December 3, 2023

Disclaimer: Before considering an investment in any of Protean's funds, please refer to our prospectus and KIID-material. Investments in a fund can both increase and decrease in value. Full return of capital is not guaranteed.

November Partner Letter

Frog in Water Syndrome

Dear Partners,
Protean Select returned 2.3% for the month. It is +1% YTD and +9.9% since inception. **Cargotec**, **Raysearch** and **Getinge** were top contributors.
On the negative side were our **index hedges**, **Lundbeck** and our **short position in EQT.**

Protean Small Cap returned 12.0% in its sixth month (yihaa!).
The benchmark Carnegie Nordic Small Cap Index was up 7.7% in November.
Balder, **Netel** and **Cint** were top contributors.
Lundbeck, **SmartOptics** and **Nilfisk** were the biggest detractors.
After six months, the fund is ahead of its benchmark by 3.6%-points.

The combined assets in our two strategies is approximately **1.4bn SEK**.

We are very pleased with the launch of the small cap fund. According to data at Morningstar, which tracks fund performance, **Protean Small Cap is the best performing Nordic Small Cap fund (of >30) over one and three months**, and the third best performer over the past 6 months.

Content of the November Partner Letter

This month's letter covers the month's developments, why the boiling frog syndrome suggests we might be at a policy bottom for renewable energy companies like **Orsted**, and Ramil Koria elaborates on why we love inflection points in companies where the market is confusing cycle with structure and exemplifies this with our thinking on **Acast**, **Dustin** and **Demant**.

December 3, 2023

What happened in November

November	2023-10-31	2023-11-30	
MSCI Nordic Total Return (SEK)	552,7	590,7	6,9%
MSCI Nordic Small Cap (SEK)	711,3	786,6	10,6%
OMX ALL (SAX)	766,0	834,4	8,9%
OMX30	2 075,8	2 232,5	7,5%
Carnegie Swedish Small Cap Index	1 105,5	1 231,5	11,4%
Carnegie Nordic Small Cap Index	680,5	731,160	7,4%
Protean Select NAV	107,4	109,9	2,3%
Protean Small Cap NAV	90,5	101,4	12,0%

What a difference a month makes. The positioning rubber band was stretched too far in one direction, and particularly small caps snapped back with a vengeance. It was a clean sweep in November: stocks up, rates down, USD weaker, credit tighter. We notice in our commercial paper and short-duration corporate bond book how financing costs have not only stalled their precipitous ascent but even started to reverse in some instances. This bodes well for some of the more indebted equities out there.

As the narrative extends into December, the combination of supportive technicals (resumption of buy-backs, net outflows turning to inflows, the absence of IPOs and placings, no pesky quarterly reports to spoil the party) and falling inflation seems to be enough to keep driving headline markets higher. Despite being a hedge fund, Protean Select is a stubbornly net-positive exposure animal. We know that it is simply impossible to time the bottom of a market. We aim to protect the downside and participate reasonably in the upside when it comes. October-November is a good example. Whilst the former month saw markets contract between 3-5%, the fund was flat (-0.2%) but still managed to print a reasonable +2.3% in November when markets rallied. Of course, we would have loved to capture MORE of the upside, but that would most likely have been at the expense of also participating MORE on the downside in prior months. It's just how the fund operates (reserving the right to change our mind here, mind you).

True to our mantra to promise nothing but commitment and volatility in the Small Cap fund, it soared in November by being up over 12%, beating its benchmark index Carnegie Nordic Small Cap by close to 5%-points. Small caps, seen as an asset class, are indeed a fickle bunch, particularly after such a prolonged period of underperformance vs the rest of the market. Long may the bounce continue!

A milestone in Protean's corporate journey was reached in November when we onboard our first international institutional investor. For those of you who have read all our partner letters since the very beginning, you will recognise that we have purposely built the company with ambitious infrastructure and robust compliance, operating policies, and suppliers from day one (example: 14 pages on "How to start a hedge fund, and why – January 2022"). We are proud to have cleared the hurdle of a professional due diligence process without any material issues. This also means we significantly increase our assets under management to now totalling close to 1,4bn SEK across the two strategies.

We remain firm believers that small is beautiful in the world of asset management. Both when it comes to the size of investee companies, but particularly when it comes to the size of funds and assets.

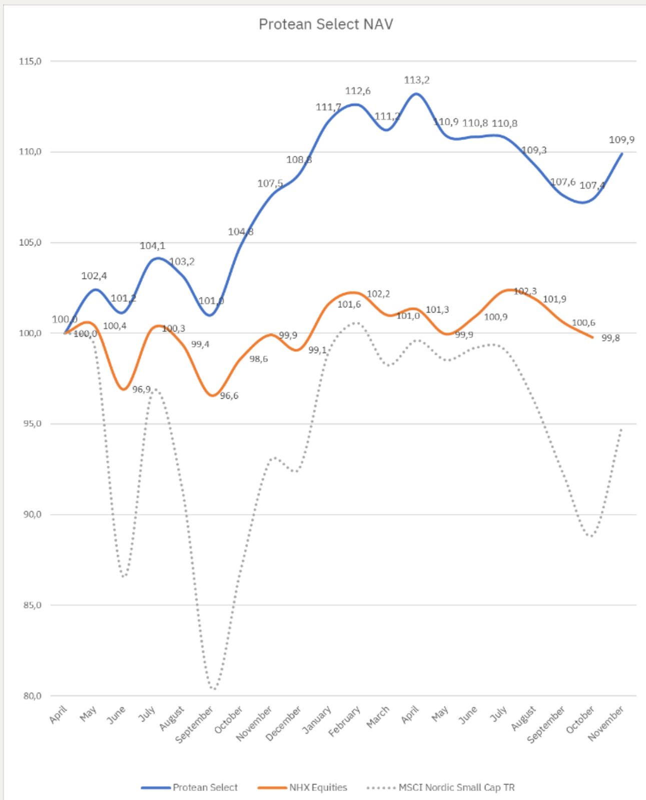
Managing a big fund is very profitable for the fund manager, but it risks coming at the expense of performance, as many opportunities are simply impossible to capture with too much capital. We are committed to closing the funds before this becomes an issue. If the Select fund – now managing close to 1,2bn SEK – continues to have decent risk-adjusted performance in the months to come, we might get closer to the 2bn SEK cap.

In other news parts of the team spent a week in the US visiting 20+ companies in 4 cities, most meetings with bearing on Nordic companies. Our high-level take-aways are that manufacturing companies to a man speak of normalising supply chains and inventory levels. Demand is described as neither fantastic nor bad, but simply "good". One interesting tendency several management teams noted was that "we have reached a tipping-point in how corporates and customers are behaving" when it comes to environmental issues. It seems the market is running ahead of legislators on this matter. They do not appear worried that a 2nd Trump term would cause a significant walk-back of enrivonmental legislation or demand.

It was also refreshing, as always, to be reminded of what fantastic global companies we have that are listed in Scandinavia and how respected the products are in their respective niches.

Protean Select – update for November

+2.3% return in November was a welcome break from the lacklustre few months that lay behind us. It does feel like we've hit the crossbar one time too many recently, but we take comfort in the fact that performance since inception remains in line with our long-term ambition of "reasonable returns at a reasonable risk over a three-year period".



**We illustrate our performance by showing a comparison with the NHX Equities index. This is an index constructed from the performance of 54 Nordic hedge funds focusing on equity strategies. NHX is published after our Partner Letter, so updates with one-month lag in the chart above. We aim to have positive returns regardless of the market, but no return is created in a vacuum, and a net-long strategy will correlate. Our hurdle rate is >8% annualized (4% + 90-day Swedish T-bills). All figures are net of fees.*

Our best-performing stock in November was Finnish industrial conglomerate **Cargotec**. It is a transformation and break-up story trading at a substantial discount to its sum-of-the-parts. This is almost a schoolbook example of a "value with a catalyst" case, as Cargotec is in the process of both selling an asset (MacGregor) and splitting the remaining company in two (Hiab and Kalmar). What seems to confuse the market from time to time is that its business is inherently cyclical, with order intake currently on a downward trajectory. Hence the low current multiples. We choose to see through that and believe there is more to come during 2024 when these catalysts materialise.

We were again encouraged by **Raysearch's** quarterly results, propelling the stock to top three performer for the month. As one of our larger positions in the fund (it's up 60% since we bought it, and we have only trimmed the position marginally) we keep a close eye on the company (we recently visited the industry conference ASTRO in San Diego) as well as the entire radiation oncology sector, and we like what we see. Not only is growth continuing, but earnings quality is improving, and the company appears to be delivering on its refreshing ambition to improve margins. The stock remains a core holding in both funds.

On the losing side of the portfolio we (unsurprisingly) find our **basket of market risk hedges**. During the month we have adjusted to again use more index options to protect the downside. With volatility cratering comes the added benefit that the cost of downside protection also tumbles. When one is unsure how much of a parabolic move is left in markets to the upside into year end, capping the max loss via options seems a reasonable bet (assuming, of course, one wants to protect the downside in the first place).

The next debate, we speculate, could be over "the wall of maturities" – most corporates have been inactive in rolling debt, seeing how rates are high and liquidity is poor. This has created a situation where an unusual amount of debt needs to be re-financed in the coming two years. When the clock ticks into 2024, we will suddenly start to look at 2025 numbers… How will they look? This could turn out a nothing-burger, as liquidity and rates are now on a path to improvement since a few weeks, but we keep an eye on it.

Danish pharma company **Lundbeck** was a top-three loser for the month. Quite frankly without any substantial news. We monitor the **Vyepti** progress and keep thinking the stock is both undervalued and underappreciated in its efforts to gradually improve the pipeline.

We were forced to back out of our short position in private equity company **EQT** during the month. Falling long rates and reinvigorated equity markets are just what the doctor ordered for these challenged business models. We still think there is something silly going on here, but tactically covered the position. With the core class of investors in PE-funds overallocated to the category, we think the last verse has not been sung on the short side just yet. We await a better entry point. This is an example of us being adaptive: despite our fundamental objections to valuations and drivers, we recognise that other forces in play will tactically capsize our thesis for a while.

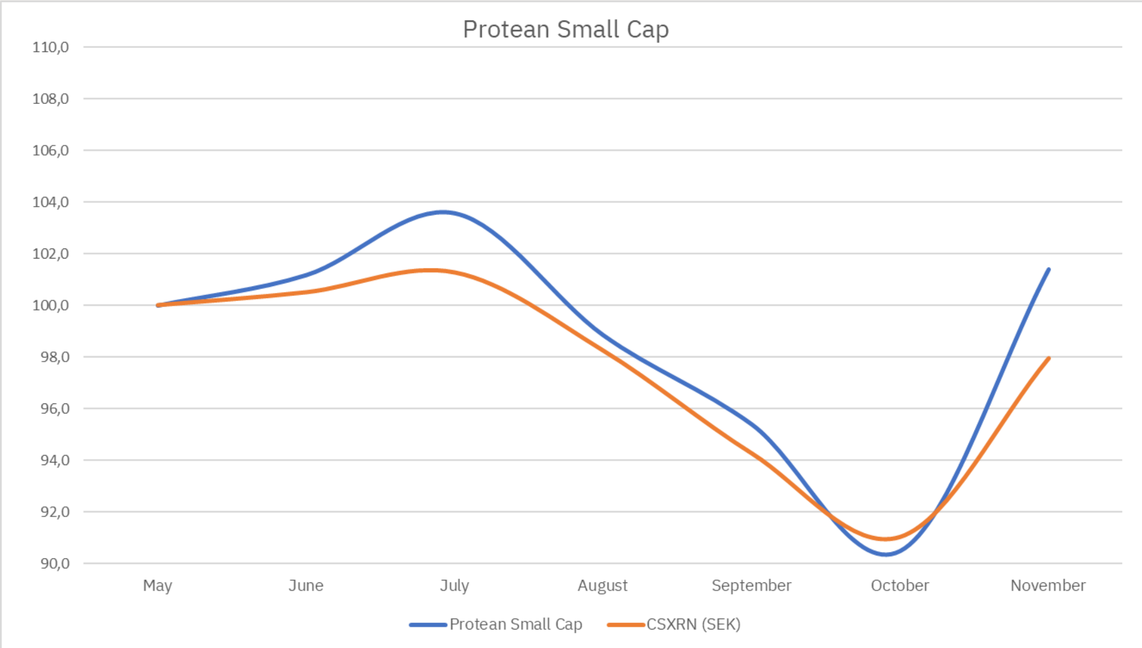
Notable is also that we have rid ourselves of our position in **Novo Nordisk** after owning it since day one. This is a fantastic company with a handful of fantastic products, but these days there is literally nobody that does not share the same sentiment. With such a dominance in sales and earnings from a single molecule, and the cost-to-society-issue top of the agenda, we suspect the stock is ready for a breather. Notable is how several positive data points in recent weeks have failed to propel the stock higher. A tell-tale sign of a stock reaching a plateau.

The fund has become more concentrated in the past months. We have been adding weight to our higher conviction ideas, both on the long and short side. This will increase the volatility of the fund, but that's by design, as our realised volatility is well below what we thought it would be when we started out 1,5 years ago. A reminder: we do not manage for a certain volatility level; it is a residual of our positioning and opportunity set. Also: don't read too much into this, we are still (and will always be) well diversified. Diversification is one of very few free lunches in equity portfolio construction.

Protean Small Cap – Carl's update for November

November was a strong month for Protean Small Cap. The fund increased by 12.1%, which was 4.5% better than our benchmark for the month. Since start in June, the fund is up by 1.4% which puts it 3.6% ahead of index. We now manage ca. 190 MSEK.

According to data at Morningstar, which tracks fund performance, **Protean Small Cap is the best performing Nordic Small Cap fund (of 30) over one and three months**.

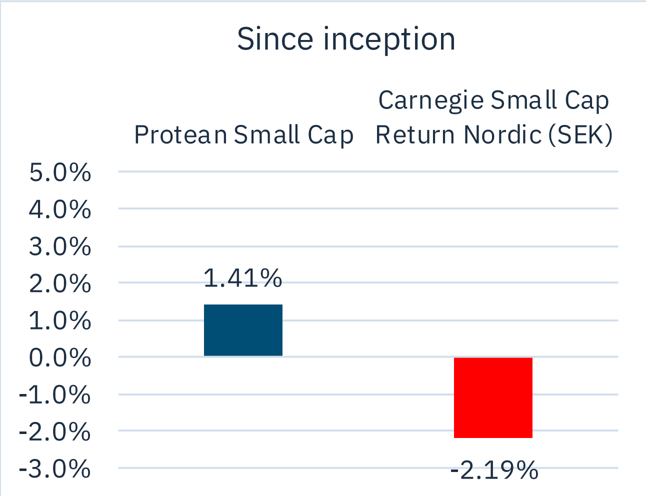


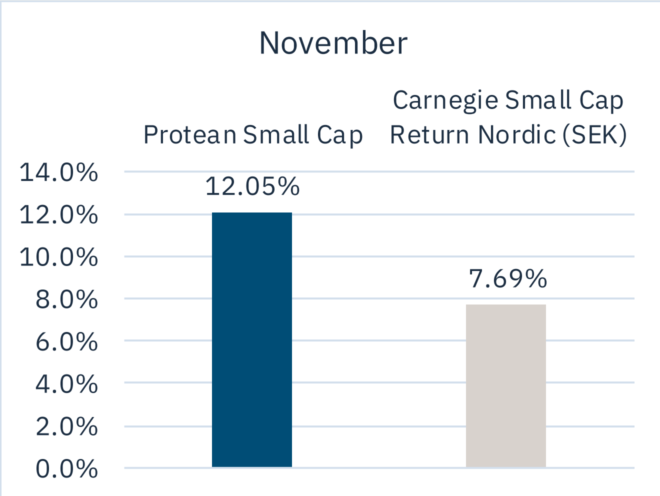
Winners include the real estate company **Balder** (relief from lower rates), the market research (buy transforming into adtech) player **CINT** (bouncing back from poor Q3 showing) and **Netel** (its report underscored low valuation and that the business is not falling off a cliff). **Lundbeck**, **SmartOptics** and **Nilfisk** were our main contractors.

We've gradually been adding to our positions in **Acast** (+27% in November) and **Devyser** (+20% in November) since we started the fund. These two do not have much in common at face value, but from an investment perspective they share a few similarities: both are semi-recent IPO's with poor performance since their listings, they are loss-making but with strong balance sheets, and they are approaching profitability.

Acast grew 26% organically in Q3 despite facing a tough ad market, since podcasts as a format is getting more attention from ad buyers. With better cost discipline in the company, an industry that is maturing (no more crazy contracts from Spotify to Barack, Harry and Meghan et al) and maintained top-line growth in 2024, the valuation at EV/S 0.4x remains extremely appealing. More on Acast later in this letter.

Devyser is active in DNA based testing. The company caught our attention when they signed a contract with Thermo Fisher for their post-transplantation testing offering. The telltale sign for organ rejection is usually a reduction of kidney function, which is a secondary, lagging indicator relative to what is happening on a molecular level. Devyser's tests improve the long-term survival rate of transplanted organs, which has quantifiable health economic effects. Thermo Fisher's One Lambda unit has been the go-to player for pre-transplantation testing (such as HLA) for decades but have lacked a product for post-transplantation monitoring. Hence the contract signed with Devyser. We believe Devyser could see accelerating growth rates from the >35% seen in Q3 as it enters 2024, and with gross margins above 85% the path to profitability looks certain.





Frog in water – Policy failure and the collapse of renewables

As the theory goes, if you toss a frog in boiling water, it would immediately jump out of the pan, avoiding certain death. Put in tepid water, which is brought to the boil only slowly, the danger is less perceptible, and the frog remains until properly boiled.

Psychologically this makes sense. If our living conditions deteriorate gradually, we adapt instead of acting decisively, until the situation becomes grave and it is too late to address the underlying causes.

This syndrome partly explains why stocks of renewable energy companies have had a terrible time recently. As we are painfully aware, greentech companies enjoyed a period of provoking valuations, buoyed by free money and the entire asset management industry herding towards ESG-branded investment products. Demand for thematic investment outpaced the supply of reasonable businesses – leading to sub-par capital allocation, obvious in hindsight when rising interest rates turned the spotlight to cash flows, and inflation revealed the capital intensity and absolute lack of pricing power in many green business models.

But who is the boiling frog in this context?

I think it is us. Mankind. We're literally about to be boiled. There is less and less controversy around the fact that temperatures and water levels are rising. But. It. Is. Happening. Only. Slowly.
Many are concerned – why else invest in ESG-funds, recycle garbage, or buy an electric vehicle– but when it becomes painful to change, when push comes to shove, when mortgage payments are due, the premium we pay to be "green" is suddenly too expensive. Renewable businesses with high up-front investments and long pay-back, dependent to varying degrees on whimsical political support, are ill suited for a *cash-flow-now!* environment.

Did the water just become a bit warmer?

The degradation of nature is a negative externality; an indirect social cost that is not accounted for in the private price of the product. Capitalism is poorly suited to correct for externalities. That's why externalities are prime examples of market failures.

The priority that was easy to make when it only involved the convenient and non-controversial choice to "invest in an ESG-branded fund" takes the back seat when green stocks and funds are the worst performers of all in 2023. Now imagine what happens when your choice to make a difference involves real inconvenience. Like triple-the-price airplane tickets, a steep CO2 tax on beef or eye-watering electricity prices. That is when you get public outcry and a populist back-lash like the one we're currently in the midst of. I note, as but a few examples, how Sweden has backtracked on its ambitious blending mandate, how the UK has tuned down its renewables ambition, how a Dutch politician promising less ambitious environmental policies won a landslide election victory, how Trump is the US frontrunner for President with basically a reverse green agenda etc, etc.

Sadly, denying the problem does not make it go away. There are areas prone to land slides that no insurance company wants to insure. There are more incidences of violent weather. More floodings. Higher temperatures. Record temperatures. Environmental migration comes next.

Did the lukewarm pan we're swimming in just become a tad uncomfortable?

How uncomfortable do we need to become to take real action? Action beyond ticking the ESG-box when picking a fund? I think and hope we will come to our senses sooner rather than later.

As a fund manager, pre-occupied with allocating capital where it creates the best possible return per given unit of risk, it is not our place to make bets on hopes and dreams. It is however our place to have a view on where the world is heading – and I think we're heading for a system where we better capture the externalities of environmental degradation. If you look hard enough you can already see tendencies of cooler heads prevailing:

- The UK has significantly increased the electricity price offered to offshore windfarm developers in the 6th annual round of CFD auctions and the recent autumn budget extended capital allowances to the industry.
- In the US, the State of New Jersey has raised price indications in the ongoing negotiations on take-off agreements.
- The State of New York has allowed contract changes with higher prices and inflation adjustments.

Basically, there is a growing political will to fix the economics of renewable developers that have collapsed in the past two years, but equity investors are myopic and appear to price a significant policy discount. Which is fair, betting on politics being rational and sensible is rarely a wise wager. But our take is that perhaps we're in the midst of a bottoming process. Peak populism?

Is the frog becoming aware the temperature is rising?

Where does that leave the listed equities in the space? **Orsted** is being held up as a prime example of the failed business model of yore. Empire builders as they are (what is it with the Danes and aiming for world domination?!) they set themselves extremely ambitious global growth targets and promptly started multiple massive decade-long projects building offshore windfarms. As economics deteriorated, more and more of these projects have become unprofitable, and Orsted's balance sheet now bears more resemblance to a Swiss cheese than a bank vault. Cue soul searching.

The company now promises to come up with a "new strategy" within a few weeks. I venture it will not be an aggressive growth strategy. Maybe it will re-focus the company back to Europe, where there is a developed supply chain and half-decent political support schemes? Maybe they will ditch a project or two – which would actually solve the balance sheet question, considering the tens of billions of investment needed over several years to get a big wind farm going.

Given where the equity trades, there is negative value attached to the pipeline of projects. Only the current portfolio is likely worth more than the entire market cap. Food for thought, that. The market fears a status quo ambition and a substantial equity issue to fund the old growth plans. This is a short-term issue. The long-term issue is that the temperature in the pan keeps rising ever so slowly...

Jump.

Ramil's Corner – The Hidden Power of Inflection Points and Positioning

In our August 2023 Partner Letter introduction, I emphasised my adaptable and non-dogmatic approach, focusing on incremental factors influencing share prices. These can be singular data points, either arguable or indisputable, capable of reshaping a company's long-term trajectory. It is a game of probabilities and investing necessitates recognising fundamental shifts in a company, sector, or market narrative. When assigned probabilities see sudden sustained shifts, inter alia inflection points happen, oftentimes share prices move rapidly. This is painful if you are a shareholder seeing the stock go "the other way", but equally it is a big opportunity if one ex-ante has done work and think that there is an impending shift of probabilities.

Bear with me and I'll rid you of the word salad and instead dig deeper into what we mean. But first let me conclude this: in the realm of fund management, where the ability to generate superior returns independent of paradigm is the ultimate measure of success, our emphasis on identifying inflection points is not merely a tactical choice but a strategic imperative.

Inverse the current inverse

Let's face it. In 2021, amid the ZIRP frenzy, tech analysts, including myself, engaged in a race to provide the loftiest estimates and target prices. Growth projections were extended, considerations of longevity and unit economics took precedence, and capital returns were relegated to a secondary concern. We were selectively pursuing datapoints with a bias towards positivity, sweeping any negative indicators under the rug. Those who didn't conform risked losing their reputation as sensible stockpickers.

While I may be exaggerating a bit, the essential point remains: we often assume that the current situation is the new normal, even though deep down, we know it isn't. **Today, we observe numerous cases, including many in our portfolio, where people confuse cyclical trends with structural shifts.** Questions arise, such as whether Nordic listed ads businesses are truly sustainable, if consumers will continue purchasing electronics as before, or whether geared companies can organically deleverage. In essence, the argument is that these issues are more structural than cyclical. Traditionally, Mr. Market pays peak multiples for trough earnings and vice versa. This explains why Maersk seemed so inexpensive last year or why certain industrials appear costly now (consider Stora Enso at a 52x 2023E PER). So, what's Protean's perspective on this? Well, we believe companies considered structurally challenged – indicated by low multiples and a weakened market outlook – offer an excellent starting point if we tilt to the its-cyclical-and-not-structural-camp. If and when these stocks shift from being perceived as structurally problematic to merely cyclical, both estimates ("it wasn't structural, so we need to revise estimates upwards") and multiples ("it wasn't structural, so risk premia decreases") move upward together. It's a powerful dynamic.

Take **Addlife** as an example, where the movement following neutral Q3 numbers illustrates what happens when concerns about a share issue are alleviated. Considering positioning (investors were underweight going into the numbers, and it changed hands at double-digit FCF yields pre-Q3), coupled with Addlife's past status as an investor darling, the ascent was swift. However, we believe the opportunity extends beyond Addlife. Below, we highlight a few cases that have recently captured our attention.

Acast: Structural or cyclical?

Does serving as a marketplace for podcasters and advertisers spell trouble when the latter decides to tighten their purse strings? Most likely. However, Acast has defied the odds, boasting a robust 16% organic growth year-to-date. Furthermore, gross margins have seen a healthy increase of over 5pp year-to-date, adjusting for write-downs related to over-optimistic contracts signed in 2020-22 wherein Acast guaranteed creators minimum revenues without anticipating the ad market challenges of 2023.

Despite these hurdles, Acast has made significant strides toward enhancing profitability, showcasing an adjusted EBIT of SEK -21m and operational cash flow of SEK -20m in Q3/23 – a stark improvement compared to the SEK -90m and SEK -96m, respectively, in Q3/22. So, if you lean towards the belief that these challenges are more cyclical than structural, you'd likely anticipate a double hit from lower prices combined with challenges arising from less profitable (or unprofitable) contracts. Assuming improvements in one, or both of these, aspects (for instance, Acast signing fewer minimum guarantee contracts or the ad market bouncing back), one can reasonably expect accelerated revenue growth, with a clear path to profitability and cash generation on the horizon.

Notably, the EV/S ratio for the next year has shrunk from 1.5x at the end of 2021 to a mere 0.4x today. Are we witnessing a **trough multiple on trough earnings**? It appears so, and there are several promising inflection points on the horizon, including the potential for growth re-acceleration, the positive impact of gross margin expansion reflected in the reported P&L with additional upside, and the promising prospects of achieving profitability and cash generation.

Dustin: Structural or cyclical?

Dustin has seemingly navigated a series of challenging decisions in recent years. In the midst of the rush to acquire IT equipment for remote work setups, the company opted to redirect funds into a EUR 425m acquisition, securing a strong presence in the Benelux markets but at the expense of stretching its balance sheet. Complicating matters, the company faced the reversal of pandemic-driven boosts, resulting in five consecutive quarters of negative organic growth in its SMB segment. On top of that, the loss of a significant public contract in Denmark, the extension of IT replacement cycles by large corporate customers for cost efficiency and operating with an inflated cost and capex base from merger initiatives and automation efforts, added to the challenges.

In an effort to address these issues and ease pressure on the balance sheet, the company successfully concluded a rights issue in November, effectively reducing leverage from 5x EBITDA to a more manageable 3x. As we approach 2024, the outlook for Dustin is poised for improvement. The replacement cycles stemming from pandemic-induced IT purchases are expected to kick in, bringing a positive trend in demand. The impact of the lost Danish public contract will gradually integrate into the comparative base, cost-saving initiatives are anticipated to show results, and capex is projected to stabilise.

This trajectory implies that Dustin, once an investor darling turned, could undergo a journey not too dissimilar from that of Addlife. The presence of inflection points and optionality makes it an appealing case.

Demant: Structural or cyclical?

Inflection points often hinge on perceptions and strategic positioning, and Demant serves as a prime illustration of this dynamic. Boasting substantial outperformance compared to peers year-to-date, both in stock performance and financials, Demant's success is attributed to market share gains from its struggling competitor Sonova. However, there is a growing narrative that these gains in 2023 might transform into losses in 2024.

Following discussions with market participants and fellow investors, our assessment leans towards scepticism about such a scenario unfolding. Intriguingly, an international bank's recent survey of audiologists revealed that these professionals do not anticipate Demant experiencing significant market share losses in the next six months. Despite this feedback, the report concludes that Sonova is favoured in their pecking order due to the expectation of substantial market share gains in 2024. The rationale behind this preference remains elusive.

This leaves me grappling with the situation. On one hand, I lack a clear perspective on market share fluctuations in 2024, aside from the usual variations around new platform launches, suggesting an optimistic outlook for Demant's growth alongside the market. On the other hand, acknowledging Demant's 30pp outperformance against Sonova year-to-date raises the spectre of mean reversion, prompting a shift in positioning towards the latter. Indeed, this shift has already transpired in the last month, with Sonova outperforming Demant by 11pp.

The inflection point we seek hinges on whether Demant can effectively retain its market share, necessitating a patient observation over the next few months, with the inherent risk of continued repositioning. Regardless, we acknowledge our lack of a competitive advantage in predicting this impending inflection point and, therefore, prefer to observe the situation unfold from a distance. *And the trick in investing is to the sit there and wait for pitch after pitch to go by. And wait for the one right in your sweet spot, and the people are yelling "swing you bum" – ignore them!*

The monthly reminder

We optimise for performance, not for convenience, size, or marketing.
You can withdraw money only quarterly (monthly in Small Cap).
We will tell you very little about our holdings.
Our strategy is tricky to describe as we aim to be versatile.
A hedge fund can lose money even if markets are up.
We charge a performance fee if we do well.
You do not get a discount if you have a larger sum to invest.
We do not have a long track record.

Thank you for being an investor.

Pontus Dackmo
CEO & Investment Manager
Protean Funds Scandinavia AB