EDISON

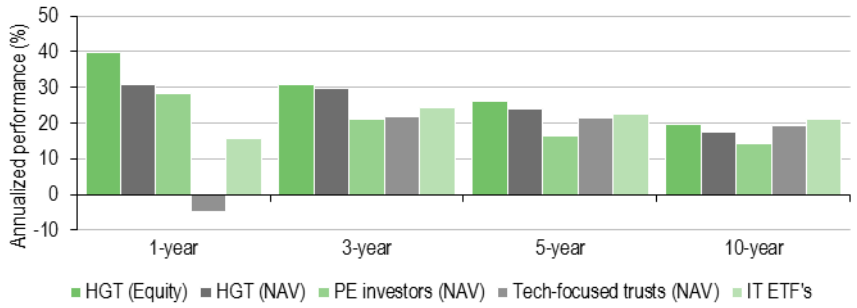
HgCapital Trust

The King of 'Dulltech'

Investment trusts
Private equity funds

HgCapital Trust's (HGT's) sector expertise has allowed it to consistently deliver strong performance, with a 10-year NAV total return (TR) at 17.6% per year (with 30.9% over the last 12 months), materially above the FTSE All-Share of 7.2% per year and LPX Europe NAV Index of 11.5% per year. Importantly, this has largely been driven by top-line and earnings growth (90% of returns on HGT's software and services holdings exited in 2001–2022 ytd) rather than multiple expansion, with five-year EBITDA growth to end-2021 across HGT's top 20 holdings of 28% per year. While HGT typically assumes a multiple contraction as part of its asset investment case, it has not actually seen much of this historically, due to its successful repositioning of portfolio companies, most notably through boosting recurring software-as-a-service (SaaS) revenues.

HGT's performance compared to other PE and tech-focused funds*



Source: Refinitiv, Morningstar, Edison Investment Research. Note: TR in sterling. *See the 'Peer group comparison' section for details on peer group constituents.

Why invest in HgCapital Trust now?

HGT's portfolio offers a blend of leading profitable unquoted European mid-market businesses, with an international footprint, offering SME software solutions with a high share of SaaS-based recurring revenues and high customer retention. Their defensive growth profiles make HGT an interesting alternative (or complement) to 'big tech' exposure, especially amid the current economic uncertainties. While tech valuations may look demanding, we believe top sponsors such as Hg (HGT's manager) may still benefit from their sector expertise, extensive deal origination networks, in-house value creation teams and an active 'buy-and-build' strategy.

The analyst's view

While HGT has been the top performer in UK-listed private equity (PE) over the 10 years to end-March 2022 (returning 406% vs PE peer average at 302%), we note its five-year NAV TR of 194% was ahead of the average 162% for UK-listed investment companies focused on public tech stocks (see below). HGT's five-year share price TR of 218% was also ahead of several tech exchange-traded funds (ETFs), which on average returned 177%. HGT's NAV TR over 10 years was less robust than these two peer groups and we believe partly due to the strong returns of 'big tech' such as FAANG stocks. While 'big tech' may find it difficult to sustain its results over the next decade, HGT's performance seems much more repeatable.

16 May 2022

Price	**390p**
Market cap	**£1,787m**
NAV*	**£1,984m**

NAV*		433.1p
Discount to NAV		10.0%
*Including income at 31 March 2022.		
Yield		1.8%
Ordinary shares in issue		458.1m
Code/ISIN		HGT/GB00BJ0LT190
Primary exchange		LSE
AIC sector		Private Equity
52-week high/low	454.0p	330.5p
NAV* high/low	440.5p	336.3p
*Including income		
Gross gearing*		0.0%
Net cash**		£108m

*At 31 March 2022.
** Liquid resources.

Fund objective

HgCapital Trust's investment objective is to provide shareholders with consistent long-term returns in excess of the FTSE All-Share Index by investing predominantly in unquoted companies where value can be created through strategic and operational change.

Bull points

- Focus on resilient software and services companies with broad client bases.
- Portfolio companies continue to deliver both solid top- and bottom-line performance.
- Experienced investment team with strong long-term track record.

Bear points

- Investors seem to have started to rotate away from tech amid increasing risk aversion.
- Ample dry powder in the market translating into strong competition for quality assets.
- A significant increase in SME defaults may reduce net client additions across HGT's portfolio.

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HgCapital Trust is a research client of Edison Investment Research Limited

Market outlook

Business digitalisation set to continue, attracting PE investors

HGT has been riding the B2B software technology investment wave for the past two decades, with software and services investments representing c 78% of the portfolio value in 2013 and 100% since 2018. Over the last decade, the investment trend HGT has followed has evolved into SaaS (see our recent Edison explains), cloud delivery and digitalisation. According to Gartner (April 2022), the digitalisation trends that drove the IT sector in 2021, including networking, cybersecurity and the cloud, look set to remain the dominant themes in 2022 and beyond. Despite the many global challenges (including price inflation, wage inflation, staff shortages, supply chain issues and Russia's invasion of Ukraine), companies are expected to accelerate IT investment in 2022 to increase business flexibility and improve their ability to respond to disruption. Gartner forecasts IT spending will rise to US$4.4tn in 2022 (4% y-o-y), led by software spending, which grew by 16% in 2021 and Gartner forecasts to grow by 10% in 2022 and 12% in 2023. Gartner concludes that the software demand picture highlights digital transformation is systemic and long term. Global uncertainties will undoubtedly weigh on companies' plans in 2022, but are still not expected to slow down technology investment.

The strength of the software investment theme is also illustrated by recent PE deal activity. According to the Global Private Equity Report 2022 published by Bain & Company, PE investors closed tech management buyouts (MBOs) worth US$284bn in 2021, 25% of all PE deals by value and 31% by deal count. Software deals made up 90% of this (US$256bn) and interestingly, US$105bn was attributable to take-private transactions of large, maturing businesses, which became 'unloved' despite sustained growth prospects. Moreover, new private capital aimed at technology made up 16% and 20% of the total global buyout capital raised in 2021 and 2020, respectively (with 56% and 63% attributable to megafunds greater than US$5.0bn, respectively).

The long-term attractiveness of software companies (especially subscription-based SaaS businesses) is underpinned by a combination of a strong top-line growth profile, a capital-light business model, high gross margins and cash generation, and recurring revenues from 'sticky' corporate clients, all factors that make software well suited to leveraged buyouts.

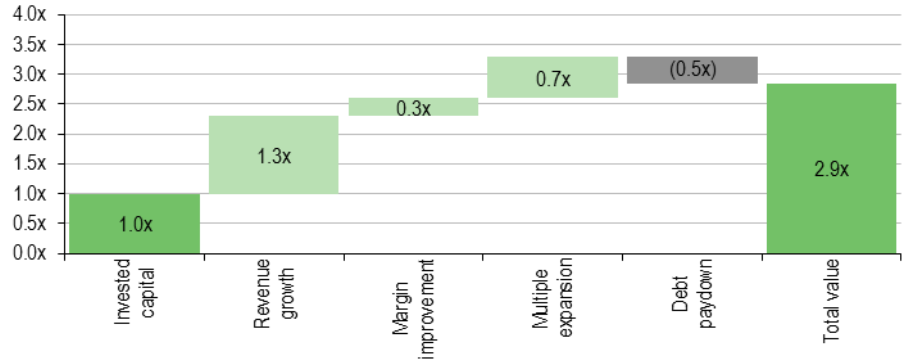
Software MBOs deliver strong returns despite rich valuations…

High investor interest kept valuations high, with the median last 12-month (LTM) EV/EBITDA multiple for entered or exited global software buyouts (those with more than US$50m of invested capital) at 18.3x in 2021, down from 21.4x in 2020 (when LTM earnings were distorted by the COVID-19 outbreak), but still ahead of the 2010–2019 levels of c 10–15x (according to Bain & Company data). That said, Bain also points out while PE hurdle rates for technology deals have been similar to other sectors (c 22% internal rate of return, IRR, on average), software investments were historically more likely to outperform and by a wider margin. We believe this is well illustrated by HGT's average IRR of +30% over the last 15 years. Software investments have also been characterised by a lower loss ratio, which for HGT was a mere 0.6% of capital deployed over the past 10 years (with 85% of realisations exited at a return on investment of least at 2x).

It is also worth highlighting (according to Bain & Company) returns from software investments were to largely driven by earnings growth, rather than an expansion in multiples compared to PE investments in other sectors. HGT's statements confirm this, as c 90% of returns on software and services holdings exited by the company between 2001 and 2022 have been achieved through revenue growth and margin improvement (see Exhibit 1). While HGT normally assumes a valuation multiple contraction in the investment case, it has not experienced much of this historically due to

successful repositioning of portfolio companies, most notably through increasing the proportion of recurring SaaS revenues.

Exhibit 1: Attribution of value creation from Hg's exits between 2001 and 2022



Source: HGT. Note: All Hg software and services aggregated exits to date (2001–2022).

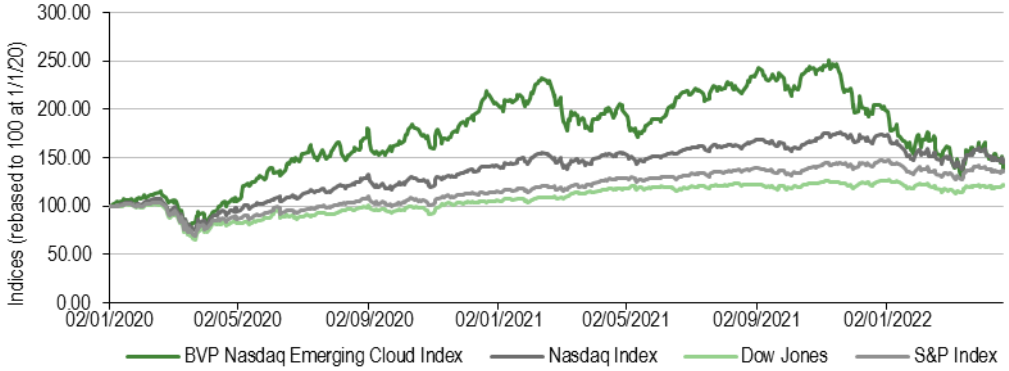
…but require in-depth sector expertise and active ownership

As the tech sector is particularly complex and fast moving, successful investment in private software companies requires in-depth expertise from sector specialists focused on sub-sectors they know well to deliver the returns from active ownership. This involves a range of activities, such as optimising software development for a subscription model and new go-to-market approaches, as well as improving the utilisation of search engine optimisation and paid media to stimulate sales, among others.

Valuation of listed software and services eased recently

Since March 2020 technology indices have soared, with the COVID-19 pandemic accelerating the digital transition as consumers and companies were forced to embrace new online ways of working. This trend is particularly well captured by the performance of the BVP Nasdaq Emerging Cloud Index, a US index of pure SaaS businesses, which we use as a reference point for HGT, given the wide range of quoted SaaS stocks in the US and the paucity in the UK and Europe. Having risen to 2.5x the level at the start of 2020 (and more than three times the low point in March 2020), the cloud index rose fairly steadily to the end of 2021 (ignoring limited valuation-driven jitters in Q221). From mid-November 2021, the index turned, losing almost half of its value until 2 May 2022 to a point where the performance of the cloud index has been broadly in line with the Nasdaq index since the start of 2020, although still up by c 35% versus end-2019.

Exhibit 2: BVP Nasdaq Emerging Cloud Index compared to main equity indices



Source: NASDAQ OMX

The fund manager: Hg

HGT is managed by Hg Pooled Management (Hg), a subsidiary of Hg Capital. Hg has more than US$40bn assets under management and has established a waterfall of funds that allows it progressively to invest in larger and more mature growth businesses. It started with the Mercury Fund (transforming owner-led businesses), moved to the Genesis Fund (creating industry champions) and ultimately, the Saturn Fund (scaling industry champions). This allowed HGT to benefit from the ownership of strong private companies for longer. Hg brings HGT an experienced team of more than 280 employees (across its offices in London, Munich and New York) and a network of portfolio partners.

The manager's view

Hg acknowledges a combination of geopolitical events, fiscal tightening, supply chain constraints and cost increases may cause broad economic challenges, to which Hg portfolio's end customers may respond with temporarily lower investment. At the same time, Hg hopes to benefit from opportunities that arise from near-term volatility. It also highlights that the imperative for digitalisation becomes even more attractive amid the tightening global supply and rising costs. According to Hg, investments in productivity enhancements free up increasingly costly staff for more complex tasks and, as customers experience the incremental value of software, they also accept significant price rises.

With respect to the valuation environment, the manager highlights that profitable, well-established software and services businesses Hg typically invests in have experienced less severe valuation declines in H221 and 2022 to date than unprofitable, high-growth tech companies (see slides 27 and 28 of HGT's recent CMD presentation). Hg states the growth in earnings is its most powerful protection against potentially declining multiples, as low to mid-teens organic EBITDA growth offsets two to three turns of EV/EBITDA contraction. According to the manager, its long-term experience with B2B software and services companies, supported by significant investment in its portfolio teams, allows it to accelerate growth, improve margins and increase the predictability of the companies in which it invests. For example, in an inflationary environment, Hg works with its companies to improve the value they add to customers, to measure this better through data analytics and to capture it via improved pricing and packaging models. Hg expects to continue to invest heavily in its portfolio team both as a crucial driver of its growth and to protect its investment performance. We discuss Hg's active ownership approach on pages 14 and 15.

Aspiring to be ESG leader across European PE firms

Hg actively integrates ESG factors into its business and this has been reflected in the highest possible scores from the United Nations-supported Principles for Responsible Investment (PRI) of AA++ in the most recent assessment, including rankings of A+ for Strategy & Governance and for Private Equity Ownership. This puts Hg among the top 10% of PE firms reporting to the PRI, according to management and its aspiration is to become the most sustainable PE firm in Europe. Three core tenets of Hg's ESG and sustainability strategy are: sustainable business practice (ie the manager's efforts towards reducing its carbon footprint at the fund level and investing in sustainable businesses); job creation (building diverse teams internally and at its portfolio companies, as well as generating employment growth across the portfolio); and charitable giving.

The manager has been certified as carbon neutral since 2019, which it achieved thanks to the reduction of its own carbon footprint and offsetting the remaining emissions with carbon certificates. As part of its environmental commitments, Hg is targeting a 50% reduction of its direct emissions (Scope 1 and 2) by 2030 and plans to adopt science-based carbon reduction targets across its portfolio companies by at least 2040. Hg continues to monitor the progress of ESG performance

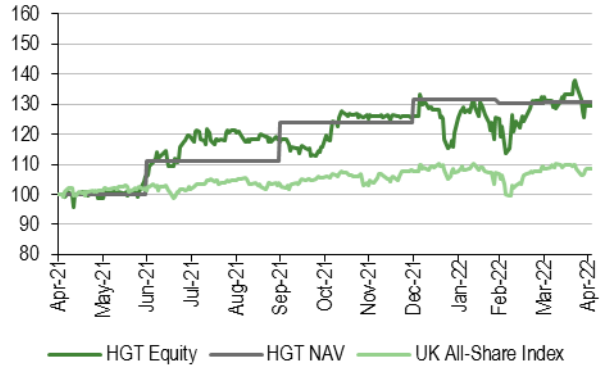
across its portfolio holdings with an internal ESG assessment framework, which is based on 170 questions (of which 98 are scored) that each portfolio company responds to. Hg highlighted that all companies improved by implementing certain ESG-focus actions in the past year, but some companies had a lower score based on the 2021/2022 assessment compared to the previous year, which reflects Hg's updated assessment criteria and scoring methodology. The job creation tenet at Hg is benchmarked against relevant KPIs, including the percentage of women in Hg's investment team (35% at present compared to 25% three years ago), the number of nationalities across Hg's team (c 40 at present vs 30 in FY20) and the average Glassdoor score as a proxy for employee satisfaction (4.3 out of 5.0 on average at portfolio companies). Finally, the manager has committed over $8.5m to support the causes of the Hg Foundation from its launch in July 2020 to date, the goal of which is to help develop the skills most required for employment in the technology industry, with a focus on individuals who may otherwise experience barriers to accessing these skills.

Performance: Visibly ahead of UK equities

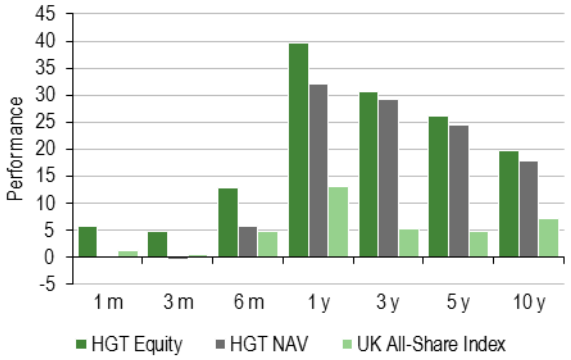
HGT's sector expertise has allowed it to consistently deliver strong performance with a 10-year NAV TR in sterling terms at 17.6% per year, materially above the UK equity markets (FTSE All-Share at 7.2% pa) and European PE market (LPX Europe NAV Index at 11.5% pa). HGT's performance is somewhat behind the booming broader IT market, with S&P Software and Services delivering 22.5% per year over the last 10 years and BVP Nasdaq Emerging Cloud (which focuses on SaaS businesses) delivering 28.9% per year since its inception in August 2013.

Exhibit 3: Investment trust performance to 31 March 2022

Price, NAV and benchmark to TR performance, one-year rebased



Price, NAV and benchmark TR performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three, five and 10-year performance figures annualised.

Exhibit 4: Five-year discrete performance data

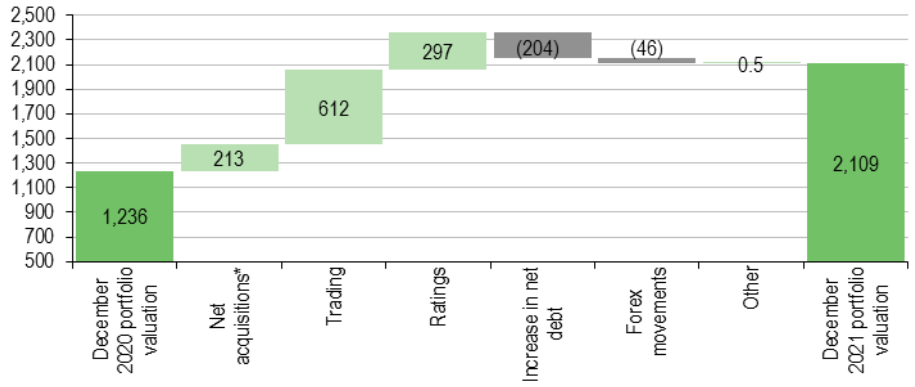
12 months ending	Share price (%)	NAV (%)	UK All-Share (%)	UK Tech Index (%)	STOXX Europe 600 Technology (%)
31/03/18	19.1	19.9	1.2	(1.9)	7.4
31/03/19	19.6	15.3	6.4	14.0	6.6
31/03/20	10.2	13.8	(18.5)	(0.5)	0.4
31/03/21	45.2	43.3	26.7	41.9	48.7
31/03/22	39.7	30.9	13.0	(4.0)	(0.7)

Source: Refinitiv. Note: All % on a TR basis in pounds sterling.

HGT's NAV TR was 43.9% in calendar 2021 (6.2% in Q421 alone) versus 18.3% for FTSE All-Share (4.2%) and 26.8% for LPX Europe NAV Index (6.0%). In line with the long-term historical pattern, HGT's NAV performance in 2021 was primarily supported by top-line and earnings momentum across portfolio companies (see Exhibit 5), with sales growth of 27% and EBITDA growth of 30% for HGT's top 20 investments (representing c 78% of HGT's portfolio value) in 2021. Here, it is important to note organic EBITDA grew by 10–20% y-o-y in every month of 2021 across

HGT's portfolio. Organic revenue growth was c 11–14% y-o-y except for January to March 2021 of 4–8% y-o-y (during the third COVID-19 wave).

Exhibit 5: Changes in HGT's portfolio valuation in FY21



Source: HgCapital Trust. Note: Net acquisitions is difference between acquisitions and disposals at last carrying value.

Peer group comparison

As HGT is a PE investor solely focused on the software and services sector, we compared its performance and valuation to four peer groups: listed PE investors; UK-listed tech-focused investment trusts; large, listed software companies; and US-based ETFs that track major tech indices.

Top performer among listed PE investment companies

In the listed PE investors peer group, we include direct funds (NB Private Equity Partners, Princess Private Equity, Altamir and Oakley Capital Investments) and funds of funds (HarbourVest Global Private Equity, Pantheon International, ICG Enterprise Trust, abrdn Private Equity Opportunities and BMO Private Equity). We also include Apax Global Alpha (a direct investor that has a portfolio skewed towards tech/IT/internet-focused businesses), although we acknowledge its 21% exposure to debt investments at end-2021, with a lower return expectation. HGT has outperformed each of these PE investors over the medium and long term. Over the last 12 months, HGT ranks sixth and is slightly below the peer group average. However, we note HGT's end-March 2022 valuations already reflect the recent public equities downturn, whereas most peers (especially funds of funds) have their portfolios still valued at end-2021. HGT's NAV TR in 2021 (43.9%) was strongly ahead of peer average (31.8%) and was second-best after HarbourVest Global Private Equity (50.6%). HGT's shares trade at a c 10% discount to NAV versus a 35% average discount among peers, which is likely a function of its strong return profile and tech focus, among other factors.

Exhibit 6: HGT versus listed PE peers at 16 May 2022*

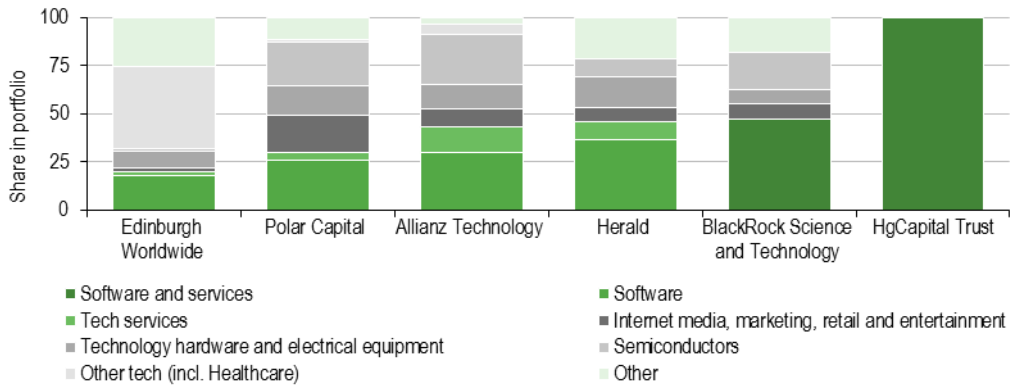
% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield (%)
HgCapital Trust	**1,786.7**	**30.9**	**118.2**	**194.3**	**405.9**	**1.4**	**Yes**	**(10.0)**	**100**	**1.8**
HarbourVest Global Priv Equity	1,784.9	42.4	98.2	147.6	404.8**	1.0	Yes	(43.2)	100	0.0
Pantheon International	1,468.1	31.6	65.8	99.7	278.0	1.2	Yes	(36.7)	100	0.0
ICG Enterprise Trust	722.2	33.2	64.7	119.7	242.5**	1.5	Yes	(35.3)	100	2.1
abrdn Private Equity Opportunities	691.9	34.4	82.5	124.1	273.1	1.1	No	(36.3)	100	3.1
BMO Private Equity Trust	326.8	35.8	84.3	118.9	275.4	1.2	Yes	(31.0)	100	4.2
Apax Global Alpha	884.0	16.3	66.1	98.7	N/A	1.3	Yes	(26.2)	100	9.8
NB Private Equity Partners	638.9	29.0	78.5	110.4	338.6	2.0	Yes	(38.2)	111	4.9
Princess Private Equity	653.6	9.2	47.7	76.1	194.9	1.7	Yes	(27.3)	100	6.0
Altamir	808.4	17.4	77.0	97.5	309.9	3.2	No	(31.2)	100	4.2
Oakley Capital Investments	738.8	34.7	98.2	147.4	240.7	2.2	Yes	(27.3)	100	1.6
Simple average (excl. HG Capital)	**931.0**	**31.8**	**77.2**	**117.0**	**302.1**	**1.3**	**-**	**(35.3)**	**102**	**3.4**
HGT rank in peer group	**1**	**6**	**1**	**1**	**1**	**3**	**-**	**1**	**2**	**6**

Source: Refinitiv, Edison Investment Research. Note: Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared). *12-month performance based on latest available ex-par NAV: HGT, NB Private Equity Partners, abrdn Private Equity Opportunities, HarbourVest Global Private Equity, Pantheon International, Princess Private Equity, Apax Global Alpha – end-March 2022; Altamir, BMO Private Equity Trust, Oakley Capital Investments – end-December 2021; ICG Enterprise Trust – end-October 2021. **Due to change in NAV publication frequency, the calculation is based on NAV estimate closest to the beginning of the 10-year period.

Outperforming UK-listed tech-focused investment companies over the last five years

We believe HGT should not be viewed exclusively as a PE opportunity, but also be considered a potential component of an investor's broader tech exposure. Consequently, we have also compared HGT to six UK-listed entities with investment strategies focused primarily on public tech companies, including IT businesses to a varying degree, alongside other tech sectors such as biotechnology, healthcare equipment, internet media or semiconductors. These include the five investment companies we list in Exhibit 7, as well as Scottish Mortgage (whose disclosed sector breakdown is not fully comparable with the remaining companies). It is worth noting both Scottish Mortgage and Edinburgh Worldwide also invest in private assets (mostly pre-IPO opportunities). Scottish Mortgage currently has 20.2% of its portfolio in private holdings (with a 30% limit as per its investment policy), mostly in the form of preferred shares. Edinburgh Worldwide has 10.8% of its portfolio in private companies and increased its limit from 15% to 25% of the portfolio in February 2022.

Exhibit 7: Exposure of selected UK-listed investment companies to IT-related* investments.



Source: HgCapital Trust. Note: *Split based on Edison's assumptions due to varying industry definitions use by the respective investment companies. Based on the latest available detailed sector split – end-April 2022 for BlackRock Science and Technology; end-March 2022 for Polar Capital; end-December 2021 for Allianz Technology, and Herald; end-October 2021 for Edinburgh Worldwide.

HGT's NAV TR was ahead the average for the above peers over one-, three- and five-year periods, and HGT is the top performer over one and three years (Exhibit 8). Over a 10-year period (starting March 2012), HGT's returns are below the peer average, which we believe may be partially

attributed to two factors. First, the period covers HGT's transition to a pure software and services play, as the company's exposure to other sectors was still c 25% in 2011. More importantly, the aforementioned peers (except for Herald Investment Trust) had c 10–20% of its portfolio allocated to FAANG stocks, ie Meta (formerly Facebook), Amazon, Apple, Netflix and Alphabet (formerly Google), which delivered a c 1432% unweighted average return in sterling terms over the last 10 years. Most of these peers (except for Herald and Edinburgh Worldwide) still have a meaningful FAANG exposure, ranging from 4.4% (Scottish Mortgage) to 21.8% (Polar Capital) and also have other 'big tech' names among their top holdings, such as Tesla, Microsoft, NVIDIA, Alibaba and Tencent.'

HGT delivers top-tier performance, while having no exposure to the 'big tech' stocks (and no Chinese tech). We note HGT focuses on profitable companies delivering mission-critical, low-spent services (primarily to SMEs) and may appeal to some investors amid earnings disappointments of several 'big tech' companies recently. We believe HGT's portfolio seems more likely to deliver consistent returns over the next five to 10 years. It is worth noting the leverage of HGT's portfolio companies (net debt to EBITDA of 7.2x at end-March 2022 for its top 20 holdings) is likely ahead of the average gearing at the portfolio level of the above-mentioned UK-listed tech-focused peers, which may have resulted in some HGT's incremental outperformance.

Exhibit 8: HGT versus selected UK-listed tech-focused investment companies at 16 May 2022*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield
HgCapital Trust	**1,786.7**	**30.9**	**118.2**	**194.3**	**405.9**	**1.4**	**Yes**	**(10.0)**	**100**	**1.8**
Scottish Mortgage	11,636.2	(13.1)	108.7	198.7	637.7	0.3	No	(5.5)	117	0.4
Polar Capital Technology	2,541.5	7.4	87.6	170.6	524.2	0.8	Yes	(14.8)	100	0.0
Herald	1,124.8	(2.9)	59.3	101.4	264.2	1.0	No	(18.7)	100	0.0
Allianz Technology Trust	961.6	9.5	102.5	220.1	744.6	0.8	Yes	(14.2)	100	0.0
BlackRock Science and Technology Trust	947.5	0.9	83.0	171.1	N/A	1.1	No	(2.8)	100	0.0
Edinburgh Worldwide	712.6	(25.1)	39.5	108.9	283.6	0.7	No	(12.8)	108	0.0
Simple average (excl. HG Capital)	**2,987.3**	**(3.9)**	**80.1**	**161.8**	**490.8**	**0.8**	**-**	**(11.5)**	**104**	**0.1**
HGT rank in peer group	**3**	**1**	**1**	**3**	**4**	**1**	**-**	**3**	**3=**	**1**

Source: Morningstar, Edison Investment Research. Note: Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared). *Performance to end-March 2022.

Finally, we compare HGT with a selection of IT-focused ETFs based on share price TR (see Exhibit 9). Again, HGT is a top performer in the short and medium term, but somewhat lags over the 10-year period. Unsurprisingly, exposure to 'big tech' among tech ETFs is far greater than in the case of the aforementioned investment companies. Four out of six indices have more than 50% of portfolio value in their top 10 holdings, except for the S&P 500 Equal Weighted/Information Technology (due to its weight design) and the broad S&P Software & Services Select Industry Index (which focuses exclusively on software and services GICS sub-sector companies). Interestingly, the SPDR S&P Software & Services, which may act as the most appropriate reference point for HGT, is at the same time the worst-performing index in the group across all periods. Again, we note HGT's portfolio offers diversification and potentially a more defensive profile compared to 'big tech'.

Exhibit 9: Peer group comparison (share price TR)*

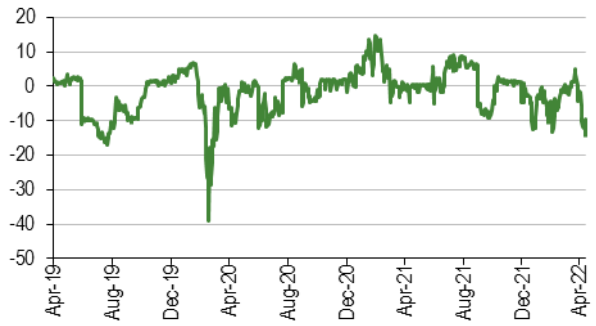
ETF	Benchmark Index	1Y	3Y	5Y	10Y
HgCapital Trust	**N/A**	**39.7**	**123.5**	**218.4**	**501.5**
Technology Select Sector SPDR fund	Technology Select Sector	26.5	120.0	202.8	648.2
Vanguard Information Technology	MSCI US IMI 25/50 Information Technology	22.8	112.0	209.1	668.1
Fidelity MSCI Information Technology	MSCI US IMI 25/50 Information Technology	22.9	112.1	200.9	N/A
Invesco S&P 500 Equal Weight Technology	S&P 500 Equal Weighted / Information Technology	13.0	74.1	140.6	567.5
iShares Global Tech	S&P Global 1200 / Information Technology	19.4	107.1	179.9	562.7
SPDR S&P Software & Services	S&P Software & Services Select Industry	(1.7)	56.0	142.5	511.6
iShares Expanded Tech-Software Sector	S&P North American Technology-Software	6.0	63.4	162.9	557.0
ETF average		**15.6**	**92.1**	**177.0**	**585.8**
HGT's rank		**1**	**1**	**1**	**7**

Source: Refinitiv, Edison Investment Research. Note: *Performance to end-March 2022.

Discount: Trading close to par

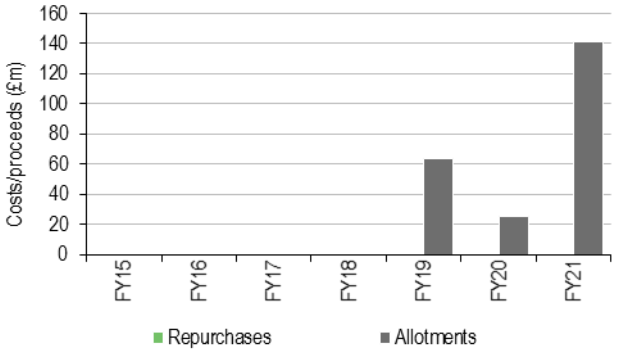
Due to its strong historic performance, proven business model and relatively clear outlook, HGT normally trades at a narrow discount or slight premium to NAV. However, it is now trading at a 10.0% discount to NAV.

Exhibit 10: Discount over three years



Source: Refinitiv, Edison Investment Research

Exhibit 11: Buybacks and issuance



Source: Morningstar, Edison Investment Research

Taking a different perspective, Hg manages one of the largest pure technology portfolios in Europe (AUM c US$90bn). Consequently, if we consider HGT as a tech conglomerate, we can estimate an EV/EBITDA multiple applied to HGT as a whole (ie fund level + portfolio), based on: the aggregate EBITDA attributable to HGT's holdings; ongoing charges at HGT's level; carried interest accrued to date; cash and other items at the HGT level; and premium/discount to NAV at which HGT's shares are currently traded.

The average LTM EV/EBITDA for HGT's top 20 investments (making up c 78% of portfolio value) at end-2021 was 27.4x (with a net debt to EBITDA ratio of 7.1x). If we extrapolate this multiple to the entire portfolio and account for the above-mentioned items at the HGT level, we arrive at an LTM EV/EBITDA of 25.4x. This represents a 4% discount to the average FY21 EV/EBITDA of 26.5x for selected listed European tech companies, such as SAP or Dassault Systems (see Exhibit 12), which, based on current Refinitiv consensus, are expected to grow their EBITDA by 36% and 16% in FY22 and FY23, respectively. This translates to 24% per year, somewhat behind the 28% per year posted by HGT's top 20 companies over the last five years (although of course growth could slow down due to macroeconomic headwinds).

Exhibit 12: Peer group comparison

	Market cap	EV/EBITDA (x)		
	(£m)	2021	2022e	2023e
Intuit Inc	85,750	33.2	23.0	19.3
SAP	98,773	13.8	12.8	12.3
Dassault Systemes	42,999	29.5	25.7	23.1
Amadeus IT Group	22,400	47.6	18.4	13.3
Xero	7,438	59.5	73.9	51.3
Nemetschek	6,300	34.5	29.0	26.9
AVEVA Group	6,425	29.0	17.7	17.2
Sage Group	7,021	17.9	16.4	14.8
Avast	5,852	15.9	14.3	13.3
Temenos	6,119	19.7	16.9	15.3
GB Group	1,361	23.5	22.3	17.6
Learning Technologies Group	977	18.4	10.6	9.5
EMIS Group	817	15.1	14.1	13.3
Craneware	501	17.3	8.4	7.7
Alfa Financial Software Holdings	549	22.8	19.8	19.0
Beeks Financial Cloud Group	106	27.3	18.0	13.4
Peer group average	**18,337**	**26.5**	**21.3**	**17.9**
HgCapital Trust	1,787	25.4	N/A	N/A
Premium/(discount) to peer group		**(4%)**	**N/A**	**N/A**

Source: Refinitiv. Note: Priced at 16 May 2022.

While HGT's multiple may look high in absolute terms, it is partially underpinned by five factors. First, high sales/earnings growth of portfolio companies; second, strong cash-flow generation across the portfolio; third, HGT's 'buy-and-build' strategy, with successful 'serial buyers' normally commanding a certain premium; fourth, the defensive profile of its portfolio companies (mission-critical, low-spend services, recurring SaaS subscription revenues, indirect sales channels); and finally, an average valuation uplift to the last year-end valuation of 30% for the 57 realised investments over the past 10 years, suggesting a conservative valuation approach. We note, as opposed to a typical tech conglomerate, Hg will realise each investment, constantly refreshing its group with younger companies entering a high-growth phase.

Asset allocation

Portfolio positioning

HGT's portfolio consisted of 48 software and services companies at end-Q122, with four more companies added after the reporting date. These are categorised into eight clusters, which are also Hg's areas of expertise. The top 10 investments represented 61% of NAV, with the top 20 making up 84% of NAV (see Exhibit 13).

Exhibit 13: HGT's top 10 holdings at 31 March 2022

Company	Location	Cluster/end market	First investment	2021 valuation uplift	% of NAV	
					31 Mar 2022	31 Mar 2021
Access	UK	ERP and payroll	2018	135%	17.0	10.0
Visma	Scandinavia	Tax and accounting/ERP and payroll	2006	53%	11.2	11.0
Litera	North America	Legal and compliance	2019	113%	5.3	3.7
Transporeon	Germany	ERP and payroll	2019	52%	4.4	4.3
IRIS	UK	Tax and accounting/ERP and payroll	2004	19%	4.3	5.4
P&I	Germany	ERP and payroll	2013	34%	4.3	4.4
Intelerad	North America	Healthcare IT	2020	45%	3.8	3.7
Sovos	North America	Tax and accounting	2016	58%	3.7	3.3
Howden	UK	Insurance	2021	N/A	3.7	3.4
MeinAuto	Germany	Automation and engineering	2018	83%	3.3	6.2
Top 10 holdings					**61.0**	**55.4**

Source: HGT, Edison Investment Research

Access became HGT's largest holding at end-March 2022, after a 135% valuation uplift in FY21 on the back of strong trading (making it the strongest driver of HGT's performance last year). The company provides ERP solutions to 35,000 customers (predominantly UK-based SMEs) and generates substantial part of its revenue from recurring, subscription-based fees. **Visma** is a cornerstone of Hg's portfolio since the first investment in 2006 (with the most recent roll-over into the Hg Saturn 2 Fund performed in 2020), growing through over 240 acquisitions to become one of the leading SaaS companies in Europe. In 2021, it recorded a strong double-digit top-line growth, leading to a 53% valuation uplift year-on-year. The third-largest NAV driver in FY21 was a 113% valuation uplift at HGT's third-largest holding **Litera**. The company provides software to law firms offering end-to-end document lifecycle, transaction and litigation management, and experience management solutions. The company is growing rapidly through M&A (Hg has supported 14 add-on acquisitions so far until end-2021 since its initial investment in May 2019).

While HGT's portfolio is concentrated in Europe (74% of value), it has a broader indirect exposure, as a number of its largest companies operate globally. Following the strong investment and realisation activity in 2020 and 2021, the portfolio is relatively young, with 52% of the investments made in 2020 or later. It must be noted that some of these are from an earlier vintage, but were rolled over into another Hg fund.

Exhibit 14: Portfolio breakdown by cluster

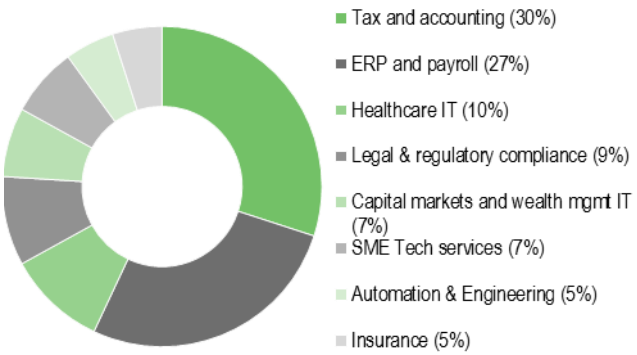
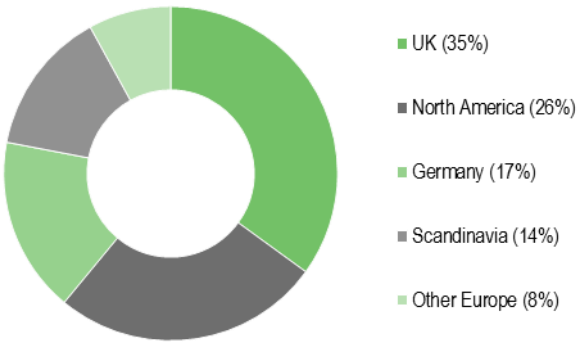


Exhibit 15: Portfolio breakdown by geography



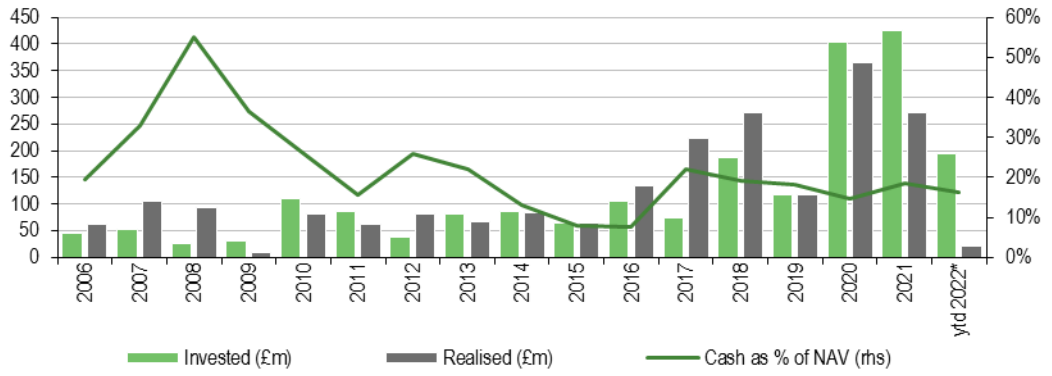
Source: HgCapital Trust, Edison Investment Research. Note: Data at 31 March 2022.

Record investment activity

HGT set a record in its investment volume in 2021 with £424m (33% of opening NAV) invested into 16 new companies (£339m) and six follow-on investments in Litera, FE fundinfo, Sovos, silverfin, Gossler, Gobert & Wolters Gruppe (GGW) and Visma (£86m). This compares to £403m (39% of opening NAV) invested in 2020 and £109m per year (17% of opening NAV) on average between 2015 and 2019. In Q122, HGT invested £24.6m into one new company (Fonds Finanz, £7.9m) and two follow-on investments (Lyniate, GGW). It also has four investments announced and not yet closed, with an estimated deal value of £170.3m (IFS and Workwave, LucaNet, pirium, and waystone).

Realisation proceeds were £271m in 2021 (21% of opening NAV), below the £364m in 2020 (35%), but still considerably higher than the 2015–2019 average of £162m (26%). Hg collected £200m from seven full exits and £103m from several partial realisations from refinancings and stake disposals. Hg was entitled to £32.5m in carried interest (11% of total proceeds). The 2021 exits were performed at a solid 2.4x multiple on invested capital (vs 2.9x average since HGT's inception in 2001), demonstrating Hg's continued successful track record. The average uplift to carrying value was 34% for full exits and 40% including partial exits. In Q122, HGT completed a £19.9m partial sale of the healthcare IT provider Lyniate.

Exhibit 16: HGT's investments and realisations, 2006–2022 to date



Source: HgCapital Trust. Note: *Includes announced transactions to 16 May 2022 that have not been closed yet.

Exhibit 17: HGT's investments in 2021 and 2022 to date

Company	Completion of transaction*	Business profile	Amount invested on behalf of HGT** (£m)	Hg fund
insightsoftware	Sep-21	Global provider of enterprise software solutions for the 'Office of the CFO'	55.1 (7.1)	Hg Saturn 2
Howden Group	Mar-21	International insurance intermediary	42.0	Hg Saturn 2
Benevity	Jan-21	Global provider of corporate purpose cloud software	31.6 (3.6)	Hg Saturn 2
Trackunit	Jun-21	Provider of software-led telematics solutions for off-highway vehicles and the construction market	26.6	Hg Genesis 9
HHAeXchange	Oct-21	SaaS platform for the homecare ecosystem	24.0	Hg Genesis 9
Managed Markets Insight & Technology	Sep-21	An intelligence platform of the pharma sector (add-on to Evaluate)	23.4	Hg Genesis 9
Serrala	Nov-21	Global financial automation and B2B payments software company	23.1	Hg Genesis 9
Revalize	Dec-21	Provider of revenue operations software for manufacturers, their distributors, and their specifiers	18.7	Hg Genesis 9
Prophix	Feb-21	Provider of corporate performance management (CPM) software	17.1	Hg Genesis 9
Riskalyze	Sep-21	Operator of risk-centric wealth management platform serving financial advisors, enterprises, and asset managers	15.9 (6.8)	Hg Mercury 3
Dext	May-21	Provider of pre-accounting software	15.6 (3.9)	HGT Saturn
TeamSystem	Feb-21	Provider of ERP and business management software to SMEs and professionals	14.3	Hg Genesis 8
Geomatikk	Feb-21	Services provider managing 'check-before-you-dig' requests in Norway, Sweden and Finland	11.4 (4.0)	Hg Mercury 2
AUVESY-MDT	May-21	Provider of version control software for smart production machinery and other industrial Internet of Things (IoT) devices	8.1	Hg Mercury 3
BrightPay, Relate Software	Nov-21	The two businesses will create a software company serving payroll and accounting bureaus and SMEs	6.5	Hg Mercury 3
ProcessMAP	Dec-21	Provider of Environmental, Health and Safety (EHS) software	5.2	Hg Mercury 3
Fonds Finanz	Feb-22	Operator of tech-enabled financial intermediary pool in the German insurance sector	8.0	Hg Mercury 3
LucaNet	N/A (Apr-22)	Provider of one-stop-shop software solution, bringing together financial control, planning and consolidation for mid-sized companies globally.	15.3	Hg Genesis 9
IFS and WorkWave	N/A (Mar-22)	Software vendor for organizations, including service management, enterprise asset management and enterprise resource planning.	114.2	Hg Saturn Fund
Waystone	N/A (Jan-22)	Provider of institutional governance, risk, and compliance services to the asset management industry	31.4	Hg Saturn 2 Fund
Pirum Systems	N/A (Dec-21)	Provider of post-trade automation and collateral management technology for the global securities finance industry	9.4	Hg Mercury 3

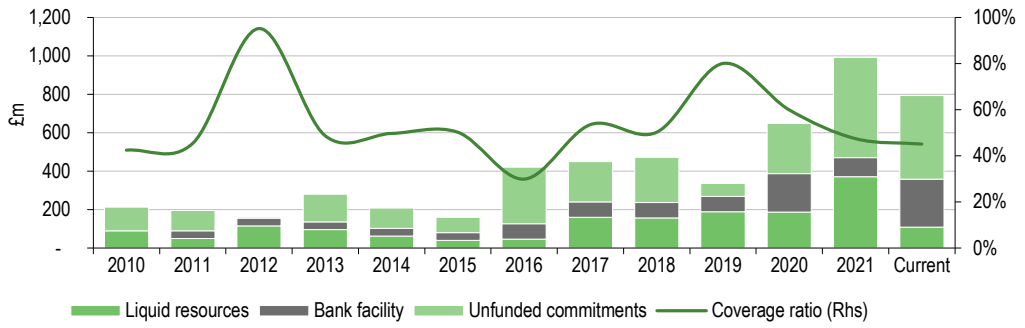
Source: HgCapital Trust, Edison Investment Research. Note: *Announcement date in brackets. **Amount of co-investment (included in the total amount invested) in brackets.

Coverage ratio

After accounting for all announced transactions to date, HGT had £358m liquid resources available for future deployment (including the undrawn amount of the credit facility), representing c 45% of unfunded commitments. While this is the lowest value since 2016, we need to highlight HGT made

significant commitments of US$975m in 2021, which will be drawn gradually over the next three to four years. While the available liquidity stands below the annual investments made in 2020 and 2021, we note HGT's investments have historically been financed largely with disposal proceeds (10-year realisations are above 10-year investments). Consequently, we consider the current coverage ratio as safe. On top of that, HGT can 'opt out' of a new investment without penalty, if it does not have the cash available to invest (although it considers this a 'disaster insurance', rather than a right it would use under normal circumstances).

Exhibit 18: Historical coverage ratio

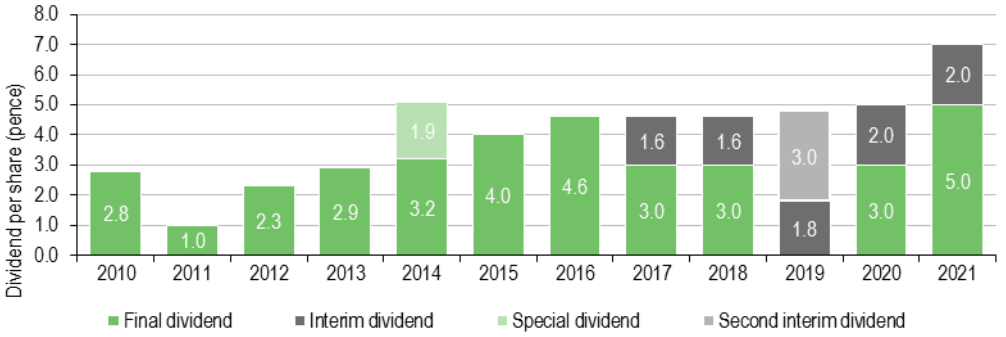


Source: HgCapital Trust, Edison Investment Research

Dividends: 40% increase in DPS, yield still moderate

HGT is primarily a capital-appreciation vehicle and, together with its shares being traded close to NAV, this translates into a modest dividend yield of 1.8%, below the PE peer average illustrated in Exhibit 6. HGT's dividend per share from 2021 profit was 7p (up 40% y-o-y), of which a 5p final dividend will be paid in May (ex-dividend 18 March 2022). HGT does not follow any explicit dividend policy and the payments depend on HGT's income streams, investment structures and liquidity events. However, HGT can only retain up to 15% of income to qualify for investment trust tax status. Management views the recent full-year dividend as sustainable.

Exhibit 19: Dividend history since FY10



Source: HGT, Edison Investment Research

Fund profile: A tech-focused, active PE investor

HGT aims to provide shareholders with consistent long-term returns ahead of the FTSE All-Share Index by investing mainly in unquoted companies (targeting a portfolio of c 30 more mature growth holdings) and creating value through strategic and operational change. HGT focuses on companies

across Europe that offer software and services with enterprise values ranging from £100m to more than £10bn. Apart from outperforming the FTSE All-Share, the company has no explicit target return. However, at the level of individual investments, it aims to achieve a gross IRR of 23–25%.

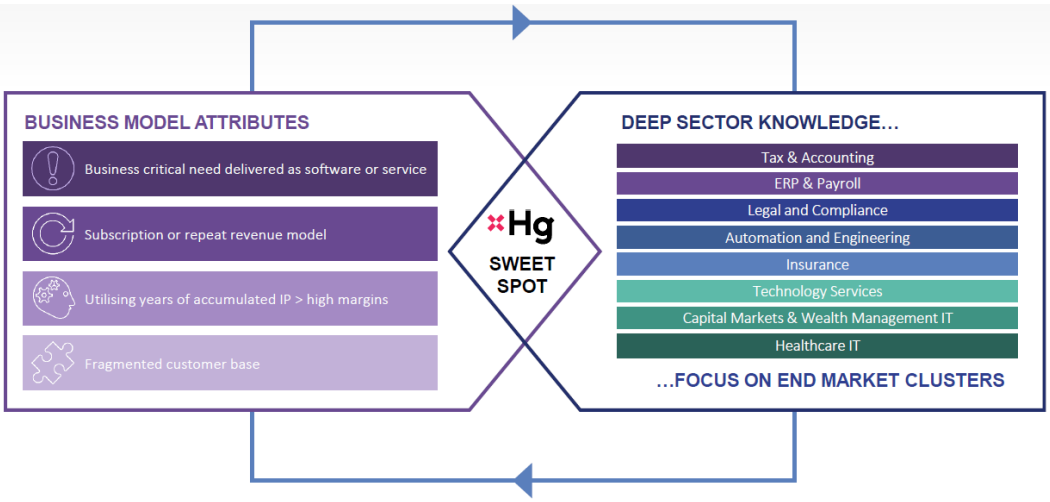
HGT's investment strategy also involves co-investments, which allow the company to manage its balance sheet more effectively and reduce the total fee load. According to the recently agreed new co-investment framework, Hg aims to allocate 10–15% of HGT's balance sheet to co-investments (vs c 6% at end-FY21).

We note two US private equity groups follow a similar model to Hg in the US, namely Thoma Bravo and Vista Private Equity – both are privately funded limited partnerships, with an investment history of more than 20 years in the sector. That said, the complexity of the European markets, with countries/regions separated by language, culture, tax, legal and regulatory differences, make it less attractive to most US investors, who mount only occasional forays into HGT's European markets.

Investment process: Actively driving growth

Hg's area of expertise (the manager's 'sweet spot') is buyouts of defensive tech growth companies operating in one of eight core end markets: tax and accounting; ERP and payroll; legal and compliance; automation and engineering; insurance; SME tech services; capital markets and wealth management IT; and healthcare IT. These companies should display high levels of recurring and contracted revenues generated from products or services that are business critical, but typically low spend. This includes solutions delivered in a cloud SaaS set-up.

Exhibit 20: Hg's 'sweet spot'



Source: HgCapital Trust

Hg looks for businesses that are able to use intellectual property accumulated over multiple years to generate high margins. It also prefers companies with a high level of customer loyalty and low sensitivity to market cycles (ie with a defensive profile), as well as low customer penetration (which may be significantly enhanced using a SaaS cloud framework). Hg aims to acquire businesses ranked second to fourth in their respective markets and create the leading player through add-on acquisitions. This approach seems particularly compelling in the context of current SaaS valuations, which remain relatively demanding and call for more sophisticated PE strategies than plain financial engineering.

Hg is a very hands-on investor, using its sector knowledge throughout the investment cycle. This is manifest in its suite of c 100 modules on topics recurring across a number of investments (eg, on governance, growth, data analytics, technology and talent) that are then tailored to the investee

company's requirements and deployed to improve operational performance, increase margins and support the growth and development of the business. Hg also actively fosters networking at different levels of its investee companies, encouraging discussions and dissemination of best practice through its network (eg through the Hive platform). It also aggregates data from its companies into a central 'data lake', to drive informed, data-driven decision making. Each of Hg's management teams is individually incentivised, with interests directly aligned with every portfolio company through a share in business performance. We described Hg's investment process in more detail in our initiation note of June 2019.

Gearing: Expansion of credit facility

HGT does not deploy structural gearing and uses debt financing primarily to bridge the gap between investments and realisations. It has a £250m credit facility in place, established in 2020 and increased in 2021 (from £200m) to optimise balance sheet management and to help manage foreign exchange risk. The facility expires on 7 October 2024 and was undrawn at end-Q122 (vs £151m drawn at end-FY21). The interest rate on the amount drawn from the facility stands at Libor, plus a 3.25% margin and HGT pays a commitment fee on the undrawn part of the facility of 1.15% per year. Hg usually applies leverage at the level of its underlying investments, which is serviced using the entity's own cash flows.

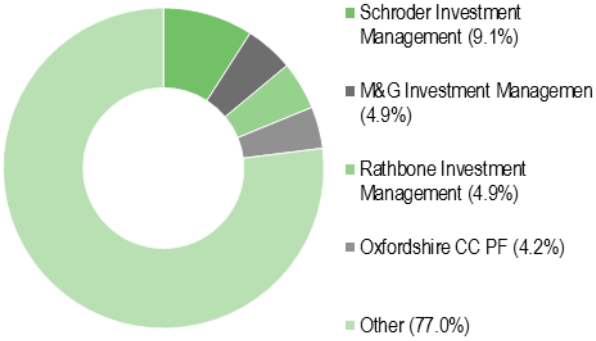
Fees and charges

HGT's total ongoing charges as a percentage of NAV decreased to 1.4% in FY21 from 1.8% in FY20, primarily on the back of NAV growth outpacing expenses. HGT pays a priority profit share corresponding to a base management fee specific to each of the Hg funds and calculated in respect of either HGT's commitments to or capital invested alongside the respective Hg fund. HGT's priority profit increased 12% y-o-y to £16.4m, yet the charge against current year income (which adjusts the amount for loans advanced to and recovered from general partners) decreased to £8.6m from £11.4m in FY20. Operating expenses were also higher at £5.7m (FY20: £4.8m). Other than fees payable for each of the underlying funds, Hg charges only a minor management fee (flat at £20k a year, paid quarterly) and an administrative fee (0.1% pa, calculated and paid quarterly).

Capital structure

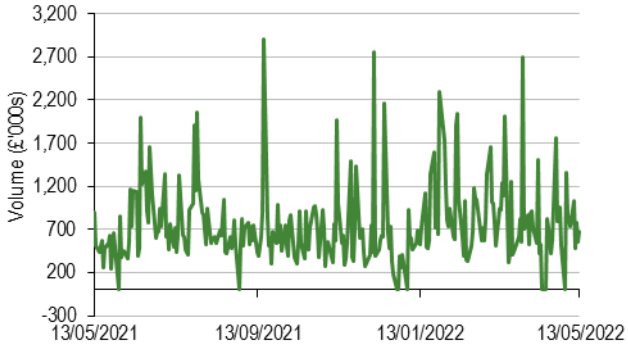
HGT's share capital consisted of 455.3m ordinary shares on 31 December 2021. During FY21, HGT performed a series of equity tap issuances, raising £143m (FY20: £25m). The 39m shares were issued at an average price of 363.18p and an average premium to NAV of 3.7%. So far in 2022, HGT has issued a further 2.85m shares, bringing the current total to 458.1m. Each year, HGT's directors renew the authority to buy back up to 14.99% of the issued share capital, at prices below the prevailing NAV per ordinary share, although the company has never executed the right. A general authority to allot shares up to a maximum nominal amount of £3.8m (representing c 33% of HGT's ordinary share capital) was also given to directors.

Exhibit 21: Major shareholders



Source: Refinitiv. Note: At 16 May 2022.

Exhibit 22: Average daily volume



Source: Refinitiv. Note: 12 months to 16 May 2022.

The board

HGT's board, led by Jim Strang (chair of the board since May 2020), consists of six non-executive directors after Pilar Junco joined the board in July 2020. We described the background of the directors in our July 2020 note, except for Pilar Junco, who we described in the March 2021 note. From 1 August 2022, the board will be extended to include Dr Erika Schraner, who has 25 years of experience from a number of senior leadership positions in Silicon Valley, UK and Europe, including Fortune 500 companies and Big Four accounting firms. She is a non-executive director (NED) and chair of the audit committee of Aferian, a NED and chair of the nomination committee at JTC Group, as well as an NED at Bytes Technologies and Pod Point Group Holdings.

Exhibit 23: HGT's board of directors

Board member	Date of appointment	Remuneration in FY21 (£)	Shareholdings at end-FY21
Jim Strang (chairman)	March 2018	86,000	109,000
Richard Brooman	October 2007	59,250	28,500
Peter Dunscombe	January 2014	52,750	60,000
Pilar Junco	July 2020	45,500	-
Guy Wakeley	March 2018	45,500	15,429
Anne West	May 2014	52,750	200,000

Source: HGT

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