DEVON Equity Management

Global Opportunities Fund: Investment Letter – Q4 2021

Performance

The Fund Returned 6.3% in Q4, and 22.7% in 2021.

As detailed in the table below, the Fund delivered 4.2% of outperformance in 2021 and 8.1% since inception (November 2020).

	Q1	Q2	Q3	Q4	2021	Since Inception[1]
Fund	-2.1%	16.6%	1.2%	6.3%	22.7%	40.7%
Benchmark[2]	4.6%	7.4%	-0.4%	6.0%	18.5%	32.6%
Relative	*-6.7%*	*+9.2%*	*+1.7%*	*+0.3%*	*+4.2%*	*+8.1%*

2021 Review

Inflation.

The narrative has been dominated by inflation and the likely and/or appropriate response from central banks.

Inflation can impact our Companies and the Fund in two ways:

1) Operating Performance (growth and profitability).
2) Valuations.

Our investment process is driven by bottom up, company specific research – we do not attempt to time the market or its preference for a specific factor, sector, or style at any given time.

Rather we look to invest in exceptional, innovative companies with excellent growth prospects providing opportunities to compound free cash flow at incrementally high rates of return.

As a result, our efforts have focused on how inflation and higher nominal and/or real rates could impact the operating performance of our investee companies.

2021 demonstrated the resiliency of our holdings in this respect. In fact, across the portfolio expanding margins has been the prevailing theme, suggesting that to date pricing power and higher utilisation has at least matched (and often trumped) input cost pressures.

This is encouraging given the high return profile of our businesses, since the ability to reinvest a higher $ amount at comparable levels of return represents accelerated value creation for shareholders.

Considering the implication of higher interest rates to reflect inflationary pressures – our portfolio is characterised by strong balance sheets and high levels of free cash flow generation. This provides comfort that any increase in interest expense will be manageable (note 22 of our 32 holdings have a net cash balance sheet).

[1] NAV per share, Net of all fees and expenses: 4th November 2020 – 31st December 2021 (Source: JP Morgan)
[2] MSCI AC World Net Total Return in USD (NDDUWI Index)

The table below offers a snapshot of the operating performance of our Top 10 holdings in 2021 (comprising 52% of NAV). In aggregate performance was impressive, with average revenue growth of 23%; 5% EBITDA Margin expansion vs pre-pandemic levels (2019); and 21% ROIC.

	Revenue Growth	EBITDA Margin		ROIC	Net Debt / EBITDA
	2021e	2019	2021e	2021e	2021e
Cadence Design	11%	28%	41%	33%	Net Cash
Thermo Fisher	16%	28%	33%	14%	1.2
IQVIA	22%	20%	22%	10%	3.5
Synopsys	14%	26%	33%	25%	Net Cash
Illumina	37%	35%	28%	33%	Net Cash
Moody's	15%	48%	51%	28%	1.4
SK Hynix	32%	42%	53%	9%	0.4
IHS Markit	8%	36%	44%	6%	2.0
Techtronic Industries	33%	13%	12%	17%	Net Cash
Adyen	45%	56%	63%	33%	Net Cash
Average	23%	33%	38%	21%	N/A

Investment Letter

Looking to 2022 we discuss one new position (Techtronic Industries) and two sizeable transactions we expect to close in the 1H of the year (S&P Global / IHS Markit & Square / Afterpay).

Techtronic Industries (4.1% of NAV)

Techtronics represents a rare Asian company outside of Japan with a leading position in the US market.

With 78% of revenue coming from the US, Techtronics are the market leader in power tools. The market consists of two channels – commercial (professional builders) and consumer (DIY) – with each segment served by distinct brands.

The key driver of Techtronics' investment thesis is the continued adoption of cordless power tools - replacing a large installed base of mains or gas-powered products. In the outdoor handheld market cordless penetration is only 40%, and sub-20% in mower and snow/leaf blower category.

We think the proposition for the customer is compelling: safer, quieter, greener, easier to use with equivalent / superior performance.

The two core brands (*Milwaukee* for professionals / *Ryobi* for DIY) are renowned for excellent product quality and have both taken substantial market share over the last decade (notably from Stanley Black & Decker – the former employer of the Techtronics CEO and a large number of senior management).

The company has accelerated R&D spend over the last three years, which is flowing through into a larger number of new SKUs in 2021 / 2022 both in the core power tool segment and adjacencies (PPE, accessories, storage).

The two key distribution channels in the US are Home Depot and Wal Mart. In 2019 Techtronics won a contract with Wal-Mart to replace *Stanley Black & Decker* brands with *Hart* (a new brand exclusive to Wal-Mart). The rollout has been successful with Hart products well reviewed and received by customers. Given Wal-Mart's scale, the ramp-up will be multi-year, and thus should represent a significant growth driver in the coming 3-5 years.

Encouragingly, the Management team of Techtronics are confident success that Wal-Mart will not cannibalise the core Home Depot channel (very distinctive customer profiles). In fact, they expect record new product SKUs into Home Depot in 2022 amid continued strong momentum and expansion of in-store sales reps.

Considering multiple tailwinds in a strong category, we believe Techtronics is capable of compounding earnings and cash flow in the low-mid teens over the coming years.

S&P Global / IHS Markit (4.2% of NAV)

On the 30th November 2020 S&P Global announced an all stock deal to acquire IHS Markit for an equity value of US$38bn (with the full support of the IHS Board). Though a sizeable deal we believed the chances of regulatory approval to be relatively high and held our position through 2021 in anticipation of the deal closing in early 2022.

We see this deal as transformational and consider the combined company a more compelling proposition vs IHS Markit standalone.

We see three core elements to the investment case over the next 3-5 years:

(i) Synergies: S&P have outlined synergies worth $680mn EBITDA by year 3, a material number considering IHS Markit standalone EBITDA of ~$1,780mn in 2021. Given the clear overlap of the two businesses, cost synergies ($480mn) should be relatively easy to achieve. Revenue synergies are always more difficult to predict (especially prior to deal close), but $350mn (of which only $140mn comes from cross-selling) in the context of a combined revenue base of US$12.5bn does not seem overly ambitious. On balance, we would expect upside risk to the announced synergy targets (especially on the cost side), accelerating EBIT margin expansion beyond the current targets of 200bps per annum to 2023.

(ii) Business Mix: The combined company will have 75% recurring revenue, well balanced across the five divisions – with the core Credit Rating and Financial Data businesses each contributing around 30%. This diversification appears timely given the likely near-term slowdown in debt issuance after 3 years of exceptional performance (which will result in lower growth in the core Ratings business). On a five year outlook we believe the combined company can deliver high single digit organic revenue growth, higher than IHS Markit on a standalone basis.

(iii) Balance Sheet capacity: The company has indicated a targeted leverage range of 2.0 – 2.5x. Since the IHS Markit acquisition will be financed 100% in stock, leverage will be around 1.5x once the deal closes. The Company are guiding US$14bn of cumulative free cash flow 2021-23. When combined with incremental debt they have in excess of $20bn of capacity for M&A and/or returns to shareholders. Given the size of the IHS Markit transaction (and the commensurate integration complexity), shareholder returns are likely to be favoured. With this in mind, large share buybacks could be a feature from mid-2022 onwards.

Square / Afterpay (2.6% of NAV)

Payments was the worst performing of our core investment themes in 2021 (our positions in Adyen, PayPal, and Square aggregate to 8.2% of NAV). Whilst there were both sector and company specific challenges, we remain constructive on the long-term opportunity for all three companies.

The most material development of 2021 was Square's acquisition of Afterpay – a pioneer in Buy Now Pay Later (BNPL) and Australia's most successful fintech company.

The all-stock transaction was announced in August with the full support of Afterpay's management team (including the Founding Shareholders), valuing Afterpay at US$27bn. The deal was subsequently approved by Afterpay shareholders in December (despite a 30% decline in the Square share price between announcement and shareholder vote).

We see Afterpay as an excellent strategic fit for Square, since Buy Now Pay Later is highly relevant for both the Merchant (payments) and Consumer (Cash App) divisions of Square.

On the Merchant side – integrating Buy Now Pay Later into Square terminals and online payments should provide a compelling proposition for Square's core SME customer base. Conversely, Afterpay's customer base of ~100,000 merchants in the US, Australia (and the UK) represents a fertile ground for cross selling the Square payments offering. Given 85% of Afterpay's volumes are via the online / e-commerce channel, the acquisition should accelerate Square's move into online payments (Square's heritage is processing in-person transactions for SMEs, which still account for ~45% of Gross Payment volumes).

The synergies are arguably easier to envisage on the Consumer side of the business. Integrating a Buy Now Pay Later feature into Cash App should be relatively straightforward and could be instantly rolled out to the existing Cash App user base (70 mn). As with the Merchant segment, Afterpay's customer base of 16mn have almost no crossover with existing Cash App users: Afterpay's customer base being much more global, and within the US largely in Coastal areas and a higher income demographic.

Though the company will need to take a careful approach to branding (retaining the Afterpay brand where it resonates above Square / Cash App), we see substantial revenue synergy opportunities from the deal.

There is rarely a dull moment at Square. Beyond the Afterpay deal discussed above, 2021 has seen a number of notable events including (but not limited to):

- Jack Dorsey relinquishing his CEO role at Twitter (to focus on Square).
- The subsequent re-brand of the corporate entity from *Square* to *Block*.
- The acquisition of fringe music streaming service Tidal (with Jay-Z joining the Square Board).
- Endless tweets and grandiose statements about crypto.

We consider the above largely noise – whereas the Afterpay deal could be highly beneficial to the company's fortunes and finances in the coming years. We expect to hear more about the integration plans subsequent to the deal closing (estimated March 2022).

Investment Outlook

The first week of 2022 saw a sharp style rotation out of quality and growth in favour of value and cyclicals.

Such an environment is clearly unfriendly for our relative and absolute performance.

As outlined in the 2021 review section above – we strive to apply a consistent approach which focuses on the Fundamentals of each Company over a 5 year + horizon.

Our efforts remain focused on Company specific research, where we see excellent opportunities.

Charlie Southern

11th January 2022

Global Opportunities Fund: Key Statistics

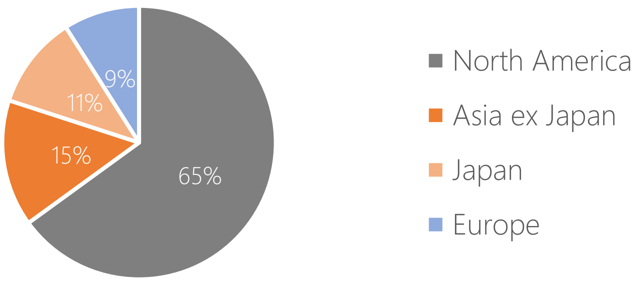
Performance

	Q4 21	2021	1 Year	3 Year	5 Year	Since Inception[3]
Fund	6.3%	22.7%	22.7%			40.7%
Benchmark[4]	6.0%	18.5%	18.5%			32.6%
Relative	*+0.3%*	*+4.2%*	*+4.2%*			*+8.1%*

Liquidity

Market Cap	No. of Positions	% of NAV	ADV (NAV weighted)
Small (< US$1bn)	0	0%	
Mid (< US$20bn)	7	12%	US$45mn
Large (> US$20bn)	19	67%	US$372mn
Mega (> US$200bn)	6	21%	US$3,172mn
Total	32	100%	
Weighted Average		US$117bn	US$767mn
Median		US$55bn	US$244mn

Geographic Allocation



Top 10 Holdings

Company	Country	% of NAV
Cadence Design Systems	US	7.9%
Thermo Fisher Scientific	US	7.6%
IQVIA Holdings	US	6.5%
Synopsys	US	4.7%
Illumina	US	4.5%
Moody's	US	4.5%
SK Hynix	S. Korea	4.3%
IHS Markit	US	4.2%
Techtronic Industries	Hong Kong	4.1%
Eli Lilly	US	3.9%

3 NAV per share, Net of all fees and expenses: 4th November 2020 – 31st December 2021 (Source: JP Morgan)
4 MSCI AC World Net Total Return in USD (NDDUWI Index)

DISCLAIMER

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