HEPTAGON
Capital

Heptagon Kettle Hill US L/S Equity Fund

Q2 2022 Commentary

Fund Manager

Andrew Kurita

Investment Objective

The Fund aims to achieve long-term capital growth through investing primarily in US small-capitalization stocks. The Fund's Sub-Investment Manager, Kettle Hill Capital Management, is a long/short equity fund manager, established by Andrew Kurita in 2003 and is in New York, USA.

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The **Heptagon Kettle Hill US L/S Equity Fund** (the "Fund") is a sub-fund of Heptagon Fund ICAV which is an open-ended umbrella type investment vehicle authorised pursuant to UCITS regulations. Heptagon Capital Limited ("Heptagon") is the Investment Manager and Kettle Hill Capital Management, LLC ("Kettle Hill") is the Sub-Investment Manager, meaning Kettle Hill exercises discretionary investment authority over the Fund.

The Fund was launched on October 5, 2017 and had AUM of USD 104m as of June 30, 2022. Since launch to the end of Q2 2022, the Fund has returned 3.4% (Z USD share class) compared to 2.9% for the HFRX Equity Hedge Index, on an annualised basis. During the second quarter of 2022, the Fund returned -9.6% compared to -4.4% for the HFRX Equity Hedge Index.

For the quarter ended June 30, 2022, Kettle Hill Partners, LP had a loss of 9.6%, net of all fees. Longs subtracted 15.7% and shorts added 6.2%. Ending exposure was 106% gross and 23% net, 65% gross long and -42% gross short, resulting in a long/short ratio of 1.55:1.

2Q22 Review

The stock market tumbled in the second quarter as historically elevated levels of inflation continued to pressure the Fed to maintain their aggressive forward guidance for increasing the Federal Funds rate. The overall indexes have declined sharply but, in our opinion, do not reflect the pain experienced in many individual stocks that are overshooting below our worst-case estimates of earnings and valuation. During the quarter, we performed roughly in line with our net market exposure, with the exception of the month of May when we posted a 3.78% loss versus flat markets. Two stocks that missed earnings (DISH and BHC) accounted for the majority of the underperformance in that month. We think that the market severely overreacted in both cases, but, unfortunately, that can happen in bear markets. While this environment is challenging in the near term, we believe that it has created an extremely attractive opportunity set for the longer term. Due to the carnage and significant value destruction in the markets, we believe that the long-term risk/reward in individual stocks is as good as it has ever been. We are making the appropriate investments while conservatively managing risk in the overall portfolio.

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2Q22 Winners and Losers

Best-Performing Long—Zoom Video Communications, Inc. (ZM)

We believed that the common view of Zoom as a Covid beneficiary whose business would decline as consumers returned to social gatherings and work was a misperception. We conducted extensive due diligence with large scale video conference users. One of Zoom's major competitors, Microsoft Teams, does not scale for large gatherings, and Zoom was winning many new contracts with big companies. We purchased the stock when it sold off to what we thought was an attractive valuation. Subsequently, the company reported better than expected earnings and guidance, and we sold some stock for a trading profit. We sold the balance after we received disappointing feedback from our ongoing due diligence. Our research indicated that macroeconomic concerns may be impacting their business and, due to the recent price appreciation, the stock was not at a valuation that reflected those concerns. After fully exiting our long position in ZM, we initiated a short in the stock based on our forward-looking research.

Worst-Performing Long—DISH Network Corporation (DISH)

We own DISH Network because we believe they will be successful in building a cost-advantaged nationwide wireless network. There are many examples of a fourth competitor with a modern wireless network taking significant market share in other countries. We believe DISH's spectrum alone is worth $50 per share, and that the stock could be worth multiples of that if they successfully gain share. The stock sold off after a poor quarter, and the company announced that they would need to raise capital to build the network. In normal times, the need to raise capital would have been obvious to any stockholder. However, in the current environment, it seems investors are shooting first and asking questions later. In our opinion, the amount of money they need to raise should not be a challenge. In addition, we think many companies may be willing to be strategic investors in return for guaranteed wholesale capacity on the network. As an aside, one of the founders of the company purchased $24 million of stock on the open market at around $20 a share. Nevertheless, we cut the position in half, adhering to our 20% stop-loss discipline. We hold a reduced position and continue to actively monitor the fundamentals.

Best-Performing Short—SPDR S&P 500 ETF Trust (SPY)

We will utilize ETFs to tactically lower net market exposure in the overall portfolio. We intend to continue to adjust our exposure dynamically, adding net exposure when the market hits certain oversold technical levels and reducing market exposure on bear market rallies.

Worst-Performing Short—Cross Country Healthcare, Inc. (CCRN)

We shorted Cross Country on the premise that the urgency for hospital hiring would abate with Covid hospitalizations decreasing. However, subsequent employment data in the healthcare sector contradicted that thesis, and we covered the position for a loss.

Investment Outlook

We would like to highlight that the strategy has been in operation since 2003, and that, over the years, we have managed capital through a variety of market conditions–good, bad and ugly. Thus, we believe that our long-tenured team of investment professionals has proven to be up to the task of capitalizing on opportunities when the world is in turmoil. Investors may be mispricing companies with superior product cycles or cost-cutting initiatives due to the terrible macroeconomic environment. Overall, it seems that sentiment is terrible, and that most investors believe we are heading into a bad recession. Based on our research, many stocks are now trading at valuations similar to those seen in the depths of despair during the Great Financial Crisis of 2008-2009 or March 2020. Our view is that the current economic environment is not nearly as bad as 2008-2009, when we thought all the big banks were insolvent, or even in 2020, when there was a global pandemic that took GDP down 40%. A typical bad Fed-induced recession is generally nowhere near as bad as those two events. As fundamentally biased and somewhat contrarian investors, we try to anticipate what will happen 12 to 18 months from now. Thus, we think there is a reasonable chance that inflation will abate as supply chains catch up from Covid disruptions and the Fed engineers a recession. There could even be a significant Fed pivot, and the forward guidance on rate increases could fall very quickly.

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Our job is to be buyers of businesses. In general, we believe it is better to be a buyer when most people think it is a bad idea. As part of our process, we run worst-case scenarios of discount rates and earnings for all of the companies we analyse in order to get a sense of potentially worst-case stock price ranges. Thus, we believe that the market has priced in a significantly bad recession impact for many stocks that we are now long or evaluating going long. If we are wrong, we do not think we will lose a significant amount from the current levels. On the other hand, if we are right, we believe we could potentially make double or triple on some stocks. Conversely, we believe that the market has not priced in the appropriate downside on the companies we are short. The following commentary delves into a bit more detail on some industries/sectors that are represented in the portfolio.

Enterprise software companies were trading at 10 to 15 times sales six months ago. Now, very few investors want to buy them when the stocks are typically trading at three to five times sales. It seems that concerns over discount rates and slowing bookings have taken the prices of some stocks to levels far below private market valuations. We think that many of these companies are still early in their penetration of their overall market opportunity and will be able to continue to grow over a multi-year period. Whether they remain public or not, we believe they are massively undervalued. Many consumer stocks are trading at low- to mid-single-digit P/Es, fully reflecting the buyside's concern that earnings estimates are too high. Demand is slowing in aggregate, and we expect record gross margins to recede back to historical levels now that inventory is plentiful. That being said, some companies have product cycles that should offset overall demand, yet the stocks are being priced for a severe recession. We think 2023 will be a better year as companies will adjust inventory purchases, demand could rebound, and freight and energy cost increases could abate. We think the banks, in general, are undervalued. The market is pricing in a severe recession and seems to be ignoring the benefits of higher net-interest margins due to rising short-term LIBOR rates, as well as the improvements that many financial institutions have made to underwriting and capital ratios.

We are bullish on the prospects for immunotherapy to create a revolution in the treatment of solid cancer tumors. We think our proactive research on vaccines enabled us to outperform in 2020 and provided us with in-house knowledge of the immune system, along with a network of contacts in the field. Many immunotherapy stocks are down 80-90% from their highs, seemingly because of the market's distaste for early-stage, money-losing companies in this interest rate environment. This distaste has made the potential risk/reward in this group very attractive for us since we believe that some of the companies in this area may potentially achieve significant breakthroughs in the treatment of solid tumors. We expect the industry to do well over the next one to two years but, in our opinion, it is impossible to know which individual trials will succeed. Therefore, we will put one to two percent total of the portfolio into a basket of small positions in 10 to 20 companies with differentiated technologies. With that many potential shots on goal and the stocks beaten down this much (many have valuations that are below the cash levels on their balance sheets), some that succeed could be multi-baggers. If some fail, they still have intellectual property and cash, so the risk to the overall portfolio should be limited.

We are short home improvement and furniture stocks. Fundamentals have held up relatively well and valuations are relatively high. We think that the current levels of business represent a pipeline of projects that were booked months ago. There is typically a three-to-six-month lag between the purchase of a home and the purchase of renovations and furniture. We think that weaker asset markets, deteriorating housing affordability and project cost inflation will significantly impact demand levels in the second half of 2022. We are selectively short some retailers and restaurants that are being impacted by lower levels of demand and will potentially experience cost inflation. We are also short certain enterprise software companies. While we are generally bullish on the sector, our research has identified certain companies that may be experiencing weak bookings. Our analysis indicates that these companies are not trading at valuations or stock prices that fully discount that weakness in their fundamentals. We expect them to be alpha shorts that will help hedge our long exposure in enterprise software.

We intend to manage the net exposure of the fund and the size of individual positions dynamically. The volatility in the market is providing opportunities as well as challenges. We will continue to actively manage risk in the portfolio. We are fully aware of the risk of recession and that company fundamentals could continue to deteriorate in this environment.

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We build potential negative expectations into every investment we make. We believe that gives us the quantitative analysis necessary to make objective long-term investment decisions in uncertain times.

Conclusion

Based on our observations of the current market environment, we cannot help but be reminded of similar environments for individual stock picking in 2008 and 2020. In both cases, we believe we were able to take advantage of those market declines, and it is our intention to do the same this year.

Thank you again for your confidence in our fund. We are working very hard to capitalize on what we think is an extremely attractive opportunity set.

Sincerely,
Heptagon Capital and Kettle Hill Management

The views expressed represent the opinions of Kettle Hill Capital Management, as of 30th June 2022, are not intended as a forecast or guarantee of future results, and are subject to change without notice.

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Annualized Total Returns as of 30th June 2022, net of fees

	Q2 22	YTD	1-Year	3-Year	5-Year	10-Year
Kettle Hill Partners, LP	-9.6%	-8.3%	-12.1%	4.8%	3.2%	5.4%
HFRX Equity Hedge Index	-4.4%	-4.7%	-0.9%	5.3%	3.5%	3.5%

Source: Kettle Hill, Morningstar

Kettle Hill manages the Irish regulated Heptagon Kettle Hill US L/S Equity UCITS Fund according to the same investment principals, philosophy and execution of approach as it manages Kettle Hill Partners, LP, a Delaware Limited Partnership available for U.S. accredited investors that launched in June 2003. However, it should be noted that due to different regulation, fees, taxes, charges, and other expenses there can be variances between the investment returns demonstrated by each portfolio. Kettle Hill Partners, LP performance is provided in the table above to show a longer track record for the underlying strategy.

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For all definitions of the financial terms used within this document, please refer to the glossary on our website: https://www.heptagon-capital.com/glossary.

Risk Warnings

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

The Fund takes sustainability risks into account within the investment process, and this is disclosed in accordance with Article 6 requirements of the Sustainable Finance Disclosure Regulation ('SFDR') in the Fund's Prospectus. However, the Fund does not have as its objective sustainable investment and does not promote environmental or social characteristics for the purposes of the SFDR. Sustainability risks may occur in a manner that is not anticipated by the Sub-Investment Manager, there may be a sudden, material negative impact on the value of an investment and hence the returns of the Fund. As a result of the assessment of the impact of sustainability risks on the returns of the Fund, the Sub-Investment Manager aims to identified that the Fund may be exposed to sustainability risks and will aim to mitigate those risks.

Authorised & Regulated by the Financial Conduct Authority (FRN: 403304)

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