HEPTAGON Capital

European Focus Fund: Monthly Commentary

October 2021

Fund Manager

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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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Supply-chain problems vs. price increases

European equities bounced back nicely in October. From a sector point of view, European utility stocks performed the best last month (+8.2%), followed by the consumer discretionary sector (+6.4%) and information technology (+6.3%). Although deep-value sectors performed well like financials (+5.9%) and energy stocks (+3.6%), the latter did not keep up with the rise of the oil price which rose by another +11.4% in October. European Focus also had a good month. The Fund strengthened by +6.7% against the MSCI Europe net benchmark index, which rose by +4.7% in comparison (an outperformance of +202bps). Following the broader drawdown of stock markets in September, this means that YTD, European Focus has still advanced by +27.6% vs. +21.6% of the benchmark (an outperformance of +602bps).

There was a big contrast when comparing the top and the bottom performers in October. The Norwegian recycling company, **Tomra**, performed the best (+19.2%) on the back of a strong quarterly set of results. This was followed by the French luxury goods company, **Hermès** (+14.5%) and the world's largest insulin producer, the Danish **Novo Nordisk** (+13.3%). It was pleasing to note that one of our very recent additions to the Portfolio in October got on to a good start; it was the Swiss dental implant provider, **Straumann** (+13.0%) followed by the world's largest 3D-software provider, **Dassault Systèmes** (+10.8%). Only one stock performed badly, it was the French testing specialist, **Eurofins Scientific** (-8.0%), while the drops of the other underperformers (**Beiersdorf**, **Intertek** and **SGS**), were contained to a range of -1.7% to -0.7%. Against this backdrop, we construe that stocks pertaining to the 'TIC' (testing/inspection/certification) segment were out-of-favour – possibly because market participants are starting to anticipate light at the end of the pandemic tunnel.

October also marked the start of the 3Q21 reporting season. During the month, 11 Portfolio companies (with a 55% combined weighting) announced figures. Although most of the companies' announcements exceeded market expectations, the overriding topic that was discussed related to supply-chain constraints. It was noticeable that the companies' underlying shares saw higher-than-normal volatility around the reporting dates as the intricacies of businesses' different supply-chain issues were discussed.

In our opinion, the Portfolio's largest holding, the Dutch semi-conductor equipment manufacturer, **ASML**, summarised this topic the best: '*Who hasn't gotten them (i.e. supply-chain issues)? But we'll overcome them…*' Another Universe company (currently not a Portfolio holding), **Assa Abloy**, also characterised this issue neatly: '*Our key challenges ahead are linked to: higher raw materials prices, logistics planning and rising salaries…*'

We have tried to bring some order into the messy topic of supply-chains. Sadly, we infer that businesses' supply-chain constraints will remain a testing topic for several quarters to come and the net effect is that prices (i.e. inflation) will have to rise further – possibly well into 2H22 when it is likely the base numbers for comparison will look more favourable.

Listening to the comments made by those companies which announced figures in October, raw materials prices have increased (sometimes dramatically), but that price increases have started to level off. For example, using the iron ore price in China, the world's biggest consumer of this commodity, as a proxy (with possibly energy as the only major exception), we believe this is a correct observation.

A related topic is the general shortage of semi-conductors and the global constraint to the manufacturing capacity of semis, which is currently concentrated to Asia. Given the ongoing environmental tightening of exhaust regulations, we sense that the automotive industry in particular is suffering from these shortages as production plants have had to close down and/or operate on reduced capacity. Given the switch to – and the scaling up of – electric vehicle manufacturing, which will require a massive increase in the number of semis per vehicle, the entire car manufacturing industry appears to be in a limbo as several producers are voicing concerns that delivery times for their new vehicles are around six months or even longer.

What seems to be at the heart of businesses' supply-chain constraints (over-and-above higher raw materials and component prices as well as the shortage of the semis) is the fact that companies cannot plan ahead. Again, referring to a remark made by **Assa Abloy**, its management commented that forward looking visibility is currently down to around six weeks compared with some six months which is normally the case. In essence, according to **Assa Abloy** the issue is not the impact from actual lost sales opportunities, (at least so far) the key problem is operational. As component deliveries are often ad hoc, there is a great strain on how organisations plan and prioritise where production should take place, which factories should be allocated what components and whether the correct components actually arrive or not. Although **Assa Abloy** was more vocal about these bottlenecks than many of its peers, we believe more or less every business is in the same situation. Hence, the above remark from **ASML** seems to summarise the whole situation up quite well.

Moving on from the companies to further back in the supply-chain, given the log-jam at container ports, where ships sometimes have to be re-routed as port authorities cannot cope with storage space and lack of lorry drivers etc, we believe the whole issue is extremely complex and won't be resolved in the short-term. For example, in Britain's largest container port, Felixstowe, it has come to our attention that ships sometimes don't even bother to dock and unload the containers as they run the risk of getting stuck with the containers still loaded on the ships as all the land-based storage spaces are full and there are not enough lorry drivers to move the incoming products to their various destinations. Although the UK may be somewhat unique because of Brexit related bottlenecks that pertain to the availability of lorry drivers, we doubt it is much better elsewhere. In conclusion, we construe that for what appears to be a contained problem relating to businesses' supply-chains, the ripples have wide-ranging consequences to society at large which will ultimately affect pricing (i.e. inflation). In conclusion, we infer that those customers who can pay up are likely to get priority.

From a Portfolio construction point of view, one way to mitigate these issues is to balance the Portfolio to more service and software related exposures and this is what we have done. *First*, we initiated a position in a new Universe company, **Adyen**, the Dutch payment provider. *Secondly*, we have ensured that there are exposures to service-based businesses. Our long-standing holding in **Dassault Systèmes** (the world's largest provider of 3D-software), which has been part of the Fund since its inception in August 2014, is such an example. Another long-term holding, **Eurofins Scientific** (which we partly pruned in August because of concerns that the exceptionally large volumes of testing opportunities relating to COVID-19 will come to an end), should still continue to prosper. Not only do we believe that 'testing' as a concept has made a step-change following the pandemic, but COVID-19 cases have again started to rise as economies are opening up.

Moreover, this trend may be exacerbated by the colder autumn and winter weather. *Thirdly*, we would also argue that businesses which are providing ‘critical products’, such as stocks in the healthcare sector, will be prioritised by governments and regulators. One such business is **Novo Nordisk**, which we commented on earlier in this report and delivered an excellent 3Q21 set of results.

On a more positive note, the profit margin of the companies which have so far reported appears to have held up better than the market expected. This implies that: (*i*) businesses’ cost-containment is still at large as companies remain reluctant to send staff out travelling, participating at exhibitions, conferences and similar and; (*ii*) price increases are gradually coming through. In our opinion, this suggests that companies continue to be more flexible and nimble than the market participants are giving them credit for.

Christian Diebitsch, Fund Manager

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