HEPTAGON
Capital

Future Trends Equity Fund

Q2 2022 Commentary

Fund Manager

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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 first half of 2022 has been challenging for all investors. The Fund has lost 27.5% since the start of the year and witnessed a decline of 18.9% in Q2. However, annualised returns since inception remain ahead of comparable returns for our MSCI World benchmark. Looking ahead, we believe that the prospects for our businesses and the themes to which they are exposed are highly compelling. Such conviction is reinforced by the growth and valuation analysis we have done.

Introduction

To suggest that the first half of 2022 was challenging might almost be considered an understatement. You would need to go back to the end of the Great Financial Crisis to find the last occasion when the global equity market fell for two consecutive quarters (then: Q4 2008, Q1 2009). This time around, if you had invested $100 in the MSCI World Index at the start of 2022, it would now be worth $79.40. The drawdown in the S&P 500 Index is similar, marking the worst start to the year for this US equity index since 1970. The NASDAQ 100 Index fared even worse, trading down almost 30% since January.

As we have noted elsewhere, **there have been few places to hide for mainstream investors in 2022**. The Future Trends Fund has, unsurprisingly, not remained unscathed. On a year-to-date basis, the Fund is down 27.5%, with a decline of 18.9% recorded in the second quarter of the year. Although almost every conversation we have had with investors recently has centred on the macro environment *before* discussing prospects for the Fund, our purpose is *not* to discuss the former in this commentary. Rather, **we believe it most important to highlight just why we remain constructive on the outlook for the Future Trends Fund**.

At a high level, *nothing has changed*. Our process for how we view the long-term investing landscape is identical to at any other time in the Fund's life. From our perspective, we have the utmost conviction that the trends to which our businesses have exposure will only continue to grow in importance, broadly irrespective of the economic backdrop. Further, **we look only to**

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own a certain sort of business: pure-play companies with market leadership positions that continue to differentiate themselves through ongoing out-innovation. How do we know that we have picked the 'right' business? It's simply a function of good governance, capital discipline and sustainable free cashflow generation (the three are, of course, interlinked). All our businesses possess these characteristics, and we believe their prospects continue to look highly robust. Below we detail the **four main reasons why we remain constructive on the outlook**.

Four reasons to be constructive

1: Long runway ahead –

All the themes to which our businesses are exposed are still in an early innings of their development. Consider the smartphone, which will seem ubiquitous to all readers of this report. Globally, however, only 50% of the population owns such a handset. As we said in our first ever thematic note, the data we produce and consume will continue to grow exponentially – but for it to have any value, data will need to be secured, stored and analysed. This creates a host of investment opportunities. Bear in mind that no more than one-in-four corporate workloads around the world have been moved into cloud environments.

Data and the cloud form *just* one of the themes in which our Fund is invested. **Our core mantra is one of pan-thematic diversification**, investing in everything from cloud to wind and fish to (semiconductor) chips. Take the other parts of this equation: renewables today make up less than 10% of the global energy mix, while non-meat-based protein consumption levels are at an even lower level of penetration.

Our project in seeking to understand how the future is evolving remains ongoing. To this end, we have published two new thematic white papers so far in 2022 – on prospects for the water industry and decentralised finance – as well as adding 26 posts to the Future Trends Blog.

2: Bottom-up conviction –

The investment approach we have consistently pursued within Future Trends is to combine top-down thematic perspectives with bottom-up company work. We build models for all our businesses and update these regularly. Our estimates tend to be inherently conservative, typically below consensus forecasts (per Bloomberg).

Given the trends to which our businesses are exposed, it should not be surprising that the projected rate of future revenue growth is *well ahead* of that of the MSCI World Index. On a three-year compound annual (CAGR) basis, we calculate that the Fund will generate 9.7% revenue growth, taking the weighted average forecasts for all the businesses within it. This is 6.3 percentage points (pp) ahead of the comparable figure for the MSCI World (3.4%). Further, while our revenue estimates have *increased* since the start of the year (the three-year CAGR was 9.1% on 31 December 2021), those for the MSCI World have *fallen* (from 4.2% to 3.4%). Put another way, the gap between our Fund and the market is widening, in our favour.

If this revenue analysis is encouraging, then we are even more pleased by the improvement in cashflow prospects. **Cash is the best indicator of a company's underlying financial health, in our view. Here, similarly, not only have our free cashflow estimates increased since the start of the year, but also the gap between our forecasts and Bloomberg's calculation for the MSCI World's growth rate have widened**. The businesses within the Future Trends Fund are forecast to generate free cashflow at 20.9% over the next three years, 10.5 percentage points more than the level for the MSCI World (10.4%). At the start of the year, the gap was equivalent to 7.3pp (19.8% vs 12.5%).

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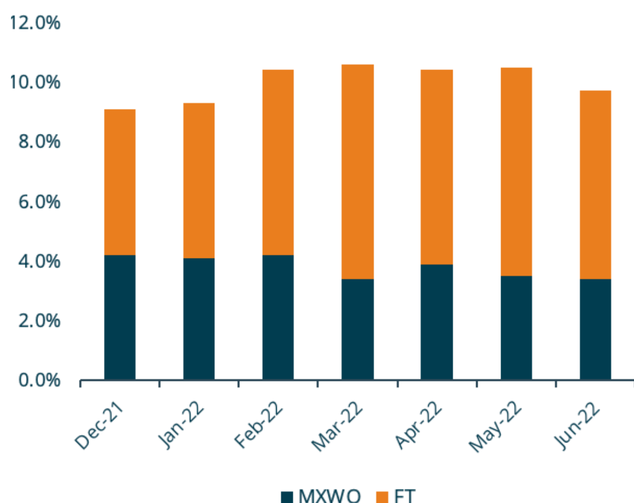

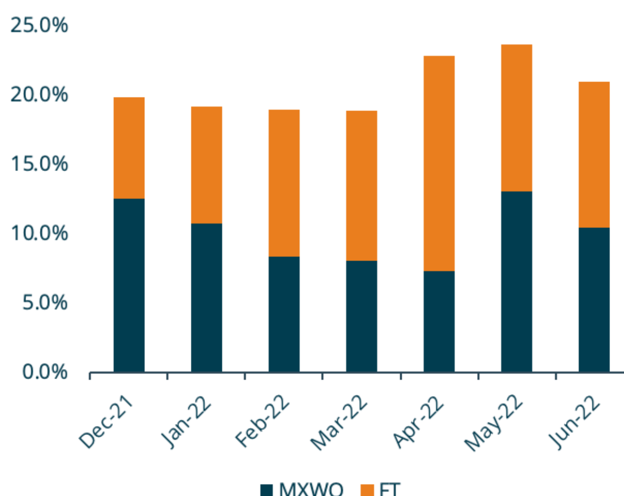

Sources: Heptagon Capital, Bloomberg

Such free cashflow growth is also mirrored in the balance sheet health of our businesses. Average net debt/ EBITDA for our businesses was equivalent to 0.8x at the end of June, ahead of the comparable figure of 1.1x for the MSCI World. Seven of our businesses have net cash on their balance sheets, which would allow them considerable flexibility in the event of more adverse financial conditions. The businesses within the Fund that carry higher debt levels on their balance sheets (for example, Prologis or Cheniere Energy) typically have this debt backed by physical assets (industrial real estate and liquefied natural gas facilities, respectively).

3: Valuation support –
The businesses within the Future Trends Fund have rarely traded on as attractive levels as at present. Take the weighted average of outputs generated by our financial models, and our businesses are 45.9% undervalued on a discounted free cashflow basis. This compares to an average undervaluation level of 28.1% since the Fund's inception. Only at the nadir of pandemic uncertainty, in March 2020, was this valuation upside potential wider, reaching 57.7%. For the record, we have also increased our cost of capital assumptions in our modelling since the start of the year.

A similar story can be seen when considering relative multiples. The forward P/E for the Fund (again, on a weighted basis) is now 20.7x. Since inception, the average figure for Future Trends is equivalent to 26.0x, with an all-time low multiple of 19.2x reached in March 2020. Throughout the Fund's life, its P/E has been at a premium to that of the MSCI World Index. However, we believe this to be justified given the better growth and cash-generation prospects as well as healthier balance sheets outlined previously.

Importantly, **the valuation gap between the MSCI World and the Fund has narrowed *in our favour* since the start of the year**. The Index currently trades on 15.5x forward earnings, 5.2pp lower than the multiple for the Fund. At the start of the year, this gap was equivalent to 9.8pp, while the average figure since inception has been 8.1pp. A similar story would also be evident were the analysis to be conducted using free cashflow yield.

4: What management teams are saying to us –
Beyond building and maintaining financial models for our businesses, we seek regularly to engage with management teams to understand how they see the future. **Since the start of this year, we have conducted over 60 meetings with company management teams**, a combination of in-person and virtual events. Our Q2 total comprised 37 meetings, of which 23 occurred in the US, where we undertook our first trip since the onset of the pandemic. While there is always the danger of seeking confirmation bias in such meetings, the conclusions we drew support the logic of our current investments. It is also important to monitor businesses for future inclusion within the Fund as well as peers of our existing holdings. More details of our recent interactions can be found in the Fund's Q2 Sustainability Report.

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Portfolio changes

As should be evident, **our strategy has always emphasised low turnover**. When we add names to the Fund, it is to increase thematic diversification. Meanwhile, sell decisions are motivated typically by higher relative conviction in new names. **We made one portfolio addition and one (unrelated) exit in Q2**. For the record, the holding period for the businesses in which we invest is potentially indefinite. We have owned three businesses (Kerry Group, Mastercard, Novo Nordisk) since the Fund's inception. The average business within the Fund currently has been owned for 44 months.

Cheniere Energy became the newest investment in the Future Trends Fund, added to the portfolio in April 2022. Listed in the US with a market capitalisation of $33.8bn, Cheniere is a full-service provider of liquefied natural gas (LNG), offering procurement, transportation, liquefaction and shipping.

We first made the case for LNG in 2011 and were previously invested in the business from 2016 to 2020. Our motivation for exiting from Cheniere two years ago was nothing to do with the quality of the business and was simply a reflection of our (then) relative conviction level, particularly in the context of the valuation opportunities presented elsewhere as a result of the broader market's pandemic-related sell-off. More recently, the changed geopolitical environment resulting from Russia's invasion of Ukraine has brought to front of mind the importance of developing diversified energy strategies. As we wrote in our March thematic piece, LNG constitutes an integral interim energy solution, a natural 'bridge' between reducing fossil fuel consumption and getting renewable sourcing up to scale. This provided part of the motivation for revisiting our investment case on Cheniere.

Cheniere has a strong track record in execution (reflected in its annualised returns of 22.5% over the last five years) and throughout the time we have followed the business, its disclosure and accessibility has been first-class, in our view. Our interactions date to 2016. We last met management face-to-face in London just prior to the pandemic and (re)engaged with Investor Relations prior to investing back into the business. May's Q1 results saw financial guidance raised by Cheniere.

Separately, in May **we exited from our position in Covetrus**, a leading player involved in software solutions for the veterinary industry and a beneficiary of the pet economy theme. The Board of Covetrus announced that it had accepted a proposal from two private equity firms (CD&R and TPG) to take control of the business. We sold our shares on the announcement. **Covetrus comprises the fourth business that the Fund has owned which has been subject to positive M&A** (the others have been ARM, Avast and Sophos).

Cheniere has fallen by less than the MSCI World Index since we made our investment. Meanwhile, over the period in which we held Covetrus, the return from being invested in this business was *superior* to that achieved by the comparable index. In both instances, we made other portfolio adjustments in order to accommodate Cheniere/ deploy the proceeds from Covetrus. **Our typical approach is to take profit in relative outperformers and add on weakness to relative laggards within the Fund**. Current cash is equivalent to 2.7% of the Fund's assets, similar to the level a quarter prior (2.6%).

Conclusion

In times of uncertainty, we believe it is important to remain focused on the bigger picture and not to lose sight of what matters. We know we can't control the macro environment. Further, we recognise that investors' risk appetite levels will vary across the cycle. Our job is stay disciplined and combine top-down and bottom-up analysis in order to build the case for the businesses we own, with a *long-term* perspective in mind.

Thank you for your interest in and support of the Heptagon Future Trends Equity Fund.

Alexander Gunz, Fund Manager

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Appendix: Q2 leaders and laggards

There have always been high levels of dispersion across the Future Trends Fund, reflecting the different themes to which the Fund is exposed. Over the past quarter, it was equivalent to over 50 percentage points. Since the start of the year, this figure is closer to 100 percentage points. **Only four businesses (Cheniere, MOWI, Novo Nordisk and IBM) are trading higher now than they were at the start of the year, while just one (IBM) ended Q2 up in absolute terms**.

As should be evident from the names listed above, the commonality across our year-to-date (and quarterly) outperformers is their relative defensiveness. Clearly Cheniere's outperformance has been helped by circumstances in Ukraine. Beyond this, IBM, Novo, MOWI and Thermo Fisher (which comprise the Fund's other best performers over the past quarter) have all benefited from the robustness of their business models. Valuation has acted as an additional support. Novo and Thermo (diabetes provision and medtech solutions) have both raised their financial guidance twice since the start of 2022, with Novo in particular continuing to benefit from Dollar strength. IBM is showing increasing evidence of execution and trades on just 14.5x forward earnings (on our estimates), one of the lowest multiples for the businesses currently in the Fund.

At the opposite end of the spectrum, both Chegg and Airbnb lost almost 50% of their value in Q2, while PayPal's decline was close to 40%. All three of these businesses were clear beneficiaries of the pandemic environment, providing learning tools, alternative accommodation and digital payment solutions, respectively. Some of the declines witnessed in 2022 reflect a reversal of outperformance in 2020 and the early part of 2021 as well as the more elevated headline valuation levels of these businesses. Expectations heading into this year were also high. While PayPal and Chegg have been forced to reset their financial guidance, Airbnb in fact has *raised* its forecasts. We met with both Airbnb and Chegg while in the US (PayPal, unfortunately, was not available) and we continue to derive reassurance in the business models of all three companies. Importantly, each of these businesses has a robust balance sheet and strong cashflow-generating capabilities. We have used weakness to add to our positions.

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