

DEVON Equity Management

Global Opportunities Fund: Investment Letter – Q1 2021

The Fund returned -2.1% in the quarter.¹

Portfolio Construction

Since mid-February a number of our core positions experienced drawdowns. Without exception, these moves were driven by style rotation in the broader market.

Reflecting our undiminished confidence in these businesses, we increased our positions in Cadence, Synopsys, Hoya, Keyence, and Accton.

Additionally, we established positions in Square, GMO Payments, and Nvidia, which de-rated on unchanged (or in the case of NVIDIA materially better) long term prospects.

Instead of trying to rehash the rates, reflation, or reopening thesis to explain possible drivers of market sentiment, we will devote the column inches to the future of *Autos* and *Electronic Design Automation (EDA)*, two important themes in The Fund.

Autos

We expect Electrification and Autonomy to be multi-decade trends.

As it relates to the power train, the die is cast: the passenger vehicle market is going electric, the debate is how quickly. The path towards full autonomy is less certain, but the trend towards greater ADAS (Advanced Driver Assistance Systems) is undeniable.

These trends have two major implications:

- 1) The move to fully electric cars (with or without a stop at the hybrid 'halfway house') places battery technology at the centre of the automakers' strategy.
- 2) Both electrification and moving up the 'autonomy curve' involve a massive increase in silicon chips and software content per vehicle.

Few companies dominate the narrative on a specific investment theme quite like **Tesla (TSLA US)** in electric vehicles. Until recently, Tesla was the only game in town, reflected in an astonishing ascent to a \$675bn Market Cap by the end of 2020: larger than Toyota, Volkswagen, Ford, Daimler, GM, BMW, Nissan, Honda, Hyundai, Kia, and Fiat Chrysler² combined – not bad considering Tesla sold 500,000 cars in 2020 vs in excess of 50 million³ from the aforementioned 'dinosaur collective'.

Clearly on an EV/Car basis, the market values the sale of a Tesla Model 3 in a different stratosphere from a VW Golf.

One could offer a multitude of reasons why this is the case, most obviously the simple fact that Tesla was first to market with a product which revolutionised the manufacturing, cost structure, interior, and carbon emissions of

¹ December 31st 2020 – March 31st 2021 (net of all fees and expenses)

² Now Stellantis

³ Estimate for 2020 (combined Sales of 65mn cars in 2019)

the passenger car. A powerful brand with revolutionary technology and styling, who can offer a cost competitive battery powered car with its combustion engine equivalent – what not to like?

Of equal importance, the cost roadmap and increasing role of silicon chips and software (much of it internally developed by Tesla) point to long term operating margin ambitions of ~40%. For context, passenger cars are a ~5% margin business for the dinosaurs (in a good year).

With market penetration below 2% it is easy to see the appeal. Notwithstanding, we can't quite get to the trillion-dollar valuation required for a multi-year investment to make sense at the current juncture.

Rather, we think the electrification opportunity looks exciting at **Volkswagen (2.1% of NAV)**. The company set out their long-term strategy at the recent *Power Day*, committing to bring battery manufacturing in-house. This is a significant move. Tesla currently stand alone in their internal battery capability (via a JV with Panasonic). The rest of the auto industry sources from external Korean and Chinese battery manufacturers. Lowering the cost per kw of the battery is the single biggest driver of cost in an electric car. Chemistry, cell packaging, The Battery Management System, and manufacturing scale all play an important role within this cost down equation. VW have recognised these are critical components of IP in an electric world, so insourcing represents an important (and in our view necessary) strategic decision. We expect this transition will take 10-20 years.

In the meantime, VW will continue to rely on external suppliers (notably LG Chem and CATL) to power their growing electric vehicle line-up. The VW group has excellent brands. Over the next 2 years the line-up of EVs across price points and markets will be unrecognisable from the quirky but ultimately niche offerings of the last decade. Indeed the recently launched VW ID.3 and Audi e-tron are a sign of things to come: mainstream models at relevant price points will become increasingly prevalent across the globe.

Tesla are in the lead, but we think electric vehicles will transform the perception and earnings profile of VW in the coming years. Whilst our investment is predicated entirely on fundamentals, it would be remiss not to highlight the valuation discrepancy between the two companies, with VW on 8x P/E vs Tesla on 150x.

Though electrification is the more visible trend in the auto market today, the increase in semiconductor and software content is arguably the better opportunity from an investment perspective. In **Infineon (3.5% of NAV)**, we have an investment which straddles both. As a leader in power and automotive semiconductors (bolstered by their recent acquisition of Cypress), Infineon are ideally positioned to benefit from the move to both electric powertrains and more advanced driver assistance (ADAS).

Simplistically – Infineon estimate their dollar content per vehicle increases by 100% in an electric vs petrol car. Separately, the bill of materials (BOM) in a car with 'Level 2' autonomy (which can be considered advanced ADAS) is US\$160-180. This increases over 500% (US\$1,000-1,250) in a Level 4/5 vehicle (approaching full autonomous capability). Whilst the pace at which we move towards full autonomy is uncertain, a modest scenario involving Level 2 / 2+ becoming industry standard over the course of the coming decade would represent a significant expansion of Infineon's auto TAM.

For Infineon, even if aggregate passenger car sales remain flat over the next decade, the content gains driven by electrification and autonomy can be a significant earnings driver for their core auto semiconductor business (43% of sales).

Electronic Design Automation (EDA)

In reports analysing NVIDIA's pending acquisition of ARM, the company is often labelled '*The Switzerland of chips*'.

One of the key reasons chip designers like working with ARM is the lack of a customer / competitor dynamic, giving designers the confidence to share detailed proprietary product roadmaps. Such value placed on

independence is evident throughout the semiconductor industry (consider TSMC's success in Foundry vs Samsung and Intel), and from the perspective of ARM customers it is difficult to see how NVIDIA ownership could be viewed as a positive.

As shareholders of **NVIDIA (2.1% of NAV)**, we would love to see the deal receive regulatory approval (though think it will prove difficult). Nvidia + ARM represents a formidable proposition to challenge Intel's longstanding stranglehold on the data centre. Intel's manufacturing missteps of recent years has opened the door to competitors, something customers are likely to actively embrace given (i) Intel's outsized margins and (ii) the entirely rational preference for competition > monopoly when presented with a straight choice.

AMD has been the prime beneficiary to date, yet over the next decade ARM based servers may come to offer another credible alternative to Intel x86 architecture in the data centre market.

Beyond CPUs, if NVIDIA's acquisition of ARM can survive multi-jurisdictional regulatory scrutiny, we could see an acceleration in the trend towards ARM based DPUs becoming the 'third leg' of the new data centre computing model (alongside CPUs and GPUs). Approaching this market via an ARM based licencing model, NVIDIA may be ideally placed to partner with key hyperscale customers on developing CPU / DPU whilst ensuring optimised performance of such products with NVIDIA's own GPUs.

Whilst ARM's role as *The Switzerland of chips* may be numbered, we think **Cadence (7.7% of NAV)** and **Synopsys (2.9% of NAV)** play an equally important but far less appreciated role in the *neutral zone* of the global semiconductor industry.

Cadence and Synopsys are the two leading EDA companies globally, providing the software and tools for the design, verification, simulation and testing of chips. Both companies also possess substantial IP libraries licenced under a similar model to ARM (though unlike ARM neither company are overly reliant on smartphone or any other single end market).

Rather, the two companies are exposed to aggregate growth in both the volume and complexity of semiconductors.

Increased computing power demands greater complexity in chip design:

The big five logic / memory manufacturers are the largest customers for EDA companies, with revenue tied to their aggregate R&D spend. Given the complexity of design associated with EUV (sub 7nm) process nodes and the 10-year roadmap for continued shrink in manufacturing, we think R&D spend will continue to increase regardless of any fluctuations in end market demand.

Cadence and Synopsys are critical partners for chip manufacturers to execute on exceptionally complicated and time critical product roadmaps. Intel's unsuccessful attempt to differentiate from competition via the use of Gate All Around (GAA) transistor structure at 10nm has proved costly. This experience underlines the fragility of technology leadership in an industry defined by ~2-year product cycles. With so much at stake, we think the risk of a large customer taking a punt on unproven EDA tools unlikely.

The proliferation of chip design beyond traditional design houses:

In the smartphone world, over the past decade Apple and Huawei (via HiSilicon) have designed their mobile CPUs in-house. This was made possible by the growing strength of Foundry manufacturing capability (powered by TSMC). Beyond these high-profile examples, the growth in both availability and quality of Foundry capacity (across leading and lagging nodes) has allowed Fabless design companies to proliferate and thrive. With technological leadership sitting with a Foundry (TSMC) rather than IDM (Intel), the market for chip design has opened up to a much broader set of market participants.

This is evident in the recent activities of the Hyperscale data centre providers, with Amazon, Google, Facebook, Alibaba and others hiring engineers to design their own chips.

All of this activity reflects a 'fragmentation' of chip design, a big structural tailwind for the EDA industry since every design engineer needs access to the tools offered by Cadence and Synopsys.

For the same reason, the rise of a domestic chip industry in China has emerged as a significant source of incremental demand for EDA, with the Chinese government playing a leading role in promoting this development. As part of the escalating technology race between China and the US (and the nationalistic approach to post-COVID recovery schemes elsewhere), we now observe a similar trend emerging in the US, Europe, and Japan. Whilst headline numbers should typically be treated with an abundance of caution, recent announcements from the EU (\$145bn) and the US (\$100bn) point to sustained State led investment into cutting edge semiconductor research and design on an unprecedented Global scale.

All considered, in Cadence and Synopsys we see two rational, well managed companies leading an industry which stands to benefit from sustained, non-discretionary investment into semiconductor R&D, design, and manufacturing.

Investment Outlook

Reviewing the investment letter for Q4 2020, the following statement in the corresponding *Outlook* section stands out:

Some of the features of the COVID-19 business and consumer environment may prove surprisingly enduring into 2021 and beyond.

Recent price action challenges the wisdom of this prediction. Yet if we consider the operating outlook for our portfolio companies perceived to be 'COVID winners', on-balance near-term prospects have improved vs December 2020.

In any event, this is not our time horizon for investment.

If our judgement of the exceptional nature of our portfolio companies proves broadly correct, fundamentals will trump (and ultimately drive) sentiment in the long term.

Charlie Southern

9th April 2021

Global Opportunities Fund: Key Statistics

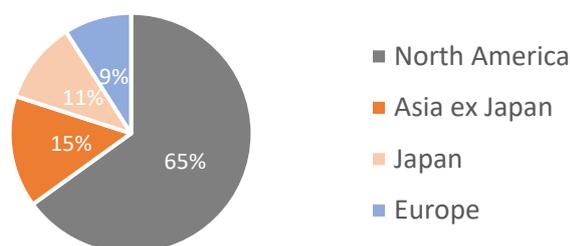
Performance

	2021 YTD ⁴	2020 ⁵	1 Year	3 Year	5 Year	Since Inception ⁶
Fund⁷	2.9%	14.6%				17.9%
Benchmark⁸	7.1%	11.9%				19.8%
Relative	-4.2%	+2.8%				-1.9%

Liquidity

Market Cap	No. of Positions	% of NAV	ADV
Small (< US\$1bn)	1	2%	US\$2mn
Mid (< US\$20bn)	3	6%	US\$41mn
Large (> US\$20bn)	22	76%	US\$522mn
Mega (> US\$200bn)	6	17%	US\$2,008mn
Total	32	100%	
NAV Weighted Average	US\$138bn		US\$680mn
Median	US\$59bn		US\$406mn

Geographic Allocation



Top 10 Holdings

Company	Country	% of NAV
Cadence Design Systems	US	7.7
Thermo Fisher Scientific	US	6.4
IQVIA Holdings	US	6.3
Fiserv	US	5.4
Illumina	US	5.2
Moody's	US	4.8
Eli Lilly	US	4.6
SK Hynix	S. Korea	4.2
Visa	US	4.1
Infineon Technologies	Germany	3.5

⁴ Latest NAV: 7th April 2021 (Source: JP Morgan)

⁵ NAV per share, Net of all fees and expenses: 4th November – 31st December 2020 (Source: JP Morgan)

⁶ NAV per share, Net of all fees and expenses: 4th November 2020 – 7th April 2021 (Source: JP Morgan)

⁷ NAV per share, Net of all fees and expenses

⁸ MSCI AC World Net Total Return in USD (NDDUWI Index)

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