DEVON Equity Management

Global Opportunities Fund: Investment Letter – Q4 2020

Foreword

Since this represents the inaugural letter of the Devon Global Opportunities Fund, I will make a couple of comments on the structure and purpose of this and all future communications:

The investment letter will be published on a Quarterly basis. The purpose of the letter is to both update investors on the performance in the preceding period and offer insights into existing or new positions. I will try to strike a balance between addressing the largest positions in the portfolio (given their relative importance to returns) and commenting on those positions providing the greatest return in the period (positive and negative).

Reflecting our investment approach, the letter will focus on company specific issues, and generally avoid market commentary or discussing macro events. This is not because we think market and macro issues to be unimportant, rather that there exists a vast quantity of excellent material in these areas – whereas our thoughts on specific investments in The Fund are more unique to Devon.

Investment Letter

The Fund returned 14.6% in the period.[1]

Illumina (ILMN US), the largest position in the fund (7.1% of NAV) returned 23%.

The company announced the acquisition of GRAIL for US$8bn in September. The market initially received this deal badly, with the stock declining 30% from its August peak. There are three main reasons for the negative reaction to the deal: (i) the somewhat complicated history between Illumina and GRAIL (ii) the question of whether the deal brings Illumina into direct competition with some of its key customers (iii) the price.

Some of these concerns are valid, but in my view these are more than offset by the opportunity to become a world leader in liquid biopsy.

The core gene sequencing business of Illumina exhibits many of the attractive qualities we look for in a large holding (dominant player in a market with excellent long-term growth prospects; high barriers to entry; large component of recurring revenue). On balance, the acquisition of GRAIL strengthens the investment case over the long term, and so the negative share price reaction represented a compelling opportunity to establish Illumina as the largest position in The Fund.

To provide some context, GRAIL was founded in 2015 and majority owned by Illumina. In 2016 Illumina took the 'strategic' decision to spin-off the business, retaining a minority stake plus royalty on future revenue. This move signalled Illumina's intention to step back from directly owning and operating a business which could bring them into direct competition with some of their customers (Liquid Biopsy players such as Guardant Health are heavy users of Illumina's gene sequencing machines).

Clearly, the decision to acquire 100% of GRAIL less than 5 years later marks a (relatively abrupt) U-turn, and ultimately a change of heart on the customer / competitor dynamic. The change of heart is not only strategic, but also expensive: having allowed themselves to be diluted down to a 15% stake, Illumina are buying back at a much higher price.

[1] Since Inception (4th Nov 2020), Net of all fees and expenses

Turning to the positives.

GRAIL are world leaders in the liquid biopsy market. Specifically, their *Galleri* test (currently in advanced clinical trials) tests for 50 different types of cancer in a single blood draw. 45 of these 50 cancers currently have no early detection tests available. The earlier cancer is detected the higher chance of successful treatment. If commercialised successfully, the *Galleri* test could revolutionise the way we screen for cancer.

Results from the two largest trials are due to be released in the first half of 2021. If the data is positive, the ambition is to launch the test before year end. The management team put the initial target market at 50 million patients in the US. Though the 2021 timeline sounds a little ambitious, if the test proves to be sufficiently accurate the addressable patient population on a global basis is many multiples of this 50mn number.

Beyond early detection (an enormous market in itself), GRAIL see potential for their products to be applied in the Minimal Residual Disease (MRD) setting. This is the most advanced area in liquid biopsy and represents a logical extension of GRAIL's products (same principle, different setting).

Illumina are globally dominant in Next Generation Sequencing (NGS). This market has substantial growth potential and will be the primary driver of Illumina's fortunes in the near term. However, since Illumina's attempted acquisition of Pacific Bio (PACB US) was blocked on competition grounds, it is clear any inorganic growth must come outside of Illumina's core sequencing market. Liquid Biopsy is a good fit with enormous potential, and in GRAIL Illumina have acquired a known quantity with a strong pipeline.

Though imperfectly handled, on balance I see the opportunities presented by GRAIL outweighing the risks – rendering the substantial decline in the share price an attractive opportunity.

Fiserv (FISV US), another top 5 holding (5.4% of NAV), returned 13% in the period.

Fiserv is integral to the digitisation of payments and banking – facilitating payments and the movement of money for businesses and financial institutions globally. The global payments industry, complex and historically fragmented, is undergoing a wave of consolidation. This is entirely rational in an industry where scale and reach proffer significant advantage.

Fiserv has been at the forefront of consolidation, culminating in their 2019 acquisition of First Data (FDN US) in an all-stock transaction worth US$22bn. Fiserv and First Data are an excellent fit – with Fiserv's longstanding strength in payments complimented by First Data's merchant acceptance business (which provides the technology for businesses to accept both online and in-store payments).

The power of the combination is evident in the substantial synergies generated by the deal (latest management estimates of $600mn revenue synergies / US$1.2bn of cost synergies).

The merged entity will be ideally placed to benefit from a number of powerful trends:

(1) Transactions moving from cash to card and digital represents the single biggest tailwind for Fiserv. Rates of change vary significantly by country and demographic, but the trend away from cash payments is structural and has many years to run. This underpins growth in the core payments business.

(2) The proliferation of peer-to-peer payments (P2P): Square (SQ US)'s *Cash App* and PayPal's *Venmo* have been the two high profile drivers of P2P payments in the US, which has become the fastest growing segment in payments. Though less widely recognised, *Zelle* plays an equally prominent role, on course to process over US$300bn of transaction volume in 2020 (approximately double *Venmo's* volumes). Fiserv plays a critical role behind the scenes, providing a turnkey solution enabling financial institutions to offer

P2P payment via *Zelle*, with over 1,000 clients expected to be live by the end of 2021 (double the current client base).

(3) Digitisation of Banking: The growing proliferation and success of Fintechs is forcing incumbent banks and financial services companies to accelerate their digital transformation, overhauling systems and procedures of varying levels of antiquity. As the provider of the core 'plumbing' essential to any such transformation, Fiserv stand to benefit from digital spend by both disruptors and disrupted.

Whilst Fiserv lacks some of the 'glamour' of Square (SQ US) or Adyen (ADYEN NA), we think it represents a compelling proposition to gain exposure to the secular trends in the payments industry outlined above. Specifically, customer concentration and churn are low – Fiserv provide the 'pipes and plumbing' to a complex industry where switching is difficult and costly. Finally, Fiserv is an exceptionally well managed, cash generative business: over the next 5 years, management expect to generate US$25bn of free cash flow (to be used for acquisitions, dividends, and share buybacks). This equates to an annualised free cash flow yield in excess of 6%.

With the potential to compound earnings at mid-high teens for the next five years, we think 20x P/E represents excellent value, especially when compared to global comps in the payments industry.

Reflecting our constructive view of the industry, the Fund has further exposure via holdings in Visa (3.0% of NAV) and Tencent (2.1% of NAV).

Palo Alto Networks (PANW US), a global leader in cyber security, was the best performing position during the period, returning 55%.

Across all industries, a growing share of workloads are moving from traditional enterprise servers to the cloud. This is a structural trend (accelerated by the pandemic) that will continue for many years. Within this broad shift there exists a multitude of 'interim' and 'hybrid' solutions, where companies operate a hybrid of enterprise server, private and public cloud business models.

This growing complexity creates an infinitely larger attack surface for hackers to target (and cyber security to defend).

In recognition of this, there is a healthy debate within the cyber security industry over the extent to which legacy firewall security architecture (the backbone of cyber security in the enterprise server world) is redundant in a hybrid and/or fully cloud based world.

Palo Alto Networks is one of the leading enterprise firewall security providers. Since the appointment of Nikesh Arora as CEO in June 2018, the company have focused on building a fully integrated cybersecurity solution, offering a cloud-based system alongside their traditional firewall offering.

For a combination of regulatory, privacy, and business reasons, Palo Alto's management are confident most large corporates will not fully migrate to the public cloud in the foreseeable future. In recognition of this, they argue the hybrid enterprise / cloud solution offered by PANW represents the most compelling option for many businesses (especially large, complex corporates).

ZScaler (ZS US) sit at the other end of the spectrum. A precocious 'cloud native' cybersecurity firm with an entirely cloud based solution, ZS are emphatic that cloud-based cybersecurity must be based on 'zero trust' architecture: an adapted 'firewall' type model simply cannot compete.

New business for both companies has accelerated in 2020; customer reviews and expert opinions point to merits in both approaches.

All things considered, I am of the view this is unlikely to be a winner takes all market, with room for both solutions to thrive in the coming years.

The more important conclusion is our conviction in the structural growth of cyber security spend, as the move to the cloud (full or hybrid) adds an enormous amount of complexity and risk.

In recognition of this, the Fund holds positions in both Palo Alto Networks (2.4% of NAV) and ZScaler (1.6% of NAV).

Finally, a comment on Xiaomi (1810 HK) – which returned 43% if the period (and represents 4.9% of NAV).

Huawei has become the symbol of the US-led clampdown on Chinese technology companies. The issues are complex, but ultimately Huawei has been denied access to Western technology critical to the production of smartphones and 5G telecom equipment. Reflecting these restrictions, Huawei are rapidly retrenching from the global smartphone market (paring back global ambitions, selling their lower end Honour brand to an unlikely consortium led by the Shenzhen local government).

Xiaomi are the prime beneficiary.

Recent market share gains underline the opportunity ahead for Xiaomi. Their success in the mid-tier smartphone market in China, India, SE Asia, and parts of Europe reflects both product quality and improving brand perception. In 2021 we think Xiaomi could replicate this success at the high-end of the market. The pressures on Huawei clearly help, but more importantly Xiaomi's strong relationship with Qualcomm provides primary access to Qualcomm's new flagship 5G chips, equipping Xiaomi with the technology to offer the best quality 5G android device on the market (Xiaomi unveiled their flagship *Mi 11* model on 29th December, the first smartphone powered by Qualcomm's Snapdragon 888 chip).

Market share gains in smartphones are important, but the 'second order effects' of these gains are longer lasting and materially underappreciated. Specifically, high margin *Internet Services* revenue lags smartphone unit sales by circa. Six months.

Over the next 2-3 years, we expect Xiaomi to continue to make rapid progress in developing products and services beyond their core smartphone handset business.

Investment Outlook

We have a strong, diverse pipeline of investment ideas. Competition for capital amongst existing and prospective positions is fierce, a healthy situation which I hope will remain a feature of the Devon Global Opportunities Fund.

Considering possible highlights in 2021, we think the upgrade to 400G Ethernet is underappreciated, and combined with the release of Intel's next generation Ice Lake processors, will be a significant catalyst for a renewed investment cycle in the data centre. Our investments in Accton (2345 TT), SK Hynix (000660 KS), and TSMC (2330 TT) would all benefit from this development.

More broadly, some of the features of the COVID-19 business and consumer environment may prove surprisingly enduring into 2021 and beyond.

Cybersecurity (as outlined above) would certainly fall into this camp.

E-commerce would be another prime candidate. In my view the pandemic accelerated an already well-established trend (the move from offline to online retail). I consider South East Asia amongst the most exciting e-commerce opportunities globally, since the ability to provide both rapid, reliable fulfilment and digital payments has finally reached an inflection point. This unlocks a growing proportion of an addressable population well in excess of 500mn people.

The Fund has a position in SEA (SE US), who operate the largest e-commerce platform in the region (*Shopee*), and benefit from a highly cash generative gaming business to help fund growth in e-commerce, payments, and other digital businesses.

Finally, I expect much of the boom in spending on life sciences equipment and testing to prove longer lasting than many anticipate. This extends to medical research, drug, and vaccine development, and is reflected by our large positions in IQVIA (IQV US) and Thermo Fisher (TMO US).

On the other side of the coin, we must consider what consumer demand looks like with a successful vaccine rollout and a 'normalising' environment: not an impossible scenario by the middle of 2021. Our positions in Marriott (MAR US), Dufry (DUFN SW), Comcast (CMCSA US), and RELX (REL LN) would all be notable beneficiaries of such an outcome.

In general, we do not try to tilt the portfolio to a particular style (or region) based on top-down predictions. Rather, we try to find a diverse blend of exciting bottom-up stories which we expect to deliver excellent operating performance over the next five years.

Weighing how each of our 33 investee companies might look in 2025 vs today, I am excited about the multitude of opportunities on offer.

Charlie Southern

4th January 2021

Global Opportunities Fund: Key Statistics

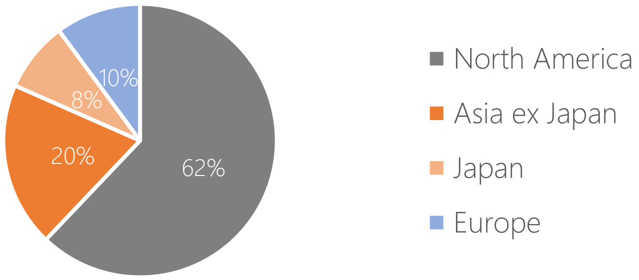
Performance

	QTD	YTD	1 Year	3 Year	5 Year	Since Inception
Fund[2]	14.6%	14.6%				14.6%
Benchmark[3]	11.9%	11.9%				11.9%
Relative	*+2.7%*	*+2.7%*				*+2.7%*

Liquidity

Market Cap	No. of Positions	% of NAV	ADV (NAV weighted)
Small (< US$1bn)	0	0%	
Mid (< US$20bn)	5	8%	US$50mn
Large (> US$20bn)	23	78%	US$375mn
Mega (> US$200bn)	5	14%	US$977mn
Total	33	100%	
Weighted Average		US$118bn	US$397mn
Median		US$53bn	US$312mn

Geographic Allocation



Top 10 Holdings

Company	Country	% of NAV
Illumina	US	7.1%
Cadence Design Systems	US	6.9%
IQVIA Holdings	US	6.5%
Fiserv	US	5.4%
Thermo Fisher Scientific	US	5.3%
Xiaomi	China	4.9%
Moody's	US	4.5%
Infineon Technologies	Germany	3.7%
Keyence	Japan	3.3%
TSMC	Taiwan	3.2%

[2] NAV per share, Net of all fees and expenses: 4th November – 31st December (Source: JP Morgan)
[3] MSCI AC World Net Total Return in USD (NDDUWI Index)

DISCLAIMER

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