HEPTAGON Capital

European Focus Fund: Quarterly Commentary

Q3 2021: Market Commentary and Attribution Analysis for 2H21

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.

Contact

Heptagon Capital
63 Brook Street, Mayfair,
London W1K 4HS

Tel: +44 20 7070 1800
email london@heptagon-capital.com

Performance and executive summary

During 9M21, the Heptagon European Focus Equity Fund (European Focus) CE share class' net asset value advanced by +19.65% to €207.5272 compared with the MSCI Europe NR (EUR) index, which appreciated by +16.20% in comparison.

The Fed and other central banks are lining up to gradually remove the punchbowl

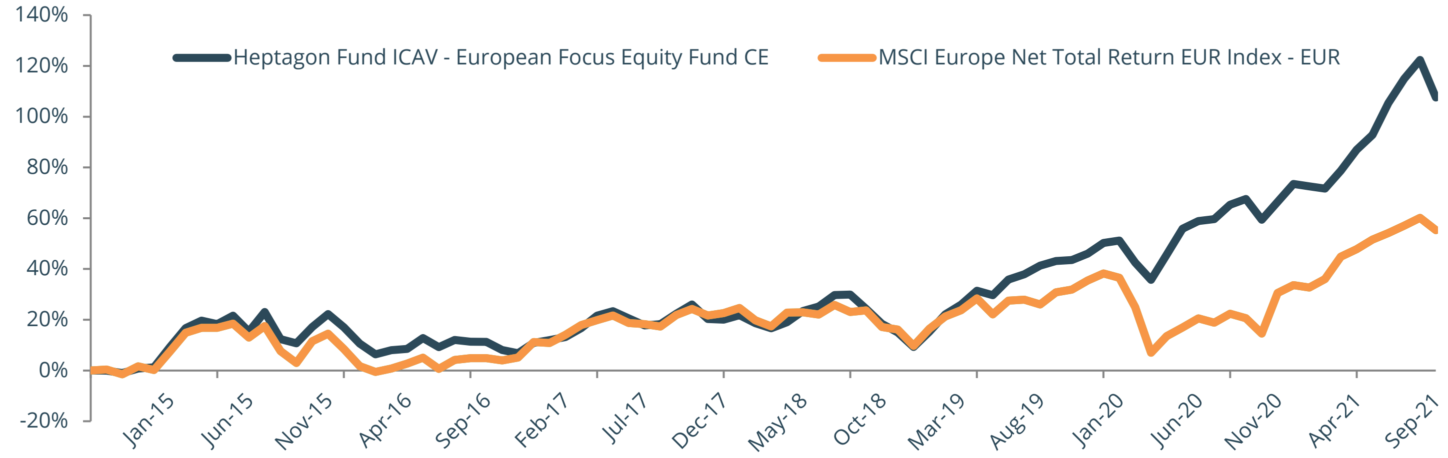
Most stock markets around the world have been in a buoyant mood during 2021 as governments in leading economies have gotten on top of the pandemic – initially through lockdowns and later by rolling out vaccine programs. Equity investors have rationally responded by anticipating that the easing of the restrictions and the ensuing acceleration in economic momentum will gain strength thereby prompting a sharp rise in corporate profit growth. For European equities, this has been verified by excellent reporting periods both in 1Q21 as well as in 2Q21, which in many ways have been the best on record. Not only have companies had extremely favourable base numbers for comparison (particularly in 2Q21) which prompted extremely high like-for-like (LfL) growth rates, but operationally we would also argue that companies have been nimble to move substantial parts of their businesses to e-commerce formats and similar channels, thereby surpassing their activity-levels against the same periods in 2019, i.e. before the pandemic set in.

As a multitude of companies have reverted their businesses to selling online we would argue that companies' supply-chains have become more conformed as they increasingly rely on similar 'pipelines' to source products for their customers and consequently, supply-chain disruptions have been building up in most sectors and that has been manifested in companies voicing concern over scarcity of components, higher raw materials prices and shipping costs. In short, input costs have increased across the board. Some companies already started to make such remarks during the 1Q21 reporting season in March and April but many more voiced similar concerns during the 2Q21 reporting season in July and August.

Meanwhile, the Federal Reserve and other central banks previously commented that inflation and inflation-expectations were likely to be transitory, but those statements have increasingly been extended with the so called '*transitory phase*' likely to be longer lasting and price pressures higher than what was previously expected.

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

The European Focus CE share class performance since inception on 26 August 2014



Source: Bloomberg

Thus, various commentaries from market observers as well as companies in 3Q21 in many ways marked a sea-change for the investment community's attitude towards inflation and its likely duration. In our opinion, these concerns were manifested in the press communiqué following the last FOMC meeting on 22nd September.

Not only had the Fed, but also other leading central banks, adopted a more hawkish stance that was based on their revised inflation-outlook. As a result, some of them (primarily the Fed as well as the BoE) announced that they were likely to rein in their bond-buying programs sooner than previously forecast.

As always, we consider the Fed to have been the clearest. Earlier this year, the Bank stated that monetary stimulus would be gradually scaled back depending on the pace of the economic recovery, employment and inflation. The first hint that the sugar bowl would be removed followed from the FOMC meeting on 28th July when Chairman Jerome Powell remarked that '*transitory*' inflationary pressures were at large in the US. At the annual central bank symposium in Wyoming on the 27th August, Powell further clarified that the Bank would differentiate between: (*i*) when the actual tapering process would commence and; (*ii*) when the Bank would begin to raise interest rates. As the economic recovery, supply-chain issues, rising energy prices etc. have since pushed inflation and inflation-expectations higher, the FOMC meeting on 22nd September further confirmed that the tapering process may commence soon after the Bank's next meeting on 3rd November.

Consequently, the price action of most financial asset classes dramatically changed following the Fed's comments in late September. Most equity markets saw profit taking; long bond yields shot up (similar to what happened in early February following the FOMC meeting on 27th January) and the US dollar started to appreciate. While a stronger US dollar normally benefits European equities (and indeed European Focus) given the region's significant export-dependency, higher bond yields generally have a negative impact on equity markets and, initially on growth stocks in particular. Although the vast majority of the Portfolio holdings in European Focus are '*European Champions*' with leading-global footprints and pricing power, these fine attributes tend to merit a premium-rating against the broader European equity market.

Against this backdrop, European Focus had its first weak month since March in September. The Fund fell by -6.67% in absolute terms vs. -3.01% of the benchmark index (-366bps underperformance), but still showed a healthy gain of +19.65% in the year to the end of September vs. +16.20% of the benchmark (+345bps outperformance). Closer analysis shows that all of the underperformance of the Portfolio in September was triggered by the Fed's communiqué on the 22nd, i.e. over the last six trading days of the month.

The table below shows some market metrics from the end of August until the FOMC meeting started on 21st September as well as over the last six trading sessions of September and during the full month. The top-part of the table (31-Aug to 21-Sep) shows that over the first three weeks, most factors behaved similarly to how they had responded during most of 2021 and the Portfolio duly outperformed its benchmark. The middle of the table (21-Sep to 30-Sep) illustrates the development of the six last trading sessions and the bottom part of the table (31-Aug to 30-Sep) the performance over the month of September.

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

Date	Oil ($)	EUR/USD	US10yr	US5yr	US2yr	S&P500	MSCI	Energy	Finance	Materials	Tech/IT	EuroFocus
31/08/21	68.50	1.181	1.31	0.77	0.21	4522.68	282.62	102.14	63.03	353.94	195.02	222.35
21/09/21	70.56	1.173	1.32	0.83	0.21	4354.19	275.68	105.39	60.31	326.58	195.59	220.65
Chg 21/9 vs. 31/8	*3.01%*	*0.67%*	*1.05%*	*7.35%*	*2.20%*	*-3.73%*	*-2.46%*	*3.18%*	*-4.32%*	*-7.73%*	*0.29%*	*-0.77%*
21/09/21	70.56	1.173	1.32	0.83	0.21	4354.19	275.68	105.39	60.31	326.58	195.59	220.65
30/09/21	75.03	1.157	1.4873	0.9649	0.2755	4307.54	274.11	115.13	63.11	327.32	182.05	207.53
Chg 30/9 vs. 21/9	*6.34%*	*1.34%*	*12.45%*	*16.37%*	*28.80%*	*-1.07%*	*-0.57%*	*9.24%*	*4.64%*	*0.23%*	*-6.92%*	*-5.95%*
31/08/21	68.50	1.181	1.31	0.77	0.21	4522.68	282.62	102.14	63.03	353.94	195.02	222.35
30/09/21	75.03	1.157	1.49	0.96	0.28	4307.54	274.11	115.13	63.11	327.32	182.05	207.53
Chg 30/9 vs. 31/8	*9.53%*	*2.00%*	*13.64%*	*24.92%*	*31.63%*	*-4.76%*	*-3.01%*	*12.72%*	*0.13%*	*-7.52%*	*-6.65%*	*-6.67%*

Source: Bloomberg

Analysing the different metrics above, the table shows that oil performed particularly well last month (the oil price started to move higher in a more distinct fashion from around mid-August) and closed nearly +10% higher in September. The US dollar considerably strengthened against the Euro following the FOMC meeting. Since there is normally a negative correlation between the oil price and the US dollar (i.e. a weaker dollar tends to lead to a higher oil price), we construe that the higher prices of oil as well as the US dollar on this occasion derived from 'other factors', such as higher energy demand in China, shortage of natural gas reserves in Europe, the UK petrol crisis and the risk of energy/electricity disruptions during the winter-months ahead.

It is also noticeable how bond yields have moved higher since the September FOMC meeting – particularly over the two and five-year durations. The S&P500 and our benchmark index, MSCI Europe, both fell in September, but the bulk of their drawdowns were incurred from the 21st. When looking at the sector breakdown for Europe, energy stocks performed well throughout September while financial stocks (primarily banks and insurance companies) did very well over the last six trading sessions of the month. While European technology and IT stocks performed well until 21st September (the sector appreciated by +0.29% while the MSCI Europe index fell by -3.73%), there was a considerable drawdown from that date until the end of the month (-6.92% vs. -0.57% respectively).

Looking ahead

Given the multi-year bull market for equities (and indeed for bonds) – it has been a worthwhile strategy to '*buy on the dips*'. Against this backdrop, it may be contentious to recommend investing in stocks (or funds) after the brief underperformance in September – especially now when bond yields have been rising. We infer that such views rhyme with remarks made by other market commentators as well as to some extent the FOMC members who are now voicing concern that supply-side constraints have caused inflation and inflation expectations to be longer lasting. In fact, these issues have caused some to argue that the world may even enter a period of stagflation.

The knee-jerk reaction when bond yields move higher is to take profits in growth stocks (similar to what happened in 1Q21). However, we note that growth companies ultimately have better pricing power (as indeed all the Portfolio companies in European Focus) compared with those in the broader market since they generally supply essential products and services – in particular the Portfolio companies in European Focus. Should the world economy enter a period of slower growth with stagflation-like characteristics, we would argue that pricing power will become an extremely important attribute. If bond yields were to continue to rise as inflationary pressures are building (which is feasible), not only should companies with pricing power be better positioned to raise their prices than price-takers, but such price increases are also likely to be stickier because of the underlying products' inherent price inelasticity.

There is also another angle to higher bond yields on which we have commented many times in the past. As debt becomes more expensive to service, it is likely that investors' focus will shift with more attention placed on the balance sheet strength of companies and in this context European Focus stands out.

Our analysis shows that the average Portfolio company's balance sheet is stronger now than a year ago. Following the 1H21 reporting season and based on Bloomberg consensus EBITDA estimates for FY21, the Portfolio's net interest-bearing debt to EBITDA at the end of Jun-21 stood at less than 0.4x (Dec-20: 0.5x) excluding lease-debt obligations while including lease-debt obligations the ratio was slightly less than 0.6x (Dec-20: 0.8x).

These strong Portfolio metrics compare favourably with the average net debt to EBITDA of the European market which still sits at around 3x. In short, it should be considerably less expensive for the Portfolio companies in European Focus to service higher interest payments than it will be for the average company in the broader European equity market. Based on this scenario, we would expect a solid relative performance of the European Focus Fund going forward.

In conclusion, over the past 30 or so years, European economic recovery periods have always been plagued by inhibiting factors, such as the risk of escalating inflation, soft consumption-sentiment bordering on frugality due to job-insecurity and central banks pursuing hawkish policies and not being fully committed to underpin economic momentum the region. This is clearly not the case now as the ECB appears to be going to great lengths to explain that its bond-buying program should remain in place in the medium-term. In comparison with such a history, we continue to argue that the stars are currently lined up for Europe and for European equities to perform well during the likely forthcoming recovery – with or without inflation.

Why European Focus should continue to perform well

The power of compounding

We first introduced the below table in April which illustrates the significant benefit of compounding. The top-part of the table illustrates how sales, EBITDA and EBIT growth have developed and are expected to progress for the European Focus Fund and for Europe (the MSCI index) during FY20 to FY22e.

The below-part illustrates how the impact of sales, EBITDA and EBIT growth rates affect the sales and the earnings power based on current consensus expectations are for FY21e and FY22e. In short, the bottom-part highlights the impact and importance of not losing sales or profits during economic weakness, such as in FY20.

Projection of sales and profit growth for European Focus and Europe (MSCI index)

HEFEF	FY19a	FY20a	FY21e	FY22e	MSCI	FY19a	FY20a	FY21e	FY22e
Sales	—	2.0%	15.3%	8.3%	**Sales**	—	-19.0%	9.6%	4.2%
EBITDA	—	9.0%	26.3%	9.1%	**EBITDA**	—	-21.2%	37.6%	5.0%
EBIT	—	11.5%	64.3%	10.4%	**EBIT**	—	-38.3%	101.8%	4.9%

HEFEF	FY19a	FY20a	FY21e	FY22e	MSCI	FY19a	FY20a	FY21e	FY22e
Sales	100	102.0	117.6	127.3	**Sales**	100	81.0	88.8	92.5
EBITDA	100	109.0	137.6	150.1	**EBITDA**	100	78.8	108.4	113.9
EBIT	100	111.5	183.1	202.1	**EBIT**	100	61.7	124.5	130.6

Note: as at 30-Sep-21 including Portfolio weighting
Source: Bloomberg

The above tables show that European Focus grew its sales by +2.0% while the MSCI index saw sales fall by -19.0% in FY20. In a similar fashion, the Portfolio's EBITDA increased by +9.0% while the MSCI index saw EBITDA fall by -21.2% with the Portfolio's EBIT rising by +11.5% while the MSCI index saw EBIT fall by -38.3%.

Since all profits (and cash flows) need to be generated from revenues, sales is critical to any business. However, some commentators argue that: '*Sales are vanity while profits (and cash flows) are sanity*', but we tend to disagree with this remark. We consider revenue is often an underrated attribute since it forms the base from where businesses grow. However, we believe it essential to analyse sales in a '*correct*' fashion. Hence, sales need to be broken down into 'organic growth' (price and volume) and 'residual growth' (such as M&A and foreign exchange rate movements). If companies continuously grow their sales organically (which is one of the core tenets for the companies in European Focus), it creates an ever-larger platform from where they can compound their profits.

What happens when sales decline; which was the case for Europe (the MSCI index) in FY20? Europe 'lost' -19.0% of its revenue base that year which means that the region needs to grow its revenues by +23.5% in FY21 to get back to square one. Since the region is only expected to grow its revenues by +9.6%, according to consensus current estimates, its sales base has shrunk to only 88.9% of its pre-pandemic base. Consequently, Europe needs to 'run faster' to generate similar levels of profits and cash flows compared with its pre-pandemic levels. In other words, profit growth needs to be higher.

While the above table shows that this is indeed the case for EBITDA and EBIT of the MSCI index (assuming that consensus current growth rates are correct). This implies that the region should be back to its pre-pandemic level already this year. However, we note that the expected +101.8% EBIT growth consensus currently factors in for Europe in FY21e is sharply higher from the corresponding expectation of a more moderate +46.5% at the end of Jun-21. What has changed are two factors. *First*, Europe's banks started to reverse the significant loan-loss provisions that were made during the pandemic in FY20 (which means that it is essentially an '*accounting-stunt*' and thus suggests a relatively low quality of earnings). *Secondly*, the higher prices of oil and other commodities have bolstered consensus expectations for raw materials-based industries.

European Focus on the other hand never lost any of its sales base during the pandemic in FY20 and it has continuously grown its profit base since 2019. The above table shows the significant impact of compounding from an ever larger revenue base, which consensus estimates to be at a notional level of 117.8 at the end of FY21e. More importantly, the earnings power of European Focus in EBIT terms (based on current consensus estimates) should have grown to 183.1 that year vs. its pre-pandemic level and more than doubled to a notional 202.1 in FY22e. This compares with the MSCI Europe index which will have grown, but still only sits at 130.6 vs. its pre-pandemic level based on current consensus expectations. In other words, European Focus does not need to run faster – the Portfolio companies only need to continue to execute as they have been doing. Given that the average established year of a Portfolio company in European Focus dates back to the 1930s, we regard the probability that our Portfolio companies will continue to execute in an exemplary manner as highly likely.

ESG considerations are continuously gaining higher priority

European Focus has an exclusion list which prevents it from investing in businesses, such as fossil-fuel, nuclear, weapons, tobacco, gambling etc. and ESG as a concept has always been integrated into our strategy given the mantra that it is essential for businesses that '***doing well and doing good are mutually dependent***'. In other words, it is not good business practice to cut corners in any of the ESG-dimensions given potential repercussions – be it financial risk, such as becoming liable to fines, damages – and/or reputational risk (which is ultimately likely to have financial implications).

In our recent Sustainability report (Oct-21), we note that the average Portfolio company in European Focus has increased its executive management team over the past five years as new functions, such as the pursuit of carbon-neutrality, e-commerce and supply-chain management etc. have been elevated to the C-suite. Moreover, female representation in the executive management teams as well as in the board rooms has doubled over the past five years.

As investors and companies are continuously re-prioritising various aspects of ESG, we note that more and more companies are tying managers remuneration to measurable ESG targets. We anticipate all Portfolio companies in European Focus to at least have partly aligned their managers' compensation to measurable ESG targets by at the time of their AGMs in 2022.

Risks and uncertainties

Below are a few bullet points regarding risks and uncertainties which we are currently considering.

- **High level of corporate indebtedness:** Higher interest rates could continue to affect the valuation of equities and companies' profitability which was the case in late September. However, as we have already outlined, since the balance sheet strength of an average European Focus company is considerably higher than that of an average MSCI Europe company, we expect the Fund to at least outperform its benchmark against this metric.

- **Taper tantrum when central banks reverse monetary stimuli:** The Fed has already given a strong indication that it will start its tapering process possibly as soon as after its 3rd November meeting and the BoE is becoming more and more hawkish by the day. The only major central bank which has not indicated that it will discontinue its bond-buying program is the ECB. While we consider it to be a fool's game to forecast currencies, we believe the '*direction of travel*' is still important. Against that backdrop, we assume the current USD strength vs. EUR weakness to persist over the next few quarters and that should support sales and profit growth of European equities as well as European Focus.

- **The delta variant (or similar) spiralling out-of-control vs. vaccine-rollouts:** While governments appear to have gotten the pandemic and even the fast-spreading Delta variant under control, we cannot exclude the re-emergence of Covid-19 clusters which could affect businesses' end-markets and/or their supply-chains. However, we believe this risk needs to be balanced against the pace of vaccine-rollouts as scientists and governments gain better understanding of the virus.

- **China's debt crisis:** We believe the current credit-crisis in China's largest construction company, the Evergrande Group (3333 HK), and its contagion to the rest of the Chinese real-estate market and banking sectors to pose a threat which could spill over into other junk-bond markets around the world. Whilst not good for equity prices, we note that well-capitalised companies in developed markets are likely to perform better should credit-conditions further deteriorate in China.

Attribution analysis for 9M21

During 9M21, the Heptagon European Focus Equity Fund (European Focus) CE share class' net asset value advanced by +19.65% to €207.5272 compared with the MSCI Europe NR (EUR) index, which appreciated by +16.20% in comparison.

There has been remarkably little rotation in the top-performing stocks and slightly more in the bottom performing stocks during 9M21 compared with the previous 1H21 and 1Q21 periods. Two of the top-five performing stocks in 9M21 (which are still amongst the largest holdings in the Fund) were in the group of top-five performing stocks in 2020 (**ASML** and **Eurofins Scientific**). Moreover, **Hermès** and **Novo Nordisk**, which were amongst the best-performing stocks in 1H21, continued to show their strength in 3Q21 period.

In terms of the five weakest-performing stocks in the Portfolio during 9M21 there was less consistency. Only one stock has been consistently weak over each of the three individual quarters this year, **Adidas**. All the other stocks in this group have only performed poorly in two out of three quarters this year. However, as far as the weakest performing stocks during 9M21 are concerned we will see catalysts for each of them which we hope will prompt re-ratings over the next 2-4 quarters.

At the end of 9M21, the top-five positions had an aggregate weighting of 28% in European Focus; the corresponding aggregate weighting for the bottom-five positions was 21%.

In the below attribution analysis, which covers the 9M21 period, the performance of each stock has been converted to EUR from its local currency. Each stock's EUR denominated performance should be compared with the benchmark index, MSCI Europe NR (EUR), which advanced by +16.20% over the same period.

Contributors

ASML (ASML NA)

ASML (the Netherlands: +62.47%), the world's #1 manufacturer of semi-conductor equipment (which remains the largest position in the Fund), was the best-performing stock in the Portfolio in 9M21 (and in 1H21, 1Q21 as well as the third best performer in 2020: +50.8%). After bottoming out during the hiatus of the pandemic last year (18-Mar-20), ASML's share recovery has been swift. Although the stock traded in a range-bound fashion during Jul-Oct 2020, it regained steam in Nov-Dec 2020. 'WFH' (work-from-home), 5G-rollouts and 'IOT' (internet-of-things) and the ramp-up of electric vehicle (EV) production have been ongoing drivers for strong demand for smaller and faster chipsets and this situation is likely to remain for some time to come. As all ASML's quarterly reports this year, 4Q20 report (20-Jan), 1Q21 (29-Apr), 2Q21 (21-Jul) and 3Q21 (20-Oct), have been excellent, the stock has been bolstered by ongoing consensus upgrades to the company's sales and profit forecasts. Management's encouraging guidance for continued strong demand for FY21 (and over the current decade), which was recently communicated during the investor day (29-Sep), should continue to underpin the ASML investment story. Given ASML's extremely strong position in its industry, where the company dominates several product-categories, such as the high-end EUV-lithography (Extreme-Ultra-Violet – extremely fine circuit patterns on micro-chips), we believe demand for its semi-conductor manufacturing equipment will remain strong in the foreseeable future. Ongoing news flow from semi-conductor giants, such as Intel Corporation and TSMC (Taiwan Semiconductor Manufacturing Corporation) regarding capacity-expansions should also further support ASML's long-term investment story. The renewed strength of the US dollar against the EUR should also help to bolster consensus sales and profit estimates of the company. However, the stock's demanding valuation makes it prone to changes in investment-sentiment (i.e. higher long bond yields). This was recently witnessed when central banks hinted that they may start to reign in bond-buying programs sooner than expected. Although the company's 3Q21 results were excellent, the company voiced concern over some component shortages. Despite this, we anticipate more upgrades over the coming months as semi-conductor shortages should lead to more price increases. ASML's 4Q21 report is due on 19-Jan.

Eurofins Scientific (ERF FP)

ERF (France: +61.50%), the leading testing-services group which provides bioanalytical services in the food, pharmaceutical and environmental markets, was the second best-performing stock in the Portfolio in 9M21 (and in 1H21 as well as the third best performer in 1Q21). Since the outbreak of Covid-19, the ERF share has been supported by strong demand for testing services and the stock has invariably responded well to the regular sales and profit-announcements as well as several upgrades to the guidance management has provided over the past one and a half years. ERF's FY20 set of results (1-Mar) prompted the market to raise the expectations for FY21 as the company raised the medium-term FY22 financial objectives. According to management, ERF should expand LfL sales by what we consider a conservative growth rate of 5% and the underlying EBITDA margin is set to rise to more than 23.5% (up from 20.4% in FY19 which is a more representative base compared with the bumper year FY20 when the EBITDA margin jumped to 26.0% because of Covid-19 testing). ERF's outstanding 1Q21 sales report (28-Apr) again reflected exceptionally strong demand for Covid-19 testing. LfL growth in 1Q21 reached 44% in 1Q21 (4Q20: +42%) primarily due to the pandemic, but the company's core business still delivered '*underlying*' LfL growth of close to +10%. ERF commented that Covid-19 related activities have gradually changed from '*standard*' testing to testing of '*variants*', which has increased the sophistication of the tests (and arguably the pricing). ERF's 1H21 set of results was even better reflecting +16% LfL growth of the underlying core business (+13% vs. 1H19). This prompted a 10.2% spike in the share price on the day (benchmark +0.4%) that was underpinned by upgrades to consensus sales and profit estimates. We have little doubt that the next few financial statements will continue to show strong underlying sales growth. However, like other highly rated stocks, sentiment to the ERF share is prone to changes in expectations of interest rates. ERF's 3Q21 sales report (21-Oct) was again strong but reflected a sequential slowdown in LfL growth to 12%. This prompted investors to take profit as management did not raise the FY21 guidance. ERF's FY21 set of results is due in Mar-22.

Novo Nordisk (NOVOB DC)

NOVOB (Denmark: +45.74%), the world's largest manufacturer of insulin, was the third best-performing stock in the Portfolio in 9M21 (and sixth best performer in 1H21). Despite a solid 4Q20 report (3-Feb) when the company raised the LfL sales growth guidance to 5-9% (from 3-6% previously) the NOVOB share was treading water during 1Q21. However, the stock revived in the run-up to the 1Q21 set of results (5-May) which reflected further acceleration in LfL top-line growth guidance to 6-10%. The 2Q21 statement (4-Aug) showed 'more of the same' as management again raised the LfL revenue growth guidance – now to 10-13% – which prompted a substantial +10.2% rise in the share price (benchmark +1.0%) over two trading days and which laid the ground for the stock to record a new all-time high (DKK680.6 on 20-Aug). The key catalyst for the renewed interest was the approval of 'Wegovy', the anti-obesity drug. Wegovy works with the once weekly subcutaneous (under-the-skin) semaglutide dosage (2.4 mg) adjunct to diet and exercise programs for chronic weight management in adults who are living with obesity (i.e. BMI> 27kg/m^2). Since this is a new form of treatment where NOVOB still appears to have considerable first-mover advantage, we believe that Wegovy will act as a growth-driver for several years to come. Consensus sales and profit revisions of NOVOB have been extremely solid with future years (FY23-FY25) showing higher growth rates than for FY21 and FY22. This implies that analyst growth projections are expected to accelerate in the future. NOVOB is due to announce its 3Q21 on 3-Nov.

Dassault Systèmes (DSY FP)

DSY (France: +36.82%), the world's largest supplier of PLM (product life-cycle management) software and 3D solutions, was the fourth best-performing stock in the Portfolio in 9M21 (the seventh best performer in 1H21 and the fifth best performer in 1Q21). DSY's 4Q20 set of results (4-Feb) was ahead of market expectations. Management hosted an upbeat webcast where the company projected 14% LfL licence fee growth for FY21 that should be further underpinned by a quick uptake in cloud-based solutions, which today accounts for more than 20% of DSY's revenue base. The market took the report extremely well as consensus expectations for FY21 and FY22 were raised. The 1Q21 report (28-Apr) was solid and the strong trajectory continued. Consequently, the 2Q21 set of results (27-Jul) showed an excellent financial performance where management reiterated 14% LfL licence fee growth for this year and again raised the guidance for FY21. DSY invoices a considerable proportion of its sales in US dollars (we estimate 55-60%) and the company therefore stands to benefit from the dollar's recent appreciation. On a separate note, over the past 1-2 years, we have gotten the impression that the long-standing CEO, Bernard Charlès (who joined DSY in 1983), is preparing to take a step back. As DSY's highly regarded CFO/COO, Pascal Daloz, has gradually become more prominent during the company's presentations, we expect him to be the natural successor. DSY will release the 3Q21 set of results on 28-Oct.

Hermès (RMS FP)

RMS (France: +36.03%), the highly focused and leading French luxury company, was the fifth best-performing stock in the Portfolio in 9M21 (and the third best performer in 1H21). So far this year, RMS has delivered excellent sales and results statements; the 4Q20 report (19-Feb) showed like-for-like (LfL) sales growth of +15.6% (sequentially up from +6.9% in 3Q20). Given the low base numbers for comparison in the period a year-ago, LfL revenue growth in 1Q21 (22-Apr) reached +43.7% (1Q20: -7.7%). Already at that time, it was evident that the company has regained its poise and is back on trend-growth after the pandemic-infused slowdown last year. Due to the 'easy' base numbers for comparison RMS's business has continued to thrive; 2Q21 LfL revenue growth was +127.1% (vs. 2Q20: LfL sales growth was -42.1%). Although RMS showed moderation in LfL sales growth in 3Q21 to +57.2%% (21-Oct), we still expect an extremely strong sales number for 4Q21 as well as for FY21. The company's recent sales and profit revisions have been solid. The company's FY21 set of results is due on 18-Feb.

Detractors

Zalando (ZAL GY)

ZAL (Germany: -12.89%), Europe's largest online fashion retailer, was the worst-performing stock in the Portfolio in 9M21 (the third weakest performer in 1Q21). This contrasts sharply with last year, when the ZAL share was the best performer (+101.6%). So far in 2021, the company has published continuously strong quarterly reports. The 4Q20 set of results (16-Mar) was excellent; management announced a substantial upgrade to the FY21 guidance in conjunction with the 1Q21 report (6-May) and again released a strong set of results for 2Q21 (5-Aug). While ZAL's sales and profit revisions have been decent, the share has continued to linger. Against this backdrop, we construe that last year's strong performance of the ZAL share reflected its status as a 'pandemic-winner' and that this attribute has partly faded in 2021 as consumers have enjoyed going out to shop in traditional brick-and-mortar outlets after several months in pandemic-related lockdowns. However, as of late we sense that there is an increasing element of concern that ZAL's management will announce supply-chain constraints which will affect the company's sales and profit outlook. Moreover, the recent US dollar strength may have an adverse impact on ZAL's gross margin since many of its garment purchases are undertaken in this currency while its main denomination for invoicing is in EUR. Nonetheless, we believe it is indisputable that online retailing will be a considerably bigger business a few years out than what it is today and that ZAL in many ways has a first-mover advantage in Continental Europe. ZAL's 3Q21 set of results is due on 3-Nov.

Adidas (ADS GY)

ADS (Germany: -8.76%), the world's runner-up sports shoe manufacturer after Nike, was the second weakest performing stock in the Portfolio in 9M21 (the third weakest performer in the Portfolio in 1H21 and the weakest in 1Q21). The company's 4Q20 results (10-Mar) were well ahead of highly set market expectations and so were the 1Q21 results (7-May) and indeed the 2Q21 numbers (5-Aug). The ADS share (along with its main rival, Nike) traded in a sluggish fashion during much of 2Q21 on concerns about China's retaliation over the Xinjiang cotton boycott. Prior to this episode, ADS hosted an excellent investor day in conjunction with the release of the 4Q20 report where management highlighted a sea change to its strategy for 2021-25 with the objective of moving the business from primarily a wholesale-driven model to a 'D2C' (direct-to-consumer) operation. This strategic change will require some €8-9bn in capex-spending (circa 40% of FY20 revenues) but should transform the group to a digital company but where '*sports-and-athletics*' will remain the core-competence. Not only should this lead to an acceleration in sales growth as an increasing proportion of the revenue stream moves online, but it should also bolster the group's profit margin since ADS is in a position to cut out lots of the middlemen. Although ADS' 2Q21 results were strong and management raised the FY21 guidance, the market focused on possible supply-chain constraints in Vietnam due to a Covid-19 related lockdown despite management's assurance that these issues had already been accounted for in the forecast. ADS is due publish its 3Q21 set of results, which is normally the seasonally strongest period, on 10-Nov.

Intertek (ITRK LN)

ITRK (UK: -8.19%), the world's second-largest TIC (Testing/Inspection/Certification) company, was the third weakest performing stock in the Portfolio in 9M21 (and the weakest performer in 1H21). The ITRK share showed higher-than-usual volatility in 9M21; having nearly bounced back to its all-time high (£64.40 on 2-Oct-20) in late April, the stock had a dismal May (-11.6% vs. +3.1% of the benchmark). What prompted this downturn was the 4M21 trading statement (26-May) when the company reported LfL revenue growth of only +2.7% (2H20: -5.6%). ITRK's 1H21 set of results (30-Jul) fell short of market expectations. Although LfL revenue growth had increased to +5.8% over 1H21 (implying a significant recovery of the business since the AGM statement), the market still took the report badly. On a general note, ITRK's management is commendably good at informing the investment community on an ongoing basis. However, its webcasts tend to be dominated by the CEO André Lacroix and to a lesser extent the CFO, Jonathan Timmis. Moreover, on these occasions, the company's scripted communication tends to be similar from one presentation to the next with little new information apart from the changes in the divisional LfL sales and EBITA growth rates. During the Q&A sessions, management has also become increasingly evasive (as the stock price has continued to linger) to give answers which frequently lack sufficient granularity. On a more positive note, however, consensus sales and profit revisions for ITRK have been surprisingly strong. ITRK is due to publish a 10M21 trading statement on 24-Nov.

Beiersdorf (BEI GY)

BEI (Germany: -1.04%), the owner of the world's largest skincare brand, Nivea, was the fourth worst performing stock in the Portfolio in 9M21 (and the fifth weakest performer in 1H21 as well as in 1Q21). BEI's FY20 statement (17-Feb) met market expectations in terms of the financial performance as the sequential growth rates improved for all the group's consumer brand names, such as *Eurcerin* (dermatology) and the *La Prairie* brand (very high-end skincare), which are more reliant on travel-retail. Nonetheless, the market took the report badly as management communicated another €300m provision to 'kick-start' e-commerce. BEI made a similar allocation in early 2019 when Stefan De Loecker took over as CEO of BEI. Against this backdrop, the investment community was (rightly) perplexed as to what management had been up to over the past two years. It had also been previously communicated that the highly regarded CFO, Dessi Temperley, would step back and that a new CFO (Astrid Herman) had been appointed. BEI's 1Q21 revenue statement (7-Apr) was pre-announced by three weeks. When the company's full statement was ultimately published (28-Apr), the key piece of news was that CEO Stefan De Loecker would be replaced by Vincent Warnery as of 1-May. Warnery is an internal manager who was previously in charge of the Pharmacy & Selective divisions (*Eucerin*, *La Prairie* and *Hansaplast*) and the North American operations. In terms of revenue growth during 1Q21, BEI reported LfL growth of 6.3% (a sharp sequential acceleration vs. -1.5% in 4Q20). More importantly, the 1H21 set of results (5-Aug) reflected a more meaningful come-back; LfL growth for 2Q21 in isolation increased by 26.1% Y/Y and the market took the report extremely well giving credit to the new CEO who hosted a strong and inspiring presentation. We are hopeful that the new management team of BEI will reposition the company more to the beauty care market than its other adhesives business (Tesa's core activity). Consensus sales and profit revisions have been strong since the 1H21 set of results. BEI is due to release its 3Q21 revenue statement on 28-Oct.

SGS (SGSN SW)

SGSN (Switzerland: -2.22%), the world's largest TIC (Testing/Inspection/Certification) company, was the fifth weakest performing stock in the Portfolio in 9M21 (and the forth weakest performer in 1H21). Unlike its smaller rival, British ITRK which offers four financial reports per year, SGSN only publishes full and half-year results. Nonetheless, the correlation between the two stocks is still quite similar. SGSN's FY20 results (28-Jan) fell slightly short of market expectations while the 1H21 statement (19-Jul) slightly exceeded expectations. Unfortunately, management came across as overly guarded in terms of the guidance but consensus sales and profit revisions have been solid since summer (notwithstanding the appreciation of the CHF). From a financial perspective, SGSN's highly regarded CFO, Dominik de Daniel, is increasingly putting his footprint on the business by implementing the 'EVA-concept' (Economic Value Added) throughout the organisation. He did this successfully in a similar capacity during his employment at Adecco, where he was CFO for a number of years. SGSN's next report, the FY21 set of results, is due on 27-Jan.

European Focus Portfolio changes

The '5/10/40' UCITS rule states that positions over 5% cannot have an aggregate weighting which exceeds 40% and that an individual position cannot have a weighting which exceeds 10%. As trades of less than 1% are too small to have any meaningful impact on the Fund's performance, we only generally comment on trades exceeding this level. Over-and-above smaller changes to the Portfolio, which relate mostly to market opportunities and/or correction of passive UCITS breaches, we rebalanced the Portfolio by making 1 change and 1 top-up in 3Q21, implying 5 changes over 9M21 (9M20: 10 changes).

- We added to **L'Oréal** on 16-Apr
- We added to **EssilorLuxottica** on 21-May
- We added to **EssilorLuxottica** on 22-Jun
- We sold **Serco** on 5-Aug
- We added to **Atlas Copco** on 27-Sep

L'Oréal (OR FP) from 3.7% to 4.7% (16-Apr)

We added 1.0 percentage point to 4.7% in OR on 16-Apr during profit-taking which took place following a slightly weaker-than-expected 1Q21 sales report. While OR's e-commerce business continued to thrive with LfL revenue growth in excess of 47% (and 29% of revenues) in 1Q21, Western Europe and the Consumer Products division (39% and 26% of revenues respectively) were sluggish due to lockdown restrictions. However, OR's management made a remark during the FY20 presentation: '*Makeup will come back as soon as facemasks disappear*' and we agree with this view. Consequently, we considered the weakness in post the 1Q21 as temporary given several national lockdowns. Since OR's 1Q21 sales report, consensus sales estimates have been raised (and more so the profit estimates) for FY21 and onwards. We were fortunate with the timing of the purchase; since our top-up in OR, the stock appreciated by +11.4% vs. +3.3% of the benchmark until the end of 1H21 and it has risen by +14.8% (benchmark +16.2%) in the year to the end of September.

EssilorLuxottica (EL FP) from 2.6% to 4.0% (20-May)

We added 1.4 percentage points to 4.0% in EL on 21-May following weakness in the stock after the 1Q21 sales report (6-May) Although the LfL revenue numbers for 1Q21 broadly met market expectations, we sensed that there was an element of relief by the investment community following a series of 'mishaps' during several prior quarters. What prompted us to increase the weighting in EL was the cross-read from the Swiss hearing aid manufacturer, Sonova's (SOON SW) FY20/21 results (18-May), where management pointed to a very sharp recovery since late April 2021. Hence, we argued that if customers were willing to visit audiologists, they were likely to visit similar types of retail outlets such as, EL's Sunglass Hut and more. Since EL's 1Q21 sales report – and indeed the 1H21 set of results (30-Jul) – consensus sales and profit estimates have been substantially raised for FY21 and for future years. We were fortunate with the timing of the purchase; since our initial top-up of EL shares, the stock appreciated by +5.0% vs. +2.8% of the benchmark until the end of 1H21 and the stock has further strengthened by +22.0% (benchmark +16.2% in the year to the end of September.

EssilorLuxottica (EL FP) from 4.0% to 4.5% (22-Jun)

We added another 0.5 percentage points to 4.5% in EL on 22-Jun following an announcement that EL had won an arbitration case against GrandVision (GVNV NA), the Dutch optical retailer which EL launched a bid for June 2019. This acquisition was considered to be somewhat contentious in that the EU antitrust authority had voiced some market share objections. While those hurdles were ultimately cleared, the arbitration outcome proved that GVNV's management had been 'dragging their feet', giving EL the option to walk away from the acquisition and/or renegotiate the price. Against this backdrop, there was a sharp drop in the GVNV share price on 22-Jun, as well as in the EL stock price (while the European market was trading broadly flat). We thought it was unlikely that EL would walk away from the deal, but the company still had the option to renegotiate a lower takeover price of GVNV. Consequently, while we felt that the EL stock should trade higher on this piece of news, it behaved in the opposite fashion prompting us to add to the position.

Serco (SRP LN) from 1.6% to 0.0% (6-Aug)

SRP was the smallest position in the Portfolio and we had not added to the holding since 2017. Despite the highly ethical elements of SRP's business, the company frequently came up as an 'outcast' during our internal ESG meetings since it partly provides facility management services (catering, cleaning, call-centre response etc.) to a wide range of organisations in society. One such customer group is the defence sector (i.e. the air-force, army and navy) in the UK as well as in a number of other Commonwealth countries and this was often a source of confusion. Financially, SRP had staged a great recovery since the ousting of its former management team in 2013. The stock was one of the best performers in the Fund during 2019 but performed poorly last year. Given the small position size in the Fund and the lengthy discussions we frequently had as to whether to hold on to the position or not, we decided to part ways with this fine company.

Atlas Copco (ATCOA SS) from 3.8% to 4.8% (27-Sep)

We have owned ATCOA on two occasions since the inception of the European Focus; the first time was in 2017 when we traded in-and-out of the position over a 7-8 month period. The second time we invested in the stock was in Mar-20 and the stock has performed brilliantly since then. Since the early 1990s, ATCOA has grown from a 'large-cap' Swedish capital goods company to Sweden's largest business by market capitalisation (even surpassing what used to be larger employers like Ericsson, Volvo and H&M). More recently (over 2-3 years), the price action of the ATCOA share has partly changed from primarily tracking other European capital goods companies to be more correlated with stock's like ASML, the Dutch champion that dominates the OEM-market for semi-conductor production. In short, the ATCOA share is increasingly perceived as a growth stock and the rationale for this change in perception is simple. Some years back, ATCOA acquired a business which manufactures and sells vacuum-pumps to semi-conductor equipment manufacturers (such as ASML). The ATCOA share considerably outperformed the benchmark in 1Q21 (+23.8% vs. 8.4% respectively) but underperformed the benchmark index in 2Q21 (-0.5% vs. +6.5% respectively). The 2Q21 set of results (16-Jul) was strong and the consensus sales and profit revisions have been solid since summer. Also the 3Q21 set of results (21-Oct) was solid but reflected an expected slowdown in sequential LfL growth. The stock saw some temporary profit-taking following the last set of results as management voiced concern over supply-chain constraints. ATCOA is a main beneficiary of a stronger US dollar. The ATCOA share has been an overall strong performer in the year to the end of September (+25.2% vs. +16.2% of the benchmark).

Christian Diebitsch, Fund Manager, Heptagon Capital

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