EDISON

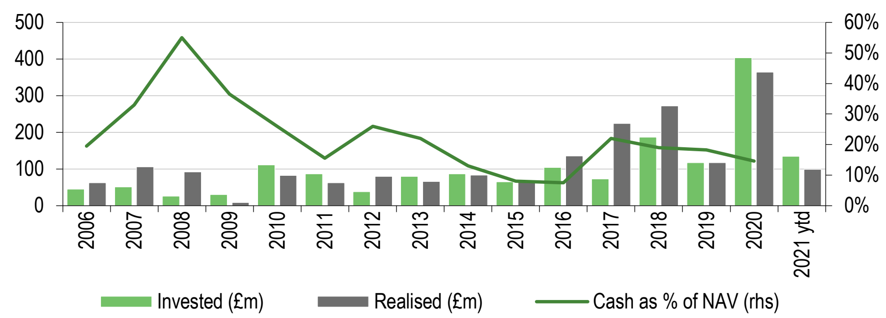
HgCapital Trust

Posting a 24% NAV total return in FY20

Investment trusts
Private equity funds

HgCapital Trust (HGT) reported a strong NAV total return of 24.0% in FY20, driven by double-digit earnings growth across the portfolio (last 12 months EBITDA for top 20 holdings up 31% y-o-y) and solid uplifts to end-2019 book values on exits (50% on average in FY20). Investments and realisations reached record-high levels in FY20 and HGT had a healthy coverage ratio of c 64% as at 24 March 2021 (vs 48% on average between 2015 and 2019), backed by a £200m credit facility secured in Q420 and c £56m raised in tap equity issues in FY20 and FY21 to end-March 2021.

HGT's record-high transaction activity in FY20



Source: HgCapital Trust, Edison Investment Research

Why invest in HgCapital now?

HGT's portfolio companies continue to benefit from the ongoing digitalisation of the economy, accelerated recently by the pandemic. Hg (HGT's manager) is confident in growth prospects of the portfolio companies and expects transaction activity to remain high in 2021. While valuations in the tech sector remain demanding despite some pullbacks recently, we believe that top sponsors such as Hg may still benefit from their strong financial position, extensive deal origination networks, in-house value creation teams and the ability to pursue a 'buy-and-build' strategy.

The analyst's view

- HGT's portfolio companies deliver business-critical software and services, offering long-term growth prospects in digital transformation, which could provide a level of resilience in the case of equity market corrections.
- HGT's share price declined c 7% on the day its 2020 results were published in mid-March, following which the premium narrowed to c 5% (vs c 8% on average in February 2021). While FY20 was undoubtedly a successful year for HGT, its NAV total return in Q420 was lower than in previous quarters due to cash drag (cash and liquid assets represented c 34% of its NAV at end-Q320 vs 15% at end-Q420) and a provision for carried interests, which could have slightly cooled down investors' expectations. However, given its private equity focus, HGT should be assessed based on its long-term performance, which has been stronger than its benchmark and the peer average over recent years.
- We note HGT's emphasis on sustainability, as illustrated by its ambitious ESG targets set at the fund level and portfolio companies (see page 4 for details).

31 March 2021

Price		**320.0p**
Market cap		**£1,362m**
NAV		**£1,270m**
NAV*		305.2p
Premium to NAV		4.8%
*As at 28 February 2021.		
Yield		1.6%
Ordinary shares in issue		425.7m
Code/ISIN		HGT/GB00BJ0LT190
Primary exchange		LSE
AIC sector		Private Equity
52-week high/low	353.0p	200.0p
NAV* high/low	310.3p	236.3p
*Including income		
Gross gearing*		15.8%
Net cash**		£126m

*At 28 February 2021.
** Liquid resources at 24 March 2021.

Fund objective

HgCapital Trust's investment objective is to achieve long-term capital appreciation by indirectly investing in unquoted companies. It does this through its investments in fund partnerships, mostly in the UK and Europe.

Bull points

- Focus on resilient software and services companies.
- Solid top- and bottom-line performance of portfolio companies.
- Experienced investment team with strong long-term track record.

Bear points

- High valuations in the software and services sector.
- 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

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Market outlook: PE market regaining momentum

We believe the top private equity (PE) funds are well positioned to seek further investment opportunities in 2021. They withstood the 2020 turmoil relatively well, as illustrated by the slight 1.8% increase in the LPX Europe Index representing the broader PE market (which also includes PE asset managers). This was partially due to the decision by PE managers to increase exposure to more resilient sectors benefiting from long-term secular trends, such as technology, media, and telecom (TMT), healthcare and consumer staples during the mature stage of the particularly long pre-COVID-19 bull market (in anticipation of a cyclical downturn). According to PitchBook Data, PE investments in IT comprised a record-high proportion of overall European deal flow in 2020, making up 21.7% of value and 25.9% of volume. Moreover, the sector's response to lockdowns was swift and involved securing additional liquidity to support portfolio companies, enabling them to avoid asset fire sales. The liquidity needs of portfolio holdings subsequently proved less severe than initially expected, which was partially a function of state support measures and monetary stimulus, as well as strong private debt activity and the prevalence of covenant-lite loans. Moreover, PE managers worked closely with management boards to implement cost savings, address potential supply chain disruptions and determine non-essential operations.

Transaction and fund-raising activities remained robust in 2020

Going into 2021, PE funds have considerable dry powder at their disposal (€294bn in European funds at 31 December 2020, according to PitchBook Data), with European fund-raising volumes slowing down only moderately in 2020 (-10% y-o-y to €92.0bn). Consequently, after an M&A market standstill in Q220, activity picked up significantly in H220, bringing the full-year transaction value (€449bn) close to the 2019 figure (€462bn), which bodes well for deal volumes in 2021. On one hand, this should provide general partners (including Hg) with additional exit options through sponsor-to-sponsor deals, but on the other, it translates into greater competition for quality private assets.

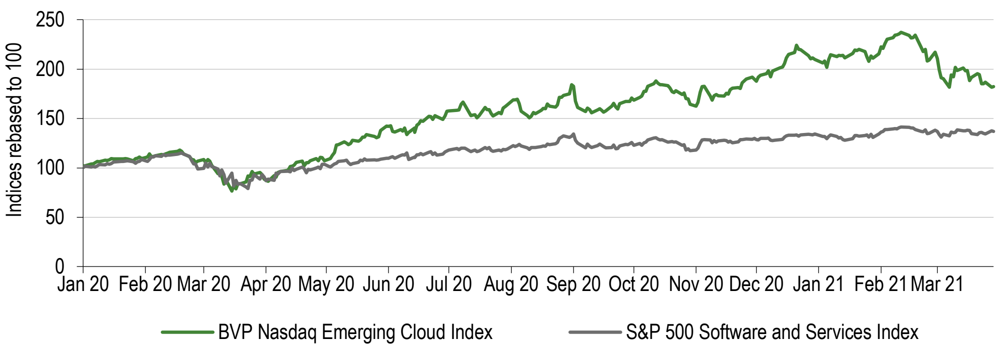
Global IT spending expected to normalise in 2021

According to Gartner's latest forecasts, worldwide IT spend fell 3.2% in 2020 as companies prioritised spend on 'mission-critical' technology and services during the pandemic, which was partially offset by accelerating digital transformation. Gartner projects spending to rise by 6.2% year-on-year to US$3.9tn in 2021, as investment in IT normalises to focus on supporting future growth. Digital businesses, offering a short payback period, are expected to remain a prime beneficiary. Gartner forecasts continuing growth in 2022, with global IT market sales rising by 4.6% y-o-y to US$4.1tn.

SaaS valuations off all-time highs as realism returns

In 2020, technology valuations have followed a markedly different trajectory to many more traditional sectors amid accelerated digital transformation driven by the COVID-19 pandemic, coupled with funds rotating out of value into growth (eg software-as-a-service (SaaS)). This was particularly demonstrated by the performance of the BVP Nasdaq Emerging Cloud Index (an index of pure US SaaS businesses), and the S&P 500 Software & Services Index, which historically has been a good valuation proxy for Hg's software and services portfolio. Given the wide range of quoted SaaS stocks in the US and the paucity in the UK and Europe, we look to the US to get a sense of where global SaaS valuations are heading.

Exhibit 1: BVP Nasdaq Emerging Cloud Index vs S&P Software & Services Index



Sources: Bloomberg

After doubling in 2020, the BVP Nasdaq Emerging Cloud Index pulled back by more than 20% from the highs established in February 2021 (Exhibit 1). Similarly, the S&P 500 Software & Services Index has risen 37% since the start of 2020. In our note published on 8 July 2020, we suggested that valuations had moved ahead of growth forecasts, with the time lag inherent in recurring revenues meaning that this was not immediately visible. This does appear to have been the case, with the impact of lockdown and the related economic slowdown now visible in individual company performance metrics.

Hg acknowledges it has benefited from overall positive sentiment towards the software and services market segment recently. At the same time, it highlights that the total return of the S&P 500 Software & Services Index in 2020 was driven by both solid earnings growth and valuation multiples expansion, while the broader equity market was primarily driven by multiples expansion as corporate earnings declined in 2020.

The fund manager: Hg

The manager's view: Well-positioned in current environment

Hg highlights that the COVID-19 pandemic has had a limited adverse impact on the portfolio and believes that it will continue to benefit from the increasing digitalisation of business processes, which has been accelerated by the pandemic. Hg's UK-based businesses have seen limited direct consequences from Brexit given the way software services are delivered to clients and the fact that business services were typically already outside most existing EU trade legislation before Brexit. Moreover, Brexit trigged increased demand for software solutions for business clients at some of its portfolio companies amid growing regulatory complexity post-Brexit.

In a typical 12-month period, the manager makes between eight and 16 platform investments (ie excluding any bolt-on acquisitions across its portfolio companies, which normally represent a multiple of this figure) and seeks to deliver a similar number of liquidity events over the period such as sales, partial sales and refinancing. Hg expects that its transaction activity will remain high in 2021, with some realisations currently underway or specifically planned for this year. The manager will maintain its cautious and selective approach and focus on capitalising on situations where it has a specific angle and many years of knowledge of the business and its end-market, as well as strong relationships with founders and management teams. Bolt-ons and strategic M&A within the portfolio remain a key focus.

Aspiring to be ESG leader across European PE firms

Hg continues to actively integrate environmental, social, and corporate governance (ESG) factors into its business, as reflected in receiving the highest possible scores from the United Nations-supported Principles for Responsible Investment (UNPRI), including A+ for Strategy & Governance and Private Equity Ownership for a second successive year. Three core tenets of Hg's ESG and sustainability strategy are: 1) sustainable business practice; 2) job creation; and 3) charitable giving.

Sustainable business practice at Hg encompasses the manager's efforts towards reducing its carbon footprint at fund level and investing in sustainable businesses. With respect to the former, the manager was recertified as carbon-neutral for the third consecutive year in 2020 and continues to offset all carbon emissions by supporting the Acre Amazonian Rainforest project, which prevents deforestation and promotes sustainable economic livelihoods in the Brazilian Amazon. Hg's strategy for 2020/21 assumes further reduction of its carbon footprint for office-related emissions, business travel, hotel stays and staff commuting, with its current focus on new working practices in the COVID-19 pandemic, which could translate into long-term policies aimed at transforming its environmental impact. Moreover, Hg became a founding member of the Initiative Climat International (iCI) in 2020, supported by the UNPRI and more than 20 PE firms, which will work towards best practices for carbon footprint and climate change in the PE sector.

ESG is embedded in Hg's investment process and the manager actively engages in improving ESG practices across portfolio companies. This includes periodical assessment of ESG performance at its investments, which is measured against Hg's internal Responsible Business Framework. It includes three key areas: essentials (ie certain minimum ESG requirements that the company expects from all its businesses, including compliance with governance, legal, data and cybersecurity standards), employees and society. The average ESG score of portfolio companies in Hg's internal ESG assessment in 2020 was 8 (out of 10), with average improvement of 22% compared with the first assessment three years ago (or more recently, depending on when a company joined Hg's portfolio). We note that for every business in its portfolio, Hg targets an ESG score of at least 8 by the second year of assessment. Additionally, Hg has developed a Climate Change Risk Assessment tool in cooperation with PwC in 2019, tailored to capture climate risks in the software and services industries. The tool concludes that none of Hg's businesses face high transition risks (ie risks of transitioning to a low-carbon economy) or physical risks (ie the increasing physical impacts of climate change) related to their own operations, while only a small number of companies face high transition risks across their supply chains and data centres.

The job creation tenet at Hg is about building diverse teams internally and at its portfolio companies, as well as generating employment growth across the portfolio. The progress is tracked with relevant KPIs, including the percentage of women in Hg's executive team (27% in FY20, unchanged vs FY19), the number of nationalities across Hg's team (c 30 in FY20) and the average Glassdoor score as a proxy for employee satisfaction (4.5 out of 5).

Finally, the manager launched the Hg Foundation in July 2020, the goal of which is to have an impact on developing the skills most required for employment in the technology industry, with the focus on individuals who may otherwise experience barriers to access these skills. The Foundation has an ambition to achieve average annual commitments of US$5.0m over the first 10 years. Hg will donate 1% of annual firm profits and each fund's carried interest to charitable causes and the Hg Foundation. We note that Hg already funded charitable causes before setting up its own foundation. For example, it committed the largest ever one-off donation to Impetus – The Private Equity Foundation in 2018.

All these efforts are part of the manager's vision to become the most sustainable PE firm in Europe, as measured by the UNPRI score, which at present puts it among the top 10% of PE firms, according to management. While Hg is not a typical impact investor, we note that impact-oriented funds have co-invested with Hg funds in the past. For instance, the Global Impact PE fund from KKR invested in Citation Group and The Rise Fund and Generation Investment Management at Benevity (the former fund is backed by rock star Bono and the latter by former vice president of the US Al Gore). Hg does not directly link its strategy to UN's Sustainable Development Goals (SDGs), although it highlights initiatives at its portfolio companies that address them.

Asset allocation

Investments and realisations at record-high levels

HGT deployed a record-high £403m into new and follow-on investments in FY20 (vs £117m in FY19 and £109m on average between FY15 and FY19) on the back of increased investment activity in H220, which followed a somewhat muted Q220 amid a broader market slowdown triggered by the COVID-19 pandemic. At the same time, we note that the full-year figure includes transactions that could be considered as partial rollovers or refinancing, including Evaluate, Sovos Compliance, Visma and Citation Group (total investments in these companies reached c £126m in FY20). Post period-end, HGT completed new investments in Benevity (£30.9m, including £3.6m in co-investment), Geomatikk (£11.4m, including £4.0m in co-investment), Prophix (£15.7m) and TeamSystem (£14.3m). We note that the latter investment via the Hg Genesis 8 Fund was coupled with an exit from the company by the Hg Genesis 6 Fund. In March 2021, HGT announced a £29.3m investment in Trackunit (see more details below).

Realisations also reached a record-high £364m in FY20, compared to £117m in FY19 and £162m on average between FY15 and FY19. Post period-end, the company completed a £21.3m exit from TeamSystem and announced realisations from Mitratech (£49.9m) and Trace One (£5.8m). We presented a full list of HGT's investments and the realisations announced in FY20 in our previous update note, while below we provide a snapshot of the top five largest new investments since July 2020, where HGT has deployed between £20 and £50m in each company:

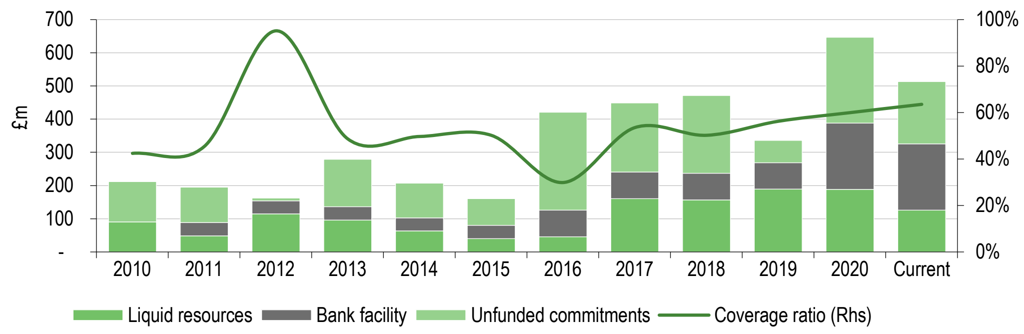
- **The Septeo Group (£38.5m investment):** a leading legal tech provider, supporting notaries, law firms, corporate legal departments and real estate property managers in France, Belgium, Canada and the US. The group now has over 12,000 clients, more than 120,000 users, over 1,400 employees, and its FY20 revenues reached £180m. According to a report from French publication *Le Figaro*, the deal values the company at more than €1bn, implying an entry multiple of 25–27x its EBITDA of approximately €43m.
- **Howden Group Holdings (formerly Hyperion) (£33.1m investment):** a leading international insurance distribution group based in London with core activities in retail, speciality and reinsurance broking and the provision of B2B insurance. The group operates across over 200 global offices in 40 countries and employs 6,000 people, managing c US$9bn of gross written premium on behalf of clients. The Hyperion management team and employees remain the largest shareholders, which makes Hyperion the fifth largest employee-owned business in the UK. Hg invested as part of a broader equity and debt raise, of up to US$1.5bn at an EV of US$5bn, to accelerate strategic growth and support investments in technology and data.
- **Benevity (£30.9m investment):** offers a global platform that enables purpose-driven brands to engage stakeholders in supporting causes through a database of nearly 2m vetted non-profit organisations. Its 650 clients and 19 million employees support issues such as food insecurity, human rights, diversity and inclusion, racial equity and mental health. Investing alongside existing investors General Atlantic and JMI Equity, as well as the Benevity management team, Hg is reported to have acquired a majority stake in Benevity at a valuation of over US$1bn. Previously, in October 2019, Benevity raised a US$40m Series C round from JMI Equity and General Atlantic at c US$400m.

- **Trackunit (£29.3m investment):** provides software-led telematics solutions for off-highway vehicles and the construction market. The company is headquartered in Denmark and the US (Chicago) and has subsidiaries in Sweden, Norway, France, the Netherlands, Germany and England.
- **CaseWare (£28.6m investment):** based in Toronto, CaseWare develops audit software solutions for accounting firms, corporations and governments. Founded 30 years ago, it has grown organically to over 500,000 users in 130 countries, operating in 16 languages.

Maintaining a healthy coverage ratio

According to our estimates, HGT's coverage ratio was at a comfortable level of c 64% at end-February 2021 (after accounting for all transactions announced to 24 March 2021, the proposed final dividend of 3.0p per share and equity raised via tap issuance), slightly up vs 60% at end-FY20, and above the average 48% between FY15 and FY19. In FY20, HGT committed a total of £750m to Hg funds across Hg Saturn 2, Hg Genesis 9 and Hg Mercury 3, driving total outstanding commitments to £647m at end-FY20, compared to £336m at end-FY19. They declined to £513m on 24 March 2021 after the announcement of further investments. These commitments will likely be invested over the next three to four years. We note that the company can opt out of a new investment without penalty across all fund, should it not have the cash available to invest (although it considers this as a 'disaster insurance' and does not intend to use it except for an extreme scenario). Liquid resources were £326m post investment in Trackunit announced on 24 March 2021, supported by the new £200m credit facility (it remained undrawn as of 24 March 2021), £25m raised in tap equity issues in 2020 and c £15m raised in tap equity issues in 2021 to 24 March 2021. HGT raised a further £16.2m in a tap equity issue conducted on 24 March 2021.

Exhibit 2: Historical coverage ratio



Source: HgCapital Trust, Edison Investment Research. Note: Last column at 24 March 2021, including all transactions announced to this date, the proposed final dividend of 3.0p per share and equity raised via tap issuance.

Current portfolio positioning

Exhibit 3: HGT's top 10 holdings at 28 February 2021

Company	Location	Cluster/end market	Portfolio weight %	
			28 Feb 2021	31 Dec 2019*
Visma	Scandinavia	Tax & Accounting/ERP and payroll	12.0%	21.5%
Access	UK	ERP & Payroll	10.4%	5.5%
IRIS	UK	Tax & Accounting/ERP and payroll	6.1%	6.2%
P&I	Germany	ERP & Payroll	4.9%	N/A
Transporeon	Germany	ERP & Payroll	4.3%	4.1%
Litera	North America	Legal & Compliance	3.8%	3.8%
Intelerad	North America	Healthcare IT	3.8%	N/A
team.blue	Benelux	SME Tech & Services	3.4%	3.0%
Sovos Compliance	North America	Tax & Accounting	3.3%	8.6%
Argus Media	UK	Capital Markets & Wealth Management IT	3.2%	N/A
Top 10 (% of holdings)			**55.2%**	**62.7%**

Source: HGT, Edison Investment Research. Note: *N/A where not in end-December 2019 top 10; in this column we show data as of end-December 2019 as the company did not disclose figures as of end-February 2020.

HGT visibly reduced concentration across its portfolio in FY20, which largely resulted from the reduction of its exposure to Visma and Sovos Compliance announced in Q320 (from c 21% at end-June 2020 to c 12% at end-September 2020 for the former and from c 10% at end-June 2020 to c 4% at end-September 2020 for the latter). HGT's portfolio remains well-diversified across the technology and services clusters as well as across geographies (see Exhibits 4 and 5) and is relatively immature following increased transaction activity in recent months, with c 81% of its investments made in 2018 or later. At the same time, it must be noted that some holdings may be from an earlier vintage because the position was rolled over from another Hg fund, with the most recent examples including Evaluate, Sovos Compliance, Visma and TeamSystem.

Exhibit 4: Portfolio breakdown by cluster

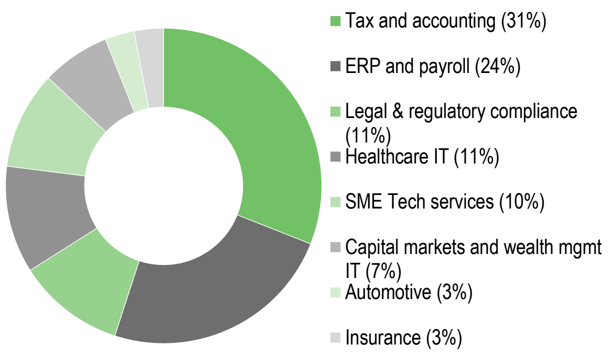
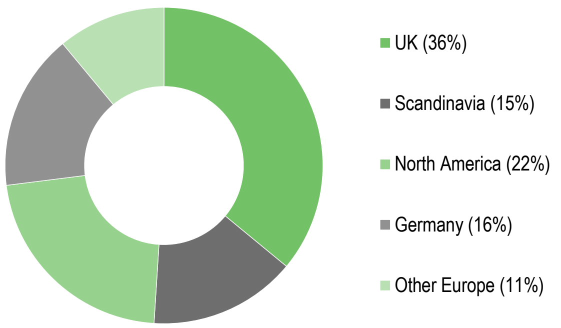


Exhibit 5: Portfolio breakdown by geography



Source: HgCapital Trust, Edison Investment Research. Note: Data at 28 February 2021.

Performance: Robust NAV TR in FY20 of 24%

HGT posted a strong net asset value (NAV) total return (TR) of 24.0% in FY20, of which c 3.6% was generated in Q420. This compares with the 9.8% decline of the FTSE All-Share in 2020, and the 1.9% rise of the LPX Europe Listed Private Equity Index over the same period (on a total return basis). HGT's NAV TR in 2020 was primarily assisted by earnings growth across its portfolio companies, with the top 20 investments (representing 83% of total investments by value at end-FY20) delivering last 12 months' (LTM) EBITDA growth of 31% y-o-y (vs 29% at end-September 2020) and LTM revenue growth of 22% y-o-y (in line with end-September 2020), according to the manager. Based on discussion with the management, we understand that organic year-on-year sales growth across the portfolio was in the high single-digit percentage range. HGT highlights very robust and consistent trading from the majority of the portfolio, in particular in the case of Mitratech, Allocate, Access, IT Relation, Intelerad, Visma and FE fundinfo, which jointly represented c 36% of its NAV at end-FY20. Only EidosMedia (less than 0.1% of portfolio at end-FY20 and 0.5% at end-FY19) performed below HGT's expectations in 2020 and was written down in the period.

Meanwhile, the average EV/EBITDA for top 20 investments went up slightly to 22.1x at end-FY20 from 19.8x at end-FY19 and 20.9x at end-September 2020. HGT highlights that at present only three out of all 36 portfolio holdings are valued below acquisition costs. Each portfolio company is valued individually, based on the trading multiples of comparable listed businesses and relevant recent M&A activity.

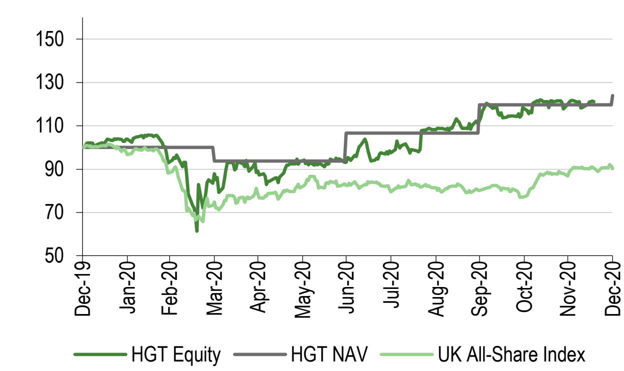
In terms of leverage, net debt to EBITDA went up to 6.4x at end-FY20 from 6.2x at end-FY19 and 6.0x at end-September 2020, which compares with a median (gross) debt to EBITDA of 3.9x for European PE buyouts and 6.3x for US PE buyouts in 2020, according to PitchBook Data. We believe that the above-average leverage at HGT's portfolio companies comes at least partially from the fact that Hg's businesses have a high degree of recurring revenue, which supports their ability to service their debt.

We estimate that realised gains contributed c 10pp to the full-year NAV total return in 2020. HGT achieved a solid multiple on invested capital (MOIC) of 3.5x and an average uplift to last carrying value of 25% on its realisations in 2020. The six largest realisations in FY20 (ie Visma, Sovos, The Citation Group, STP, Evaluate and Eucon) generated an uplift to their 31 December 2019 book value of c 50% on average.

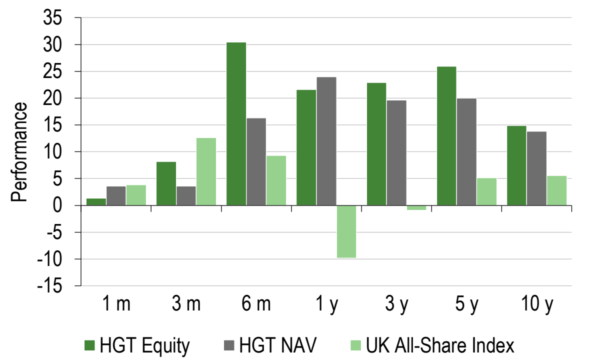
NAV TR in 2021 to end-February 2021 was a negative 1.7%, but this is largely attributable to FX movements as it is still based on end-December 2020 portfolio valuations.

Exhibit 6: Investment trust performance to 31 December 2020

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



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

Peer group comparison

Although HGT's specialisation in the software and services sectors makes it difficult to select comparable listed PE companies, we have compiled a set of potentially comparable companies (Exhibit 7), with Altamir being HGT's closest peer in this group. We described similarities and differences between HGT and its peers in more detail in our previous review note.

HGT has outperformed the peer group average in terms of NAV TR over one, three, five and 10 years, with the highest NAV TR over the five-year period. We note that performance figures are based on the latest available ex-par NAV, which for most peers is dated to earlier periods than end-February 2021 (except for NB Private Equity Partners and Standard Life Private Equity). While HGT reported NAV at end-February 2021, it reflects portfolio companies' valuations as of end-December 2020 and FX movement to end-February 2021.

HGT is the only company from the peer group trading at a premium to NAV, while its peers are trading on an average discount to NAV of 21.5%. We note that historically, HGT's discount to NAV was visibly narrower than for its PE peers, with an average discount to HGT's NAV of c 2% in 2020 and c 5% between 2018 and 2020, compared to a typical 10–20% discount to NAV for its peers. HGT's dividend yield of 1.6% is below the peer average of 3.1%.

Exhibit 7: Selected peer group at 30 March 2021*

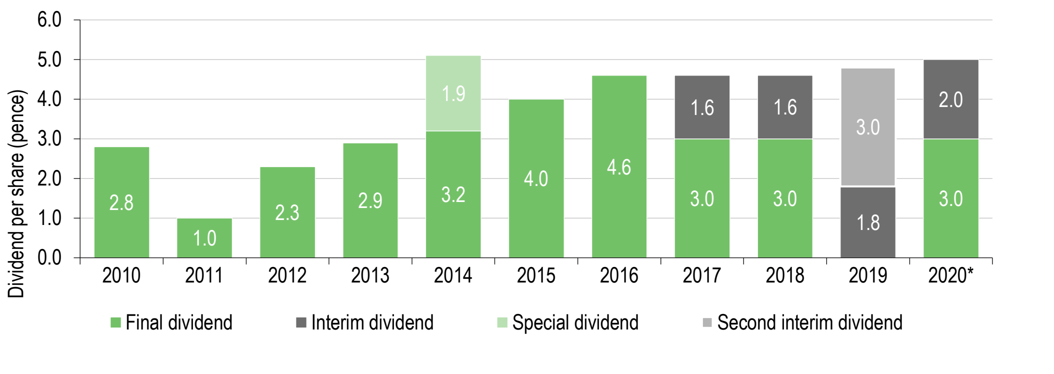
% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield
HgCapital Trust	**1,362.2**	**22.2**	**69.0**	**138.6**	**245.5**	**1.8**	**Yes**	**4.8**	**100**	**1.6**
Altamir	855.8	20.1	56.8	132.8	257.4	2.6	No	(24.1)	100	2.8
BMO Private Equity Trust	266.9	22.7	53.4	98.0	198.5	1.3	Yes	(25.7)	115	4.5
ICG Enterprise Trust	687.7	11.1	41.2	97.0	202.5	1.5	Yes	(19.5)	100	2.3
NB Private Equity Partners	544.8	10.4	36.9	80.9	216.7	2.1	Yes	(25.0)	123	3.9
Oakley Capital Investments	540.0	18.2	71.6	116.2	157.4	2.5	Yes	(25.8)	100	1.5
Princess Private Equity	685.2	13.1	39.4	102.7	174.5	1.9	Yes	(15.5)	100	3.9
Standard Life Private Equity	667.3	17.5	41.2	93.4	191.7	1.1	No	(14.5)	100	3.0
Simple average (excl. HgCapital)	**606.8**	**16.2**	**48.7**	**103.0**	**199.8**	**1.9**	**N/A**	**(21.5)**	**105**	**3.1**
HGT rank in peer group	**1**	**2**	**2**	**1**	**2**	**5**	**N/A**	**1**	**8**	**7**

Source: Morningstar, Edison Investment Research. Note: TR = total return. 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, Standard Life Private Equity – end-February 2021; Princess Private Equity – end-January 2021; Altamir, BMO Private Equity Trust, Oakley Capital Investments – end-December 2020; ICG Enterprise Trust – end-October 2020.

Dividends

The board will recommend paying out a final dividend of 3.0p per share, which together with an interim dividend of 2.0p per share paid out in October 2020 will translate into an annual dividend of 5.0p in FY20 (up from 4.8p in FY19) and represent a dividend yield of 1.6% as of 30 March 2020. The board aims to sustain a minimum annual dividend of 5.0p per share, though HGT is primarily a long-term capital appreciation vehicle rather than an income trust and the ability to pay out a dividend is influenced by the capital structures of the transactions entered into by the manager and on income received on any liquid resources being held subject to investment.

Exhibit 8: Dividend history since FY10



Source: HGT, Edison Investment Research. Note: *The proposed 3.0p final dividend is subject to shareholder approval.

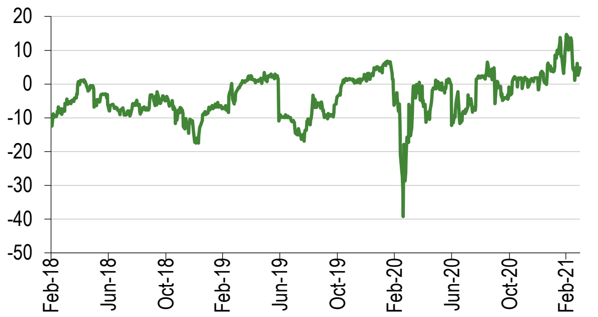
Discount: Trading at a premium to NAV in 2021

The robust NAV TR has been reflected in HGT's share price increase such that HGT has been trading in line with its NAV on average in Q420. The premium to NAV had been increasing since the beginning of 2021 and reached c 13% on 12 March 2020. That said, it declined to c 5% on 30 March 2021 following a c 7% one day share price drop after publication of the annual report and

NAV per share as of end-February 2021. We believe this was at least partially triggered by HGT's NAV TR in Q420 of 3.6%, which was lower than in previous quarters despite the strong growth of tech indices in the period (including the S&P 500 Software and Services Index, which delivered a total return of 8.1% in Q420), coupled with continuously strong trading at HGT's portfolio companies as can be seen from the reported figures. Having said that, we note that PE trusts such as HGT should be evaluated based on their long-term performance rather than the NAV TR recorded in any given quarter.

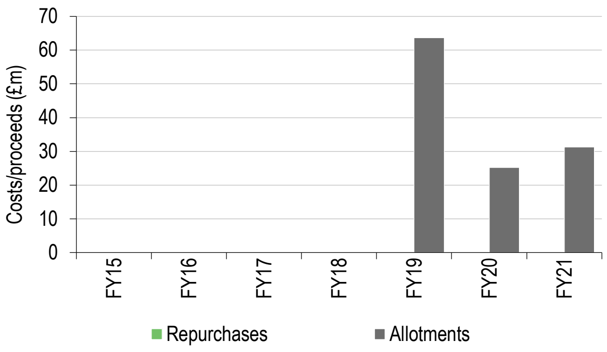
In the past the stock has only occasionally moved into double-digit discount territory, which is typical for PE investment companies. This has usually coincided with major UK stock market corrections, including the March 2020 market crash triggered by the COVID-19 pandemic, following which, however, the discount to NAV closed relatively quickly.

Exhibit 9: Discount over three years



Source: Refinitiv, Edison Investment Research

Exhibit 10: Buybacks and issuance



Source: Morningstar, 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 growth holdings beyond the venture capital stage) and creating value through strategic and operational change. 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 internal rate of return (IRR) of 23–25%.

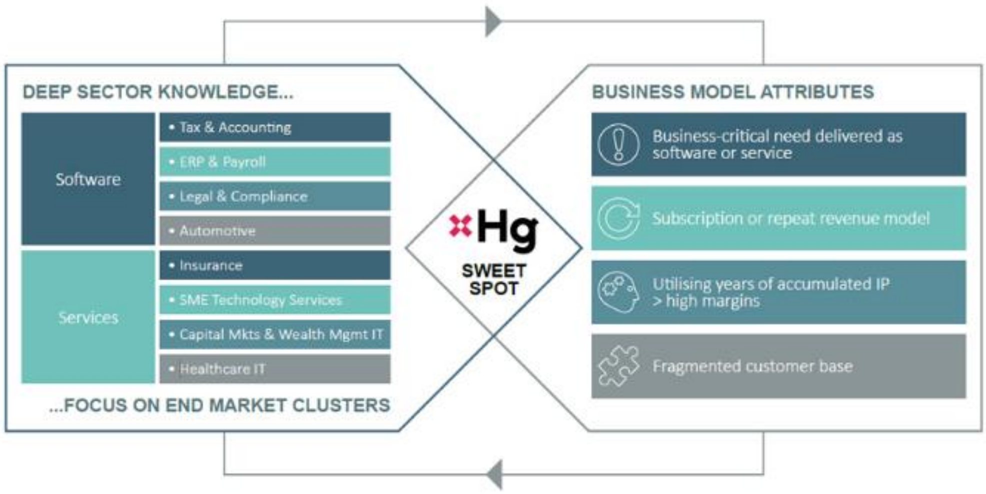
HGT focuses on companies that offer software and services across Europe with enterprise values (EVs) ranging from £50m to more than £5.0bn. HGT displays the characteristics of a tech conglomerate and is not a PE fund of funds. In fact, if Hg was classified as a tech conglomerate, it would be (according to the company) the second-largest and the fastest growing technology company in Europe with a focus on software and services by EV (after SAP), as HGT's existing tech investments are valued by the company at around £33bn and provide superior top-line growth. It must be noted that Hg's management incentive system is relatively effective, as each management team is individually incentivised to align its interest with the portfolio company through a share in business performance. In addition, unlike a traditional conglomerate, Hg will realise each investment, constantly refreshing its group with younger companies entering their high-growth phase.

HGT's investment strategy assumes the use of 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 6.2% at end-FY20).

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; automotive; 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 in particular solutions delivered in a cloud SaaS setup.

Exhibit 11: Hg's 'sweet spot'



Source: HgCapital Trust

Hg looks for businesses that are able to use their intellectual property accumulated over several 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 valuations in the SaaS market, which remain relatively demanding and call for more sophisticated PE strategies than plain financial engineering.

Hg's key competitive advantage is its strong involvement in the strategic development and value creation of its portfolio holdings. We see this as a particularly important differentiator in an adverse macro environment, given that PE companies with in-house value creation teams tend to outperform the broader PE space in the period following a market downturn. Hg's high degree of involvement supports its deal-origination process. We described Hg's investment process in more detail in our initiation note.

Gearing: £200m credit facility remains undrawn

HGT agreed a new £200m facility in early October 2020 after it repaid its previous £80m credit line, which was fully drawn then. The interest rate on the amount drawn from the new facility stands at Libor plus a margin of 3.25% (vs Libor plus margin of 2.15% on the previous facility), HGT pays a commitment fee on the undrawn part of the facility of 1.15% per year (0.9%) and the term of this facility is four years. The facility remained undrawn at mid-March 2021. Hg usually applies leverage at its underlying investment level, which is serviced using the entity's own cash flows (see more detail on net debt to EBITDA ratios above).

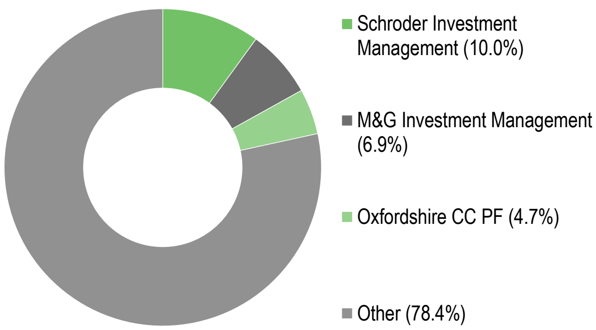
Fees & charges

HGT's total ongoing charges as percentage of NAV increased to 1.8% in FY20 from 1.6% in FY19 due to higher total operating expenses (£4.8m in FY20 from £3.3m in FY19), driven by legal and other administration costs (£3.3m in FY20 vs £1.9m in FY19). In FY20, priority profit share was £11.4m and equalled 1.3% of HGT's average NAV in the period (vs £10.8m and 1.2% in FY19, respectively).

Capital structure

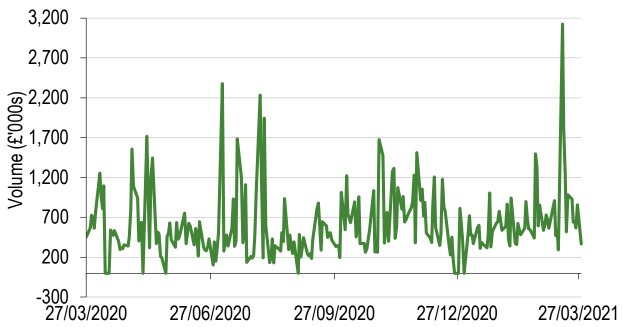
HGT's share capital consisted of 425.7m ordinary shares on 31 March 2020. In FY20, the company conducted a series of equity tap issuances, raising a total of £25m over the period at an average premium to NAV at issuance of c 3%. In 2021 to 31 March 2021, HGT issued 9.7m shares at a price of 3.2p per share (4.7m in total) and 3.24p per share (5.0m), translating into gross proceeds of c £31.2m. 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 £3.5m (representing c 33% of HGT's ordinary share capital) was also given to directors.

Exhibit 12: Major shareholders



Source: Refinitiv, at 31 March 2021

Exhibit 13: Average daily volume



Source: Refinitiv. Note 12 months to 30 March 2021

The board

HGT's board, which is 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. Pilar Junco is a managing partner and chief strategy and client officer at Altamar Capital Partners, an independent manager of international PE and other private assets. Before joining Altamar, she worked at Blackstone for 13 years, where she held the positions of senior managing director and head of its non-US private wealth management and retail business. We described the backgrounds of the other directors in our previous review note.

Exhibit 14: HGT's board of directors

Board member	Date of appointment	Remuneration in FY20 (£)	Shareholdings at end-FY20
Jim Strang (chairman)	March 2018	60,121	34,000
Richard Brooman	October 2007	52,750	21,900
Peter Dunscombe	January 2014	47,250	60,000
Pilar Junco	July 2020	18,428	-
Guy Wakeley	March 2018	40,500	15,429
Anne West	May 2014	47,250	200,000
Roger Mountford*	April 2004	25,385	N/A

Source: HGT. Note: *Retired in May 2020.