EDISON

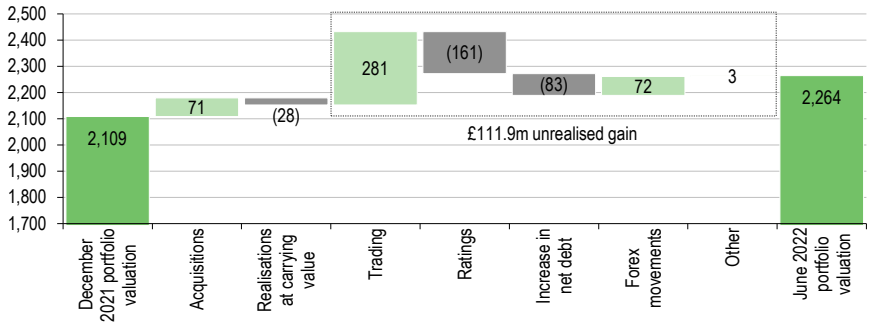
HgCapital Trust

Business as usual for boring but critical tech

Investment trusts
Private equity funds

HgCapital Trust (HGT) consistently executes its successful active ownership strategy, undeterred by the turbulent macroeconomic conditions. It has invested a net amount of c £332m ytd (16% of opening NAV) in announced deals (closed and to be closed), all in the manager's (Hg's) core areas of software and services expertise. Moreover, HGT should receive net proceeds of c £180m from exits and refinancings announced so far this year (with more exits in the near-term pipeline). HGT posted a 1.8% NAV per share total return (TR) in H122 and a one-year NAV TR of 20.6% (22.2% per year over the last five years). HGT's discount to end-June 2022 NAV is now c 17%, while it has traded much closer to NAV in recent years.

Earnings growth of HGT's holdings more than offsetting lower multiples



Source: HGT; Note: All figures in £m.

Why consider HgCapital Trust now?

HGT is a reliable long-term digitalisation play based on its leading profitable unquoted European mid-market businesses with an international footprint. These offer 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 in all phases of the economic cycle. HGT's appeal is underpinned by Hg's sector expertise, in-house value creation team and 'buy-and-build' strategy, which makes HGT akin to a tech conglomerate in an investment company wrapper.

The analyst's view

HGT's slightly positive NAV TR in H122 of 1.8% (2.7% ytd to end-August 2022) was driven by continued strong portfolio performance with last 12-month (LTM) revenue and EBITDA for its top 20 holdings up 31% and 26% y-o-y, respectively. This is in line with the 2017–2021 average EBITDA growth of 28% per year, of which c 10–15% is normally organic. We believe that despite the weaker global economy, the earnings outlook for tech and services companies with a mission-critical, low-spend offering (such as HGT's holdings) remains favourable as corporate customers seek to improve business flexibility and cost efficiency. In July 2022, Gartner forecast global software and IT services spending to increase by 9.6% and 6.2% in 2022, respectively (followed by 11.8% and 8.3% in 2023).

12 September 2022

Price	**368.5p**
Market cap	**£1,688m**
NAV	**£2,030m**
NAV per share*	443.2p
Discount to NAV	16.9%
* at end-June 2022.	
Yield	2.0%
Shares in issue	458.1m
Code/ISIN	HGT/GB00BJ0LT190
Primary exchange	LSE
AIC sector	Private equity

52-week high/low	454.0p	312.0p
NAV high/low	440.5p	373.3p

Gearing

Gross gearing at 14 July 2022	0.0%

Fund objective

HgCapital Trust's investment objective is to provide shareholders with consistent long-term returns in excess of the UK 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

- Investor rotation away from tech amid increasing risk aversion.
- The impact of a worsening macroeconomic environment on SMEs may result in reduced net client additions across HGT's portfolio.
- High net leverage of portfolio companies (7.5x EBITDA for top 20 holdings on average) but supported by high share of recurring revenues, strong earnings growth and high cash generation.

Analysts

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Creating value through earnings growth, while underwriting a multiples contraction

HGT's profitable 'dulltech' companies less affected

The impact from lower valuation multiples on HGT's portfolio was -7.6% in H122 (£160.7m), which is significantly less severe than the c 30%+ contraction in LTM EV/EBITDA multiples across major tech indices such as NASDAQ Composite, S&P Information Technology or BVP Emerging Cloud index in H122 (based on Bloomberg data). We believe this is due to several factors. HGT's portfolio holdings are mature (but fast-growing), profitable, B2B businesses with broad client bases and high proportion of recurring revenues. As a result, its close listed peers experienced a less significant share price de-rating than the broader tech universe including major 'big tech' names (affected by the reversal of the strong investor sentiment they had enjoyed in recent years), as well as more speculative, unprofitable companies that saw a particularly strong fall in their market values during the recent downturn.

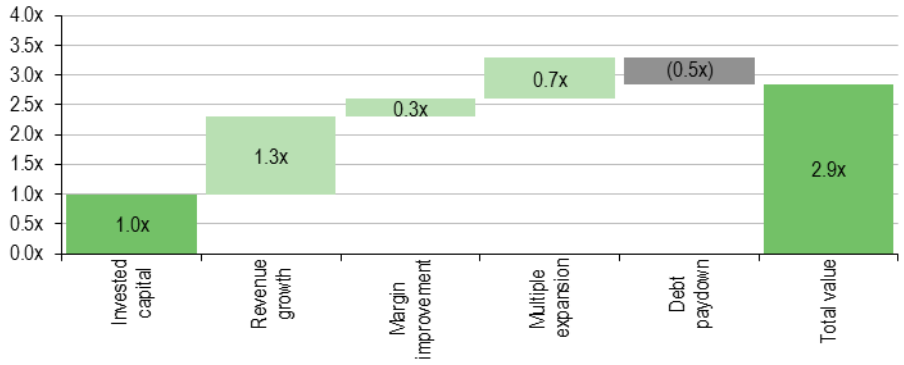
Multiples less volatile for private deals than listed equities

Moreover, we see two main technical factors that smooth out portfolio valuations of listed private equity companies such as HGT. In accordance with the International Private Equity and Venture Capital (IPEV) Valuation Guidelines, HGT multiples used to value its holdings are a blend of public market and private M&A deal multiples. The latter tend to be less volatile than listed multiples (and have a 'smoothing' effect against public multiples), because they are not subject to the same short-term swings in investor sentiment. Moreover, private deal multiples are likely to lag a worsening macroeconomic environment, as fewer deals are carried out and buyers and sellers reassess valuation expectations (with the latter willing to sell only at prices that have not been materially marked down compared to previous expectations). Finally, private equity companies normally value their new investments in line with the acquisition price over the subsequent 12 months, which means part of HGT's portfolio holdings may still be valued based on the transaction completed before 2022. The average EV/LTM EBITDA multiple across HGT's top 20 holdings was 27.1x at end-June 2022 (vs 27.4x at end-2021).

Revenue and earnings growth key value drivers in the long run

While we believe it is instructive for investors to consider the above-mentioned short-term determinants of HGT's valuation multiples, we note that HGT's main long-term value drivers remain revenue and earnings momentum across its portfolio, underpinned by the secular digitalisation trend and Hg's value creation expertise leading to improved market position of HGT's software and services companies, as illustrated by its 20-year track record (see Exhibit 1). HGT normally assumes a valuation multiple contraction in the investment case, even if 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 between 2001 and March 2022.

Uplifts to carrying value suggest prudent valuation approach

We believe the best validation of the valuation approach of a PE company is its ability to realise investments at or above the carrying value reflected its recent NAV. HGT's 62 realised investments over the last 10 years (representing an average gross IRR and multiple of invested capital of 26% and 2.6x, respectively) were carried out at a strong average uplift to the last year-end carrying value of 25%, demonstrating a prudent approach to portfolio valuations. This was also evident in the two full and one partial exit announced by HGT this year, which we understand represent estimated realisation proceeds of c £108m. In June 2022, HGT announced a full exit from Medifox, a German provider of out-of-hospital software solutions, with c £47m returned to HGT at a 47% uplift to end-2021 carrying value. Importantly, the business is being sold to an NYSE-listed strategic investor (ResMed), which illustrates that these buyers are generally willing to accept high deal multiples for HGT's businesses as they factor in post-acquisition synergies (Medifox is being acquired at c 28.6x CY21 pro-forma EBITDA). Valuations of the two other realisations announced so far this year, the full exit from Itm8 (with an estimated £32.7m returned to HGT) and partial exit from Interelad (with estimated proceeds at c £28m), which were both sponsor-to-sponsor deals, offered uplifts of 9% and 26% to end-2021 carrying value, respectively.

Access Group refinancing the key value driver in H122

Although almost all of HGT's valuation gains in H122 were unrealised, we note that these include uplifts based on prices agreed for realisations and refinancings to be completed post period-end. A major such contributor was Access Group (HGT's largest holding making up 19% of end-June 2022 NAV), a provider of business management solutions to mid-market organisations in the UK, Ireland and Asia Pacific, which has delivered 20%+ y-o-y organic revenue growth in 2022 to date. The gain from the uplift on Access Group was £128m, compared to HGT's total unrealised gains of £112m in H122. Hg has completed a refinancing for Access Group, involving a partial reduction in holdings by Hg Genesis 8 (one of Hg's mid-market funds) and an investment from Hg Saturn funds (Hg's upper mid-market funds), which will result in £55.6m of net proceeds to HGT (£232.2m returned less £176.6m reinvestment). Transactions such as this are quite common for Hg as portfolio holdings grow and are sold by Hg funds and third-party investors focused on smaller companies (measured by enterprise value), while Hg funds and other investors focused on larger companies acquire a stake in these businesses (allowing investors who are limited partners across different Hg funds to benefit from owning high-quality businesses for longer). The transaction values Access Group at £9.2bn, implying a value for HGT's stake 31% above the end-March 2022 carrying value, leading to HGT's overall investment portfolio rising by c 6.0% versus end-March 2022. As part of the transaction, TA Associates (a PE company that first invested in Access Group in 2015) will make a

follow-on investment, while GIC (a Singaporean sovereign wealth fund) will participate as a new minority shareholder, providing external validation of the transaction price.

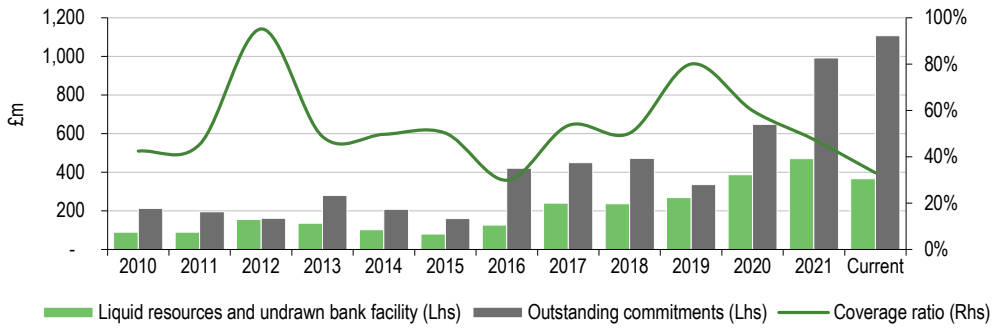
Overall, HGT expects to receive £355m gross proceeds from these three realisations and the Access Group refinancing (c £162m net of the reinvestment in Access Group through the Hg Saturn funds, according to our calculations) at an average uplift of c 29% to end-2021 carrying values and a healthy multiple of invested capital of 4.2x. HGT has also completed two refinancings in H122 (Lyniate and Argus Media), which represent most of the c £29m gross proceeds returned to HGT in the period.

Commitments increasing, but seem manageable

HGT's outstanding commitments to Hg funds stood at c £1.1bn at end-August 2022 after HGT made c £530m new commitments to Hg Genesis 10 (€400m) and Hg Saturn 3 (US$225m) in April 2022. With liquid resources (including undrawn part of the credit facility) at c £366m at end-August 2022, this translates into a coverage ratio of 33% compared to a 2017–2021 average of 58%. However, we note that a large part of HGT's commitments represent the 2022 vintages of Hg Saturn and Hg Genesis funds, which are expected to be drawn gradually over 2022–2026 (and are likely to be at least partially funded by further realisations). Moreover, HGT is considering a further expansion of its credit facility throughout 2022 (to match its NAV growth). Finally, HGT retains its right to opt-out from any commitments to Hg funds, although it does not intend to use these opt-outs under normal circumstances as it considers these rights as 'disaster insurance'.

HGT's board indicated that HGT can deliver 'modest dividend progression'. The H122 interim dividend of 2.5p per share (up 25% compared to the H121 interim payment) is payable in October. Together with last year's final dividend of 5.0p, this implies an LTM dividend yield of c 2.0%.

Exhibit 2: HGT historical coverage ratio



Source: HGT, Edison Investment Research. Note: Current figures are based on pro forma numbers as at end-August 2022 as reported by the company.

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