HEPTAGON Capital

European Focus Fund: Monthly Commentary

December 2020

Best of Breed

Beating an index in the long-term is extremely difficult because of the markets' Darwinist characteristics where the strongest (businesses) grow larger and the weakest are replaced. This ongoing process underpins a reinvigorating circle that renders index-constituents '*the best of breed*'. Subsequently, when individual stocks exceed previous all-time highs they command some exceptional attributes that put them in that position – particularly if economic conditions are highly complex, such as they are now. We tend to nurture such '*all-time-highers*' by holding on to them for as long as their valuations make sense; they are accompanied by decent sales and profit revisions until either the revisions reverse and/or businesses' underlying fundamentals change.

It is generally considered to be a fool's game to try to time the markets, but we still believe savvy investors need to be conscious of what lies ahead since markets are ultimately two-dimensional, i.e. if conditions are good, prices rise and vice versa. Against this backdrop, it is fair to assume that '*history rhymes*' in that the behaviour of price movements follows a broadly set paradigm; stock prices are determined on the margin by those who last buy and sell them. With this in mind, we believe that the Heptagon European Focus Fund is well positioned to enter 2021.

The Fund had a strong finish to 2020, which in its entirety was an exceptional year in terms of relative performance. The Fund's CE shareclass NAV advanced by +4.24% in December, vs. +2.37% of the benchmark MSCI Europe NR (EUR) index, reflecting an outperformance of +187bps and that put the absolute return for 2020 at +15.43% vs. -3.32% of the benchmark, i.e. +1875bps over the benchmark.

In fact, 2020 was the Portfolio's strongest-ever relative year, which we believe reflects the Fund's durability for different market environments. European Focus clearly showed its mettle by displaying considerably less downside capture during weak months. For example in March, when many countries first imposed national lockdown restrictions and the benchmark fell by -14.35%, the Fund fared considerably better, declining by a 'mere' -4.77%, thus reflecting an outperformance of +958bps. The other side of the coin was reflected in November (Europe's strongest-ever month on record), when the Fund advanced by +4.43%, but fell well short of the benchmark, which jumped by +13.95% (i.e. an underperformance of -955bps). What caused the short-and-sharp market-rally in November was a cyclical rebound, which prompted unloved sectors like energy and banks that had suffered for most of the year to spike by +31% and +30% respectively. Since the basic idea with European Focus is '*slow and steady wins the race*', there was little we could do apart from tweaking some exposures to mimic a more cyclical profile (which we did).

From a stock selection point of view, 2020 was also a very successful year for the Fund. The five largest positions were the best-performing stocks last year. All of them had a +5% weighting in the Portfolio and a combined exposure of nearly 32% by the end of December. By far the strongest performer was the second largest position in the Fund, Zalando (Germany/fashion-online retailing), which advanced by nearly 102%. This stock was followed by Lonza

(Switzerland/active ingredients to the pharmaceutical industry: +62%); ASML (the Netherlands/semi-conductor equipment: +51%); Tomra (Norway/bottle-recycling and sorting machinery: +44%) and Eurofins Scientific (France/food-environment-clinical testing: +39%).

Looking into 2021, we see more turmoil ahead. A number of countries have re-imposed tighter lockdown restrictions and the sheer logistics and administration of getting the world's population inoculated for COVID-19 already appears to be an exceptionally cumbersome enterprise that will take several months – most likely well into 2H21. This has implications; some are positive (ongoing indiscriminate monetary support from leading central banks), while others are negative (subdued demand/consumption; the prospect of higher unemployment when furlough schemes cease and considerable absorption of debt – sovereign as well as corporate). On the whole, we construe that visibility is limited and we believe it makes sense to stick to what worked well in 2020.

We consider the two biggest risks for European equities in 2021 to be the: (*i*) USD-weakness and; (*ii*) generally high level of corporate indebtedness. Given Europe's export dependency, the USD-weakness vs. EUR-strength will affect the sales and profit outlook for all the region's equity markets when analysts are making their adjustments during the forthcoming year-end results. According to our calculations, at its current level the EUR is around 11% stronger than the USD in 1H21. Assuming that USD-invoicing represents around 50% for an average European exporter, that weakness should knock 5-6% off the absolute sales growth in 1H21. Although this negative effect will partly be offset by companies' FX hedging policies, we will still carefully monitor this impact. In this regard, we have already made some changes to the stock allocation in the Portfolio by selecting companies which are less USD-sensitive (Zalando, Beiersdorf and to some extent Tomra, to mention a few). Moreover, given the high quality of the products that a typical Portfolio company in European Focus supplies, price elasticity is seemingly low; it generally costs a customer more to have a business idle than to pay up for a swift delivery since most Fund's holdings are generally B2B as opposed to B2C.

In respect to the high level of corporate indebtedness, we see this as a competitive advantage for the Fund since the average Portfolio company appears to be well-capitalised (see table below) – especially since many COVID-19 related loans will need to be rolled over in the coming months. While we cannot guarantee that this will translate into higher stock prices for the individual businesses in the Fund, we are confident that it will be an attribute for a possible re-rating of Portfolio holdings against other businesses in the broader market.

We regularly check how well-capitalised our Portfolio companies are in terms of the composition and the duration of their debt vs. their EBITDAs, cash flows etc. In this respect, we note that from the beginning of FY19 to the last point when companies reported their balance sheets in 2020 (either during the 1H20 reporting season in the summer or during the 3Q20 period in October-November), the average balance sheet of a Portfolio company improved (see table below). Furthermore, five Portfolio holdings were net cash positive (Beiersdorf, Hermès, L'Oréal Novo Nordisk and Zalando), including lease obligations and pension debt, and they had a combined weighting of 24% at the end of 2020.

The table below shows the combined balance sheet strength of European Focus after the FY19 results had been released in February-March and how it progressed through 2020. We have calculated the unweighted and the weighted averages based on the various exposures at the end of 2020 and we note that the weighted averages come out more favourably than the unweighted. Moreover, in order to avoid using our own (and perhaps biased) EBITDA projections, we have used

Bloomberg's consensus estimates for FY20 and FY21. The calculations show clearly that the average Portfolio company's financial shape improved over the course of 2020.

Progress of balance sheet strength of Portfolio holdings in European Focus during 2020

	After FY19				After 1H20/3Q20			
	Weighted		Unweighted		Weighted		Unweighted	
	2020e	2021e	2020e	2021e	2020e	2021e	2020e	2021e
Net debt / EBITDA (exc. leases)	**0.77**	**0.75**	0.79	0.75	**0.64**	**0.57**	0.81	0.72
Net debt / EBITDA (inc. leases)	**1.33**	**1.25**	1.33	1.24	**0.98**	**0.84**	1.20	1.03
Short-Term debt (exc. leases) / total debt (exc. leases)	28%				26%			
Short-Term debt (inc. leases) / total debt (inc. leases)	23%				23%			

Sources: company accounts and Bloomberg consensus

Consensus revision-changes during December for the Portfolio companies were broadly contained to slightly reduced 2021 estimates to reflect USD-weakness. However, given the solid business quality, balance sheet strength and the fact that the vast majority of the companies in European Focus have stood the test of time, we look forward with confidence to the next few months as far as the Fund's relative performance is concerned.

Christian Diebitsch, Fund Manager

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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.

Heptagon Capital LLP, 63 Brook Street, Mayfair, London W1K 4HS
tel +44 20 7070 1800
fax +44 20 7070 1881
email london@heptagon-capital.com

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