HEPTAGON Capital

# Heptagon European Focus Equity Fund

## Sustainability Report

H1 2020

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The **Heptagon European Focus Equity Fund (HEFEF)** was launched in August 2014 and is led by Portfolio Manager Christian Diebitsch. The Fund seeks to invest in companies in growth industries that show consistent earnings power and have sustainable business strategies that offer fit-and-proper ESG company profiles.

The objective of HEFEF is to identify great companies in good-and-sustainable industries which grow organically by 2-3x global GDP growth over time. We seek companies where the end-market is increasing in size by value and by volume.

1) **Companies should ideally have a global footprint;** they should have a diverse customer-base and be the #1 or #2 in the industry in which they are active.
2) Companies should be ***'price-setters'*** **and not '*price-takers*'** and they **should not operate in harmful industries as these are deemed to be detrimental to good and long-term business opportunities** and thus solid investment returns.

HEFEF's investments align with the United Nations Sustainable Development Goals and by integrating ESG factors into our investment process, we seek to be owners of businesses that also conform with these goals.

The Fund has a **high active share** (typically over 90%) and holds **top-tier ESG rankings**.

- ✓ Sustainable Investment – ESG Fund Overall
- ✓ Sustainable Investment – ESG Engagement
- ✓ Sustainable Investment – ESG Incorporation
- ✓ Sustainable Investment – Low Carbon/Fossil Fuel Free

Morningstar Sustainability Globes

Environmental, Social and Governance (ESG) factors have always been part of HEFEF's in-house due diligence process when adding new companies to the universe. The Fund has **historically not invested in harmful industries,** such as coal-fired power generation; coal mining; controversial weapons; fracking; nuclear power generation; nuclear power plant operators and/or producers of essential components; oil sands and uranium mining.

We believe society's sea-change in attitude towards ESG-enhancing factors, such as climate change and the release of $CO_2$, will benefit these types of companies going forward, and we will explore how we approach our ESG due diligence in this report.

**boohoo – Case in Point**

A recent revelation of the British online fashion group, 'boohoo.com', shows how a seemingly successful business can rapidly fall from grace through lack of control. Following some investigative journalism, boohoo was found out to have indirectly paid its supplier less than half minimum wage for what appears to be almost slave-like working conditions in Leicester for the provision of some of its fashion. While management claims ignorance, we find it unlikely that they were unaware from where boohoo's garments were sourced – particularly since the company appears to be a tightly run business. In our view management has systematically tried to obfuscate the governance structure by registering the business in Jersey despite having its central activities in England. A recent inter-company transaction in conjunction with a capital-raising exercise involving some of the founder's family members also appears to be odd. Moreover, despite attaining a market capitalisation of more than £5bn at its peak, boohoo has retained an AIM-listing on the London Stock Exchange where the listing requirements are much less transparent than on the Exchange's full-board.

Equally important, from an investment point of view – as the boohoo case has shown – shareholders can experience a dramatic value-destruction in a very short period of time. In this respect, we find it unbelievable that even large institutional shareholders with considerable inhouse research capabilities (and even some who claim to be ESG-compliant) have fallen for what appears to be a scam like the boohoo one. In our opinion, common sense suggests that if a business sells product (i.e. fast fashion) at price points, which appear considerably too low, that should raise a warning flag since like most things in life: '*you get what you pay for*'. In conclusion, to us this indicates that many institutional shareholders are not sufficiently vigilant or critical when selecting stocks for their investment portfolios.

**How do we identify sustainable businesses?**

HEFEF has a pre-defined investment universe consisting of 35-45 businesses. To qualify as an investable stock in the Portfolio, each company is subject to a comprehensive in-house due diligence process where we analyse areas such as business strategy, market position, long-term growth prospects in conjunction with necessary ESG criteria.

We generally use a **three-tiered approach to identify new businesses**. *First*, we conduct a quantitative screen consisting of 800+ companies. We rank these businesses on sales and profit growth over the past 10 years to identify the fastest and most sustainable growers. *Secondly*, we exclude any harmful business and any business which does not comply with the United Nations Sustainable Development Goals and our exclusion list. Thus, we are left with broadly speaking ESG-compliant companies. *Thirdly*, we make a qualitative assessment about the growth prospect of the industry/company where we seek a larger end-market by value and volume. Such themes include, amongst others, **ageing population, emerging markets**

**opportunities, and increased affluence**. Once we have identified 10-15 new companies, we drill down into the due diligence process. At this stage we also ascertain that there is a strategy for the new company to become **net carbon-neutral** (many of our universe companies have set the deadline for 2030 but will probably get there earlier). In addition to the above points, companies should have transparent and clean accounts with few restatements, strong balance sheets and healthy cash flow profiles.

**How do we score businesses?**

We do not rely on 3rd party research from banks/brokers and **all our models are built inhouse**. Our models include ESG as well as productivity measures. Against this backdrop, we look at all our universe companies from the point of view that they can improve in a holistic way irrespective of what industry they are active in. **We analyse several ESG-criteria and monitor these on an ongoing basis.** ESG-criteria under consideration include: GHG emissions, waste/water consumption, energy/renewable consumption; percentage of female employees/managers/board-members; board-size, compensation to board of directors, size of executive management team, compensation to executive management team. We compare the ESG-criteria in absolute terms and we '*normalise'* them so they can be compared against other Portfolio companies.

For example, in terms of ***Environment,*** is the company becoming more efficient in terms of GHG emissions? In a similar fashion, how does: waste/water-consumption – energy/renewable energy – develop? For ***Social,*** we analyse if the female representation (overall number in the organisation/managers/board of directors) is increasing. For ***Governance***, we analyse the size of the board, number of independent directors, board compensation; in the same manner we look at the size of the executive management team and its compensation.

Although we consider all our Portfolio companies to be great in their respective areas of activities, we don't want them simply to rest on their laurels. Ideally, we want to see improvement from an absolute level, but if this is not possible because of excessively high growth rates of the business, we still want to see a gradual improvement. Consequently, **we look at ESG also in terms of productivity**, i.e. per unit of sales and by employee. This way we can compare companies against each other by assessing how their '*rate of change*' is developing. The rationale for this approach is simple since even if a business is great in its own right, it is only fair to assume that it can improve further across every dimension. In fact, **we believe this is what characterises great companies, i.e. there is an established culture for the pursuit of excellence in a holistic sense throughout the organisation.**

### *1. Environmental productivity – where has the most progress been made?*

In terms of ***Environment***, every Portfolio company discloses greenhouse gas (GHG) emission, but it must be noted that there is substantial inconsistency in other areas of how energy/electricity usage, waste and water consumption are reported. This is why we restrict our *Environmental* analysis to GHG-improvement.

**GHG decrease**

***Per unit of sales***

| GHG*/sales | 2014-19 | 2017-19 |
|---|---|---|
| *Leaders* | | |
| Zalando** | -38.6% | -52.6% |
| Coloplast | -27.8% | -21.3% |
| ASML | -23.4% | -32.7% |
| *Laggards* | | |
| Lindt & Sprüngli | 3.6% | -8.7% |
| Dassault Systèmes | 2.4% | 30.1% |
| Serco | -1.1% | -2.8% |
| **Portfolio average** | **-3.4%** | **-4.9%** |

***Per employee***

| GHG*/employees | 2014-19 | 2017-19 |
|---|---|---|
| *Leaders* | | |
| Zalando** | -31.6% | -49.3% |
| ASML | -24.7% | -31.1% |
| Beiersdorf | -17.2% | -24.4% |
| *Laggards* | | |
| Lindt & Sprüngli | 3.1% | -7.4% |
| Dassault Systèmes | 1.2% | 16.9% |
| Novo Nordisk | -0.6% | 9.5% |
| **Portfolio average** | **-3.9%** | **-9.6%** |

**refers to Scope 1 (direct GHG emissions) and Scope 2 (indirect GHG emissions)*
***data for Zalando 2015-19*

All companies bar **Lindt & Sprüngli** and **Dassault Systèmes** have shown efficiency gains in terms of GHG emission vs. units of sales over the past five years. The main reason why these two companies have not improved is because of substantial acquisitions (Lindt & Sprüngli: Russell Stover and Dassault Systèmes: Medidata and more). Over the past two years, however, Lindt & Sprüngli has improved GHG to sales. Dassault Systèmes stands out alone in this respect, but the Medidata acquisition was conducted in late 2019 and will thus have increased GHG on what we feel is a non-comparable basis.

Both **Lindt & Sprüngli** and **Dassault Systèmes** figure as laggards along with **Novo Nordisk** when looking at improvement in GHG emission per employee. With regard to Novo Nordisk, the company has launched several new drugs over the past 2-3 years where we believe inevitable capacity-expansion has not yet been sufficiently optimised. Hence, we have no doubt that Novo Nordisk will improve on this metric over time.

**Zalando** was floated on Deutsche Börse in October 2014 implying that data points are not available for the entire five-year period. Nonetheless, the company shows the most impressive improvement and this trajectory has accelerated since 2017. In terms of consistency and disclosure, we consider **ASML** to stand out as the overall best Portfolio holding in respect *Environmental* disclosure.

### *2. Social productivity – where has the most progress been made?*

Relating to ***Social***, women's increased engagement in organisations is much more difficult to quantify due to the sensitivity of companies' progress/deterioration to meet any targets (at least when it comes to management

positions). Against this backdrop and in the spirit of conducting an unbiased and fair analysis, we have restricted in our approach to only analyse productivity measures when comparing women's participation to units of sales and in terms of overall headcount.

**Female participation in terms of sales and in the organisation**

***Per unit of sales***

| Women/sales | 2014-19 | 2017-19 |
|---|---|---|
| *Leaders* | | |
| ASML | 4.9% | 1.6% |
| Givaudan | 4.7% | 4.6% |
| Dassault Systèmes | 3.4% | 11.0% |
| *Laggards* | | |
| Serco | -20.4% | 3.5% |
| Zalando* | -10.3% | -9.5% |
| Assa Abloy | -8.9% | -9.6% |
| **Portfolio average** | **-1.5%** | **1.0%** |

**data for Zalando 2015-19*

***Per employee***

| Women/employees | 2014-19 | 2017-19 |
|---|---|---|
| *Leaders* | | |
| Nestlé | 4.8% | 3.4% |
| Tomra | 3.1% | 5.4% |
| ASML | 3.1% | 4.1% |
| *Laggards* | | |
| Serco | -9.0% | 0.6% |
| Givaudan | -4.0% | -8.2% |
| Diageo | -1.0% | 3.7% |
| **Portfolio average** | **2.1%** | **1.5%** |

**ASML** appears to have the highest increase in female participation vs. unit of sales over the 2014-19 period. The runner-up, **Givaudan**, shows a steady improvement with a similar percentage increase over the long period and since 2017, though in regard to women as a percentage of employees in the organisation it lags somewhat. We believe this is due to several acquisitions over the past few years that have temporarily distorted the company's trajectory.

**Serco** is the laggard over 2014-19, but the company went through a massive reorganisation phase. From 2017, however, when restructuring measures were starting to bite, the company's female representation vs. sales has increased. **Assa Abloy** (the world's largest provider of door locks and locking solutions), has shown a consistent dilution in terms of women to sales both over the 2014-19 period and since 2017. However, this company is quite acquisitive, and we believe restructuring may consistently be running behind the integration of new businesses, which implies that the company's underlying progress is not fully reflected.

**Nestlé** has had the highest increase in women as a percentage of employees since 2014. Although the rate of change has slowed down over the past three years, it is still reasonably consistent with its longer time horizon. We were somewhat surprised to see that **Diageo** shows a lower percentage of women in the organisation over the 2014-19 period given that the group's CFO since 2013 (Kathryn Mikells) should have set a good example for increased female participation. Diageo's ESG and sustainability disclosures are generally very good in our view and the company appears to have a clear understanding of what is expected to be a good corporate citizen despite being a supplier of alcoholic beverages. However, Diageo's percentage of women in the organisation has increased at a more rapid rate since 2017.

### *3. Governance productivity – where has the most progress been made?*

For many years (before ESG became an established and formal part of asset managers' investment process), we have been curious to see if there is a correlation between compensation in a wider sense and companies' ownership structures. Consequently, we have always regarded ***Governance*** to be an extremely important part of our due diligence process.

Our hypothesis has been that organisations which lack a strong core shareholder, such as a founder or a family that takes a holistic and active approach to the ownership, creates an environment where the board of directors and the executive management team become more powerful and place them in a position where they may over-compensate themselves at the expense of the minority shareholders.

**Board compensation**

***Per unit of sales***

| Board Comp/sales | 2014-19 | 2017-19 |
|---|---|---|
| *Leaders* | | |
| Eurofins Scientific | -14.4% | -9.4% |
| Tomra | -10.4% | -10.9% |
| ASML | -8.6% | -18.3% |
| *Laggards* | | |
| Zalando* | 55.9% | -6.8% |
| Lindt & Sprüngli | 21.7% | 110.7% |
| Adidas | 11.2% | 18.3% |
| **Portfolio average** | **-0.4%** | **0.2%** |

**data for Zalando 2015-19*

***Per employee***

| Board Comp/employees | 2014-19 | 2017-19 |
|---|---|---|
| *Leaders* | | |
| Eurofins Scientific | -12.4% | -11.5% |
| ASML | -10.1% | -16.3% |
| Givaudan | -9.3% | -16.2% |
| *Laggards* | | |
| Serco | 23.6% | -15.4% |
| Lindt & Sprüngli | 21.1% | 113.6% |
| Novo Nordisk | 15.2% | 11.9% |
| **Portfolio average** | **1.1%** | **-4.2%** |

**Eurofins Scientific** was founded and is managed by the Gilles Martin family, who remains the majority owner of the business. Over the past few years, however, the compensation to the board has fallen dramatically as the size of the business has increased. This paradigm is evident not only in terms of units of sales but also by employee.

In terms of the laggards**, Zalando** sticks out. However, following the IPO of the company in 2014 there has been stock options at play benefitting the board of directors which explains the high compensation that has been awarded in comparison to the substantial sales growth the business has generated. Against this backdrop, the board's compensation as a percentage of sales has fallen since 2017.

**Lindt & Sprüngli** has always compensated its board of directors (and indeed the management team) very well. Lindt & Sprüngli's largest shareholder is the company's own pension fund which controls 20.3% of the business. Another large shareholder is Mr. Ernst Tanner (2.3%), who is the former CEO and the current Executive Chairman. Given the lack of 'challengers' (for a better word) to these two ownership-parties, which internally are likely to hold significant power against other shareholders, we do not find it strange to see the company as one of the highest compensators to its board of directors.

**Serco** appears to have compensated its board of directors extremely well in comparison to the number of employees during 2014-19, but there is a fallacy with this conclusion. Not only has the compensation to the board of directors been broadly unchanged in absolute terms over the entire period, but Serco's headcount has fallen by more than 50%. Over 2017-19, however, when the business has been considerably better organised, the compensation to the board of directors in terms of the headcount gives a truer representation of the picture.

**Management compensation**

***Per unit of sales***

| Mgmt Comp/sales | 2014-19 | 2017-19 |
|---|---|---|
| *Leaders* | | |
| Eurofins Scientific | -18.2% | -14.5% |
| Adidas | -15.5% | -13.1% |
| Lindt & Sprüngli | -15.4% | -20.4% |
| *Laggards* | | |
| Diageo | 13.2% | 52.8% |
| Zalando* | 10.8% | -6.6% |
| Atlas Copco | 4.4% | -32.2% |
| **Portfolio average** | **-5.4%** | **-9.6%** |

**data for Zalando 2015-19*

***Per employee***

| Mgmt Comp /employees | 2014-19 | 2017-19 |
|---|---|---|
| *Leaders* | | |
| Eurofins Scientific | -16.3% | -15.7% |
| Lindt & Sprüngli | -15.8% | -14.5% |
| ASML | -11.7% | -15.5% |
| *Laggards* | | |
| Zalando* | 23.3% | -1.3% |
| Serco | 19.9% | 7.9% |
| Diageo | 13.4% | 44.5% |
| **Portfolio average** | **0.0%** | **-7.0%** |

**Eurofins Scientific** again appears to have addressed compensation to its executive management team as it displays the highest reduction in comparison to units of sales. In contrast to how **Adidas** compensates its board of directors, its executive management team seems to be worse off. However, Adidas former long-standing CEO, Herbert Hainer, and other members of his team left the company around 2016. Since then, the current management has been subject to a new and more moderate compensation structure. In respect of **Lindt & Sprüngli**, the executive management team appears to have had their compensation more appropriately aligned for the benefit of its minority shareholders and it looks as this trend has accelerated since 2017.

**Diageo** appears to remunerate its executive management team extremely well in comparison to units of sales and this trend appears to have accelerated over the past three years. Against this backdrop, we note that Diageo's ownership structure is highly disbursed with a considerable proportion of large institutional shareholders. Following the IPO, the executive management team of **Zalando** (which includes two of the founders) have reaped the benefits from stock option divestments and share disposals. In respect of **Atlas Copco** (the highly regarded Swedish capital goods company), it looks as if the remuneration to the executive management team has fallen considerably over the past three years. However, this is due to the spin-off of its mining business (now called Epiroc) in June 2018 when the management team was richly rewarded.

**Conclusions**

In terms of improvement along the entire ESG-spectrum and disclosure, we consider the Dutch group **ASML** (currently one of the biggest positions in the Fund) to rank #1. Over the past five years, the company shows steady improvement in terms of *Environment*; from a *Social* point of view, it has also increased female representation in the business and from a *Governance* perspective, it has better aligned the compensation to its board of directors and its executive management team.

In terms of improvement, another business which has scored highly is **Eurofins Scientific**. While this is somewhat of a paradox since the company in our opinion is the worst in the Portfolio in terms of *Environment* disclosure as well as in terms of *Social* disclosure. However, it has clearly pulled itself together when it comes to the compensation to its board of directors and its executive management team.

Four companies appear to be laggards in terms of gradual improvement, but most of this can be explained by significant structural changes to the organisations. These companies are **Lindt & Sprüngli, Diageo, Zalando** and **Serco**. Further details are found in the above analysis, but the main points are highlighted in the four bullet points below:

- **Lindt & Sprüngli** scores poorly on *Environment* because of the US acquisition of Russell Stover (2014); the company also scores poorly on *Governance* because of excessive compensation mostly to its board of directors.
- **Diageo** scores poorly primarily in *Governance* given to excessive compensation to its executive management team. We believe this is caused by lack of control due to a dispersed institutional shareholder structure where nobody holds sufficient power to veto the board and the management.
- **Zalando** scores poorly due to *Governance* because of the legacy-effect of a generous stock-option program from the time when the company was floated on Deutsche Börse (2014). However, Zalando has shown the most impressive improvement in terms of *Environment*.
- **Serco** is a victim of considerable restructuring. Since 2014, its revenue base has fallen by close to 20% and its number of employees have shrunk by more than 50%. Consequently, from the entire ESG-spectrum, the business appears to be penalised in terms of ESG-productivity, i.e. rate of change.

**Final Remarks**

**The above analysis is merely a snapshot and one out of several methodologies of how we analyse different ESG-metrics in our due diligence process for finding new investment candidates.** As we commented on earlier, we want to see gradual improvement across our businesses – both in absolute terms (which is not always possible if the underlying growth rates are too high) and in terms of ESG-productivity. Having gone through the ESG-disclosure and sustainability metrics of all these businesses, one trend is clear

– every company has improved over the past 2-3 years – and the rate of disclosure-improvement appears to be accelerating.

**As regards the aforementioned boohoo case, could HEFEF have been affected by a similar misjudgment by our investment team?** Of course, there are no certainties in life, but we have a checklist and there are no visible or invisible compartments between the Portfolio Managers and the Investment Analysts since we are a small and integrated team. Moreover, since HEFEF's portfolio holdings are generally '*good'* in terms of *Environment* (no energy, fossil, mining, nuclear, tobacco, etc.), we have always been fortunate to be able to pay extra attention to the *Social* and the *Governance* dimensions.

In respect of *Social*, our companies typically do not sell on '*value'* – they sell on '*quality'*. Hence, a low price point is not the main attribute of why customers want to do business with them – it is reliability, service and access to quick and hassle-free replacement should something go wrong. (In fact, we are trying to avoid businesses which we consider to sell their products/services too cheaply). Given the quality-angle of the products/services our Portfolio companies offer, wages and salaries to their staff tends to carry a higher proportion of their overall cost-base than for more mature and/or commodity-based industries. In respect of supply-chains, we are also vigilant from where companies source their products and/or how much or to what level certain components are outsourced to 3rd party suppliers.

In respect of *Governance*, we have an extensive list for 'checks-and-balances' where we not only try to form an opinion of management through face-to-face meetings, but we also look at who and which categories the main shareholders belong to (founder/family, institutional, pension fund, trust and if there are any cross-holdings in place or other defense mechanisms etc.). In essence, the core question we seek an answer to is: '*Do we want to be in business with these people?*'

Everyone knows that you cannot be everything to everyone at all times, but as transparency is increasing and the shift to a more digitalised world is gaining pace, the necessity to appear to be a '*good corporate citizen*' in a wider sense, will make it increasingly difficult to remain opaque.

***Christian Diebitsch***

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Signatory of:

PRI Principles for Responsible Investment

## Glossary

| | |
|---|---|
| Active Share | Measures the percentage of holdings in a portfolio that are different from the benchmark it tracks. |
| AIM | Alternative Investment Market. A stock market owned and operated by the London Stock Exchange. |
| Assets under Management (AUM) | The total market value of all assets a financial institution or fund manages on behalf of its clients. |
| Carbon Footprint | Amount of carbon dioxide released in the atmosphere that either directly or indirectly support human activities |
| Comp | Compensation |
| Concentrated Portfolio | Portfolio that holds a small number of holdings. |
| Coporate Governance | System of rules and practices by which a firm is directed and controlled. |
| Corporate Social Responsibility (CSR) | Type of business practice that aims to incorporate social and environmental concerns into the business model. |
| ESG | Environmental, social and governance (ESG) are three main factors used to measure the sustainability and ethical standards of a company or business. |
| Investment Universe | Securities that share similar characteristics such as industry or size of market capitalization and meet a specific investment criteria. |
| Market Capitalization | The market value of the outstanding shares of a publicly traded company. |
| Renewables | Sources of alternative energy that are not depleted by use, such as wind and sunlight. |
| United Nations Sustainable Development Goals | A collection of 17 global goals set out by the United Nations whereby there is a universal call to end poverty, prolong the planet's resources and bring about peace and prosperity. |

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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.

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