HEPTAGON Capital

Heptagon Kettle Hill US L/S Equity Fund

Q2 2024 Commentary

Portfolio Management

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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Opinions expressed whether in general or in both on the performance of individual investments and in a wider economic context represent the views of the contributor at the time of preparation.

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 $74m as of June 30, 2024. Since launch to the end of Q2 2024, the Fund has returned 5.9% (Y USD share class) compared to 4.9% for the HFRX Equity Hedge Index, on an annualised basis. During the second quarter of 2024, the Fund returned 2.6% compared to 1.7% for the HFRX Equity Hedge Index.

For the quarter ended June 30, 2024, Kettle Hill Partners, LP had a loss of 0.4%, net of all fees. Longs subtracted 1.6%, and shorts added 1.3%. Ending exposure was 88% gross and 45% net, 66% gross long and -22% gross short, resulting in a long/short ratio of 3.03:1.

2Q24 Review

We were able to contain losses in a quarter when the small-cap market was under pressure, and some of our stocks did not perform as expected during earnings season. In April, we reduced exposure and preserved capital during a largely down month for the market. In May, we proactively covered shorts and increased our long exposure. Unfortunately, we did not perform well during earnings season, and four of our software longs guided down. The performance of our software exposure prevented us from participating in a more meaningful way in an up market. In June, the Russell 2000 fell as the S&P 500 rose. Our opinion is that investors are expecting lower rates, but are increasingly concerned about the risk of a hard landing, so have attempted to de-risk by group-selling small- and mid-caps and buying the "Magnificent Seven." The small- and mid-cap sell-off in June has resulted in some potential opportunities, and we are focused on trying to capitalize on some of the dislocation of smaller-cap stocks. We believe we weathered a difficult period and have identified attractive investments in companies with positive fundamental change that, based on our research, are being undervalued in the current environment.

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2Q24 Winners and Losers

Best-Performing Long—TKO Group Holdings, Inc. (TKO)
TKO provides sports entertainment services and organizes live events through two leading brands: UFC (mixed martial arts) and WWE (professional wrestling). We began evaluating the stock after a big downturn. The consensus was that professional wrestling was in secular decline, partly due to its reliance on traditional broadcast media. Overall, the number of cable subscribers has been shrinking due to cord-cutting, which mistakenly made it appear that WWE was losing relevancy with consumers. Our thesis was that the value of sporting events would increase as video streaming services entered the market as bidders for these assets.

One of the biggest expenses for big tech streamers is subscriber churn. Weekly live events have been proven to reduce customer churn, and WWE and UFC have uncommonly loyal fan bases. We believe this is the reason Netflix made a $5 billion, 10-year deal for broadcasting rights to WWE's flagship program, "Raw." The rights were formerly held by USA Networks at half the annual price. With 270 million global subscribers, Netflix will bring WWE to many more consumers around the world. In addition, we believe that WWE will increase sponsorship revenues beyond consensus estimates, just by following the game plan that UFC has already successfully executed. Based on the strong market for sports events, we think TKO will renew UFC and Peacock for higher contract values than previously estimated. We continue to hold a position in the stock as we see continued upside, albeit at a smaller-size position than before, as consensus has shifted the risk-reward proposition.

Worst-Performing Long—MongoDB, Inc. (MDB)
MDB sells the most popular NoSQL enterprise database software used by developers. This stock was a winner for us in 2023, and yet, was our largest losing position in the second quarter. We believed that revenues were accelerating following both a full-year conservative guide and investor concerns around unused credits. We estimated that new client growth was on track. During their earnings calls, Google and Amazon Web Services (AWS) indicated that cloud optimization was ending. Therefore, we forecasted accelerating growth and purchased the stock after it sold off on growth concerns in the software space. However, the company guided down when they reported, and we exited the stock for a loss. Although we were correct about MDB's growth being on track, the added clients have not yet added a material amount of revenue to the company.

In addition, the increase in consumption at Google and AWS was due more to AI training rather than AI application development, the latter of which would more directly benefit MDB. It will take longer than we expected to develop enterprise AI application and to connect with the data and knowledge bases stored inside of MongoDB.

Best-Performing Short—iShares Russell 2000 ETF (IWM)
We actively manage the net and gross exposure for the fund, and we will use ETFs to change exposure expeditiously in anticipation of future market moves in the short term.

Worst-Performing Short—Synchrony Financial (SYF)
SYF provides white label credit cards and instalment loans for retailers. Many credit card companies experienced record-low levels of credit loss during the pandemic as stimulus money allowed consumers to pay down debt. Managements of credit card companies have said that they expected delinquencies and charge-offs to rise to pre-pandemic levels, but then to level off. We shorted the stock as delinquency and charge-off rates increased to levels higher than pre-pandemic levels. It was an invalidation of prior statements made by these managements. This escalating level of credit loss was occurring during historically low levels of unemployment, which makes us question the quality of underwriting in the portfolio.

Continuing unemployment claims are now higher than pre-pandemic levels. Higher-for-longer rates and the lag effect of monetary policy are bringing the Fed's ability to manage a soft landing into question. We were expecting increasing delinquency rates, but instead the company reported a series of sequentially lower delinquency rates. This could be seasonal in nature, related to larger-than-expected tax refunds. In addition, there were signs that they might receive late-fee regulatory relief, although a negative outcome was never priced into the stock. We exercised our risk controls and exited the position at a loss. We will re-evaluate our thesis after they report earnings.

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Investment Outlook

Look at the chart of the Russell 2000 since the beginning of 2023. In just 18 months, there have been multiple boom-bust moves. Following a 25% burst of performance in the last two months of 2023, many investment strategists were recommending increasing small-cap allocations. Since then, the Russell underperformed the S&P 500 by over 13%, and you didn't hear many people making that same call at the end of the second quarter. The maximum point of frustration with an asset class is when capital should be allocated. Since that contradicts human nature, you rarely see it done.

Through the second quarter, small caps were being used as a funding short for holders of S&P 500 stocks. IWM and SPY seem to be inversely correlated on a day-to-day basis. When we first started the fund, they were positively correlated. Despite being positively or negatively affected by economic fundamentals or the level of interest rates in the same way as large caps, small caps were not being appropriately valued. While frustrating, we have been well aware of these new patterns of price movement and, many years ago, adjusted our trading strategy accordingly. Buy low, sell high. Take advantage of the volatility.

We've operated this fund for over 21 years in a variety of market environments, long enough to see investment fashions come and go and to see small caps in and out of favour at various points in the economic cycle. We base our optimism on the opportunity set in front of us. As you know, we love dislocation and adverse market moves. We think it creates more investment opportunities for us than stable markets do.

As the small-cap market is pressured from factor-based selling, positive changes in companies are not being recognized in valuations, and we believe that creates a superior opportunity set for experienced stock pickers in this asset class. As unemployment rises and wage growth and inflation abate, we like the risk-reward in many dividend-paying stocks that are poised to outperform as rates decline. We can earn dividend yields of 3% to 9% on some securities as we wait for potential capital gains from a re-rating should yields drop.

We've reduced our exposure to software stocks after a difficult period of performance. Our remaining positions in the group trade well below private market value; we believe they have limited valuation downside with low expectations and therefore present superior risk-reward. We've identified consumer stocks with new positive product cycles. Some will benefit from increased demand due to falling interest rates. New management teams are present in many of the companies in our portfolio, and we expect them to monetize untapped potential in durable brands that have been poorly managed in the past. For many of the stocks we've invested in on the long side, insider buying is present.

The consensus appears to be for the Fed to pull off a perfectly orchestrated soft landing. It is our experience that gauging the magnitude of a decline is nearly impossible to predict once monetary policy has been set in motion. The Fed has been slow to cut rates, waiting to see inflation rates at desired levels before indicating a willingness to reduce rates in the future. We believe there is a rising risk of policy error as the Fed has once again been data-driven, rather than anticipatory, and slow to change course. Small business confidence is declining, and unemployment is rising. Growth is still decelerating for the vast majority of software companies not in the Magnificent Seven. These companies will probably not be able to grow revenues by raising prices. Fiscal spending tailwinds will turn into headwinds, and consumers seem to have reloaded their credit card debt. A potential Trump presidency may bring increased protectionism and immigration reform, both of which are inflationary. We're in a cold war with Russia and China, and the Middle East is in turmoil. There are massive investments being made in AI with unknown returns and unknown impacts on employment. There are so many uncertainties, and yet, investors are mostly bullish. Therefore, we think it is important to stay liquid and attempt to have a good short book in place.

We are short companies that are reliant on the discretionary consumer spending of lower income consumers. Restaurants have overpriced their product, and consumers are fed up. We are short consumer companies with faltering demand trends and increasing competition. We are betting against commercial construction companies as the pipeline of construction projects from a prior era of low interest rates are being completed, and new orders are either not materializing or have slowed substantially. Businesses are rationalizing spending, and other capital projects are being crowded out by investments in AI, presenting short opportunities in companies with that end market exposure.

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Operational Update

There were no changes to personnel in the quarter and no material changes to the overall business.

Conclusion

While we are confident in our research process and the opportunity set, we'll continue to run the book with liquidity and humility. We don't hold any opinions with absolute certainty. We are flexible in our thinking, quick to recognize our errors and move on with optimism. That should provide some comfort for our investors as we face an increasingly complex and challenging investment environment. Thank you for your continued trust in Kettle Hill.

Sincerely,
Heptagon Capital and Kettle Hill Management

The views expressed represent the opinions of Kettle Hill Capital Management, as of 30th June 2024, 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 2024, net of fees

	Q2 24	YTD	1-Year	3-Year	5-Year	10-Year
Kettle Hill Partners, LP	-0.2%	2.0%	10.4%	2.6%	7.1%	6.0%
HFRX Equity Hedge Index	1.7%	5.1%	9.1%	4.2%	5.9%	3.3%

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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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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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

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