-performer**, up 18.3%. Novo has been one of three businesses we have owned in Future Trends since the Fund's inception in 2016. The trend to which this company is exposed – that of growing obesity and diabetes – sadly remains as significant as ever. Novo boosted its financial guidance at the time of its results in August, leading to earnings upgrades and sustained momentum. **Thermo** (discussed earlier) was the Fund's second-best performer in Q3, up 13.3%, while **ASML** gained 11.5% even with its abrupt contraction in the final week of September.

At the opposite end of the spectrum, the Fund had two notable laggards, with both **Covetrus** and **Alibaba** losing more than 30% of their value in the period (closing down 32.8% and 35.4% respectively). We were more surprised in the move of the former than the latter. We made the case for Covetrus specifically and the pet economy more generally in our previous quarterly commentary. In the past three months, Covetrus has raised its guidance for organic revenue growth and provided substantial disclosure on its ESG commitments. In other words, news flow has been markedly more positive than negative. Further, we believe the threat posed by potential disintermediation from businesses such as Chewy is over-stated, an impression confirmed by our attendance at a recent pet industry conference. We also note Covetrus offers over 50% upside to our long-term fair value and trades on less than one times forward sales.

Turning to Alibaba, the business has been subject to well-documented regulatory scrutiny. This is obviously unfortunate, but we also believe necessary. Businesses such as Alibaba will *need* to work with the regulator/ government and a more constrained (but hopefully also more transparent) future framework should provide much-needed visibility and provide a floor for future operational direction. Even if earnings estimates are somewhat at risk in the near-term, we see long-term growth and valuation prospects for Alibaba as remaining superior to those of both local and international peers.

In both the case of Covetrus and Alibaba, **position sizing matters**. Each business currently constitutes a weight of no more than 2.5% in the Fund. When visibility improves, we are happy to grow our position, but neither is likely to be an investment that shares the same conviction level that, say, ASML or Thermo does. Nonetheless, our approach remains firmly oriented on the long-term. **The Fund also currently has a cash balance of ~4%** (up from ~3% a quarter prior), which will allow us to remain flexible and opportunistic.

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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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