

DEVON Equity Management

Global Opportunities Fund: Investment Letter – Q3 2021

The Fund returned 1.4% in the quarter.¹

Darktrace

The shares have appreciated 230% since the IPO in April 2021, representing our top contributor to performance.

The core attraction of Darktrace is their 'inside out' approach to cybersecurity.

Traditional cybersecurity products (both firewall and endpoint) could be characterised as 'outside in', meaning they typically identify potential threats based on what previous threats have looked like. Darktrace's *Enterprise Immune System* takes the opposite approach, analysing the historical patterns of a network to train the algorithm to learn how a network **should** operate during the normal course of business, flagging activity which looks unusual vs the network's historical operating patterns.

Artificial Intelligence (AI) and Machine Learning (ML) are two of the most overused buzzwords in the corporate lexicon, but for Darktrace the self-learning nature of the *Immune System* product is a genuinely powerful selling point, since the product inherently improves as the data set expands.

In terms of product development, as the product is rolled out to more customers the collective experience of analysing a larger number of networks should allow for better understanding of 'normal' and a more targeted approach to identifying potential threats (i.e. the algorithms get better).

From the perspective of an individual customer, the user experience improves as the *Immune System* gains experience in analysing a specific network over longer time periods, allowing more precise identification of actual threats (i.e. fewer red flags with a better hit rate).

Beyond the core *Immune System* product (Detection), Darktrace have built complimentary products which help with the response to potential threats identified (*Antigena, Cyber AI Analyst*). The future product roadmap envisages a comprehensive offering covering the 'Heal' and 'Prevent' stages of managed threat detection.

The Cybersecurity Industry is fast moving and complicated. We are attracted to Darktrace because the approach appears genuinely innovative, and the core product is broadly complimentary to established products (there is no suggestion a company should replace a core firewall or endpoint software with the *Immune System*). This means Darktrace are not going head-to-head with Palo Alto Networks, ZScaler, or CrowdStrike, rather persuading CIOs to spend a small amount of their incremental security budget on this relatively new product category (and with cybersecurity budgets universally increasing, there is always a conversation to be had).

To-date the sales focus has been small and mid-sized Corporates. Over 75% of 30 day 'proof of value' trials identify a serious threat other cybersecurity products have missed. We see validation of the efficacy of the product from a 5,000+ customer base contributing to a revenue backlog over US\$750mn.²

Penetration remains low, and whilst the SME market will likely remain the core driver, with the IPO proceeds driving investment into the salesforce, there is clear potential to address larger corporates with the potential of larger contracts.

¹ 31st March 2021 – 30th June 2021 (net of all fees and expenses).

² **Remaining Performance Obligations (RPO): \$758mn with a weighted average contract length of 18 months.**

After exiting our position in **Palo Alto Networks** in May 2021, we retain exposure to cybersecurity via holdings in **Darktrace (2.0% of NAV)** and **ZScaler (2.2% of NAV)**. Whilst the modest position sizing reflects exceptionally strong YTD performance, we remain positive on the fundamental growth outlook for the industry.

Nvidia

Regulatory scrutiny of the proposed ARM acquisition will ratchet up over the coming months.

The biggest hurdles are the UK, EU, and China.

The (now former) UK Culture Secretary ordered an in-depth review into the deal, citing both competition and national security, which is a little confusing since ARM plays no role in national security. ARM technology is free for anyone to licence, and the UK approved a foreign takeover in 2016.

In focusing on what the UK might 'lose' from NVIDIA ownership, the UK government is approaching the deal from entirely the wrong viewpoint.

The correct question is what the UK stands to gain from NVIDIA's takeover?

If the takeover is successful, NVIDIA's largest international R&D centre will be based in the UK (ARM HQ). NVIDIA are the most innovative company in computing, AI and semiconductors. The UK could conceivably become their hub for CPU and licencing development (and possibly more).

This would be a significant win for the UK – and will burnish Cambridge's position as a semiconductor, computing, and AI hub.

ARM dominate the mobile market – but this is mature. The future of ARM is in the Data Centre, AI, IOT, and autonomous vehicles. These are the areas where NVIDIA are a world leader.

The Data Centre is the most important near-term opportunity for ARM. Over the last 5 years, NVIDIA's GPU (and now DPU) have revolutionised how the Data Centre operates. They are the ideal owner to drive adoption of ARM based servers from their current market share of less than 2%. It is no coincidence **Marvell**, another key proponent of ARM based server CPUs (and NVIDIA competitor), have publicly supported the deal.

The UK government should recognise this deal as a golden opportunity for the UK technology industry and enthusiastically support the takeover.

The EU are instinctively protectionist and dislike large mergers in general and US technology companies in particular. NVIDIA have offered remedies, but we fear the bar for EU approval is high.

China is more of a wildcard.

Contrary to perception, China's track record in approving mergers is remarkably good. NVIDIA/ARM is complicated by the protracted legal battle between ARM and the ex-CEO of their Chinese JV. The structure of the ARM China JV was designed to ensure continued Chinese access to ARM IP in the event of US sanctions. This proved prescient given the subsequent actions of the US government against Hisilicon and other Chinese companies, but it remains an imperfect arrangement.

Ultimately Chinese approval is likely to hinge on the extent to which the takeover improves or diminishes the ongoing access to ARM IP for Chinese semiconductor design houses. Given the recent history of the US 'weaponising' IP associated with American companies, this may prove challenging.

All considered, we continue to think the deal is unlikely to close.

Notwithstanding, ARM is not make or break for the NVIDIA investment thesis. Since NVIDIA can licence ARM's IP, the development of NVIDIA's first CPU (Grace) and the future development of other ARM-based products are unlikely to be materially impacted in the event the deal is blocked.

Of greater significance than the prospective ARM takeover is NVIDIA's imminent commercial release of **Omniverse**, which represents a sustained move into software (albeit powered by NVIDIA GPUs).

Omniverse is an ambitious undertaking – in the near-term representing a foray into the simulation and PLM market dominated by well-established software companies. Customer case studies of the beta version suggest the initial aim is to become a 'collaborative' tool which allows integration with all the established design tools (think Autodesk, Ansys, Dassault, PTC modules), with the addition of proprietary digital twin and other simulation offerings (which we would expect to grow in quality and scope over time).

For the true believers, from a longer-term perspective Omniverse could become a core component / enabler of the *Metaverse* (a nebulous concept loosely defined somewhere on the spectrum from *augmented reality* to fully fledged *virtual world*).

From an earnings perspective, the multi-year subscription-based revenue model of software contrasts with the more immediate and volatile buying patterns of NVIDIA's GPU customers (gaming, data centre, and crypto miners). If Omniverse proves successful it could both transform NVIDIA into a hardware + software company and improve the earnings visibility of The Company.

Power Semiconductors

We established a position in **StarPower Semiconductor (2.2% of NAV)**, China's leading domestic power semiconductor company. This represents our second investment in the sector, alongside global leader **Infineon (3% of NAV)**, which we have held since the inception of the Fund.

Driven by Electrification and Autonomy, our [Q1 2021 Investment letter](#) discussed Infineon's exposure to the increase in semiconductor content in cars. Within the context of China's domestic EV makers, StarPower is benefiting from the same trend: in their core IGBT module business StarPower expect to supply 500,000 units in 2021 (+150% yoy).

Based on an ambitious R&D roadmap we expect StarPower's technological capabilities will continue to improve, and this should be reflected by continued gains in domestic market share (whilst establishing a foothold into the global supply chain – most likely via the China operations / JVs of Global Auto manufacturers).

China's ambition to become less reliant on Western technology is well documented. Within the semiconductor universe, Power semis is a good candidate since these chips are not manufactured on leading edge nodes (i.e. those dominated by TSMC / Samsung / Intel and exclusively manufactured outside of China). As a result, StarPower are reliant on domestic foundry partners to manufacture their IGBT products.

A further attraction of power semis is the medium-term technology roadmap, which does not rely on 'scaling' (i.e. more advanced nodes), rather a move to 'wide band gap' compound semiconductors. Again, the Chinese domestic industry is relatively well prepared for this development, reflected in the evolution of Starpower's business from a fully Fabless manufacturing model (reliant on Foundry partners) to a hybrid IDM / Fabless model (mix of manufacturing in-house and with Foundry partners). The Company plan to raise equity to fund the construction of a 6" Fab to produce IGBTs and Silicon Carbide chips in-house from 2023.

Whilst we are positive on StarPower's prospects, we do not think their success necessarily comes at the expense of Infineon. In the Auto segment, the proliferation of Chinese EV companies represents an addressable customer base for StarPower to target with IGBT and Silicon Carbide products. Though China is a leader in EV volumes, the

broader transition to electric vehicles on a global basis requires a massive increase in semiconductor content in general, and specifically power semiconductors (a point re-emphasised by Infineon at their recent Investor Day). Though this trend is most pronounced in Autos, it is also evident across a number of other sectors (consider the semiconductor content in fossil fuel production is \$0 vs \$2,000 - \$5,000 per MW for renewables)³.

With extremely tight global supply, the major concern for Infineon is ramping new internal capacity at their Villach Fab in Austria (and securing maximum external Foundry capacity) to meet strong customer demand for the coming years.

Investment Outlook

Towards the end of September concerns over inflation / growth / Fed taper made a comeback, accompanied by the inevitable equity market weakness and stylistic rotation. Our approach is entirely bottom-up and we do not try to position the portfolio to *defend against* or *capitalise on* specific macro trends.

We continue to see excellent long-term prospects for the companies in our portfolio.

Charlie Southern

7th October 2021

³ Source: Infineon Capital Markets Day (October, 2021)

Global Opportunities Fund: Key Statistics

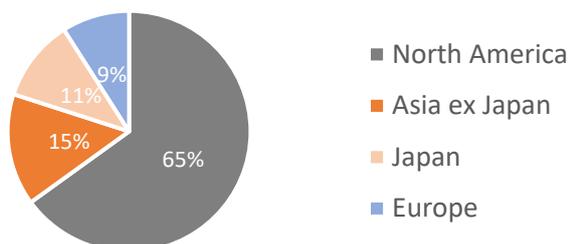
Performance

	2021 YTD ⁴	2020 ⁵	1 Year	3 Year	5 Year	Since Inception ⁶
Fund ⁷	15.5%	14.6%				32.4%
Benchmark ⁸	11.8%	11.9%				25.1%
Relative	+3.7%	+2.8%				+7.3%

Liquidity

Market Cap	No. of Positions	% of NAV	ADV
Small (< US\$1bn)	0		
Mid (< US\$20bn)	10	18%	US\$44mn
Large (> US\$20bn)	18	54%	US\$346mn
Mega (> US\$200bn)	8	23%	US\$1,755mn
Total	36	100%	
NAV Weighted Average	US\$120bn		US\$563mn
Median	US\$64bn		US\$213mn

Geographic Allocation



Top 10 Holdings

Company	Country	% of NAV
Cadence Design	US	7.0
Thermo Fisher Scientific	US	6.2
IQVIA	US	5.7
Moody's	US	4.4
Illumina	US	4.3
Eli Lilly	US	3.5
SK Hynix	S. Korea	3.4
Synopsys	US	3.3
IHS Markit	US	3.2
Keyence	Japan	3.0

⁴ NAV: 29th September 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 – 29th September 2021 (Source: JP Morgan)

⁷ NAV per share, Net of all fees and expenses

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

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