30 May 2024

April Monthly Report

Dear Investors

We are pleased to provide you with the April 2024 Monthly Report for the Fawkes Capital Fund (“Fund”). Please be advised the new Information Memorandum for the Fund was issued on 24 May 2024. If you would like a copy, please let us know or you can download a copy from https://www.oneinvestment.com.au/fawkescapital/.

In this monthly report, we:
(1) Update our performance for April 2024;
(2) Provide a brief overview of some of the Fund’s investments and our rationale for these investments.

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Performance Update

April saw a small reversal in the recent rally in equity markets since the start of 2024. Performance for the Fund over the month was -1.4% net of fees. The main contributors to the decline over the period were several of the Fund’s equity positions. In particular, Hammond Power Solutions delivered a pullback on the final day of the month after missing on their expected profit, largely due to one-off factors. Offsetting this, AudioEye was a strong performer over the period, and this has continued into the first half of May. Additionally, some of the Fund’s macro exposures also held up well.

Apr-24	1 Mth	3 Mth	1 yr	2 Yrs	3 Yrs	SI (ann)	SI (cum)
Fund (Net)	-1.4%	6.3%	16.5%	5.3%	7.6%	8.4%	26.5%
Blended Index	-1.2%	1.3%	7.3%	4.8%	4.9%	5.1%	15.5%
All Ords	-2.7%	1.5%	9.9%	5.6%	7.1%	7.1%	23.0%
RBA Cash	0.4%	1.1%	4.3%	3.3%	2.2%	2.2%	6.9%

Returns are calculated net of fees and represent the combined income and capital returns over the specified period. All returns provided are in AUD. Blended Index returns are composed of 50% All Ords / 50% RBA Cash. Past performance is not a reliable indicator of future performance.

Despite the global equity retracement over the month, which we believe will be temporary, we’re pleased about how the portfolio held up relative to most global developed market equity indices, which pulled back between approximately -2.5% and -4%. The resilience shown by several of the Fund’s key positions and the continued strength in the overarching themes reinforces our conviction in the positioning of the portfolio. That said, we will continue to monitor the portfolio closely and as always, are prepared to make adjustments as needed should the facts change.

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Review of Investment Theses

(1) Artificial Intelligence (AI) and Energy Infrastructure (Including Renewables)

We continue, on behalf of the Fund to invest in this theme. Now that the recent earnings season is mostly over, it's become even clearer that utility companies across the US are starting to invest and prepare for larger baseload demands for electricity. It's likely that we'll run out of electricity supply before we run out of artificial intelligence demand. As a result, significantly more solar and wind farms and gas power plants need to be built. Companies that manage, build and install generation assets will likely benefit. As at the time of writing, we hold positions in Primoris, Emcor, Willdan and Argan and are looking to build a position in one other company. Companies that make electrical products like transformers and switchgear that are high in demand will also benefit. To this end, we own Hammond Power Solutions. We also believe that companies that supply generation energy will benefit, especially if they operate in the unregulated generation space. Here we own NRG Energy and Dominion. As power constraints begin to get hit, companies that can lessen the demand for power from data centres will likely benefit. We believe Qualcomm and Photronics will benefit by making produces that enable smaller LLMs being run on-device rather than through the cloud.

We will be providing more detailed research notes on this theme and some of the companies exposed in future updates.

(2) AudioEye

The Fund has also taken a position in AudioEye. Through more than 200,000 lines of code, US-based AudioEye makes websites more accessible for disabled people. Importantly, the company also has a significant portion of certified website accessibility auditors. The company is twice as large as the second largest of about 4 companies in the industry. The second largest is about twice as large as the third largest. Importantly, AudioEye is based in the US where major legislative changes are occurring, whereas its next 2 largest competitors are based in Israel.

Under Title II of the Americans with Disabilities Act (ADA), the Department of Justice (DOJ) recently published a final rule to "establish specific requirements, including the adoption of specific technical standards, for making accessible the services, programs, and activities offered by State and local government entities to the public through the web and mobile applications." For most public entities, compliance must occur before 24 April 2026. The DOJ estimates that the implementation costs will be around $17 billion over the first three years and the average annualised cost of complying with the rule to be $3.33 billion. These numbers are significantly more than the $40 to $50 million in revenue we estimate that the major players in the industry currently earn.

Shortly after the DOJ made their rule, the Department of Health and Human Services (HHS) created their own rule. The new rule ensures that web content and mobile applications provided by organisations that receive funding from HHS, including hospitals, doctor's offices, social services, nursing homes, among other organisations, are usable by people with disabilities. In response, the CEO of AudioEye, David Moradi, commented that "[w]e recently scanned over 96,000 healthcare website pages across the United States and found that the average page had an alarming number of violations. The sheer scale of this problem can only be fixed through a combination of artificial intelligence and human-assisted technology, backed by testing from members of the disability community."

Further regulatory changes are afoot. In Europe, the European Accessibility Act takes effect in June 2025 and requires digital accessibility for websites and mobile apps by that date. The state of California has proposed AB 1757, which would extend the requirement to have accessible websites and mobile devices to private businesses that operate in the state. California is the largest US state by population and is estimated to be home to around 4.7 million businesses.

We believe that these regulatory changes will support our investment in AudioEye.

(3) Macro – Copper

We anticipate that there will likely be a shortage of copper in the world this year. We will publish a separate note that unpacks this thesis in further detail, however, have provided a synopsis below.

While the world demanded less electrical appliances and China underwent its construction bust, copper prices stabilised around $3.5 to $4.0 per pound (lb) for much of 2023. Declining demand from China masked the underlying supply and demand dynamics underway. Now that China has released significant policy measures to stabilise the property market, including the state purchase of apartments, as well as a new trade-in scheme for newer electrical appliances, the fundamental supply-demand imbalance can begin to play out.

We estimate that with the construction and electrical appliance industries globally bottoming out, copper demand will increase from here in this industry segment, adding around 1-2% to global demand. India's rapid economic growth under Modi's nationalism is expected to produce a 1% increase in demand. Chinese subsidies for trading in old electrical appliances and internal combustion engine vehicles for newer electric models is also expected to add a percent to demand. These factors alone may add 3-4% to copper demand. Historically, copper demand has increased the fastest after economic growth has bottomed out globally, which is what is happening today.

But in addition to these factors, the demand for copper from data centres globally is significant. We've seen varying reports from Schneider Electric and investment banks like Goldman Sachs, but, generally speaking, new GPU-stacked data centres need a lot of copper. For every 1 gigawatt (GW) of data centre capacity, around 65,000 tonnes of copper is consumed. Based on estimates from SemiAnalysis, a research provider, somewhere between 12-15GW of data centre capacity will be added in 2024 globally. Even more will be added in 2025. At the lower end of the range, 12GW will increase copper demand by around 0.78 million tonnes, or 3% of global demand.

However, there's likely to also be a major change to data centre design in the immediate future. NVIDIA has worked out that the most efficient way to build a data centre is to cram as many memory and GPU chips within a single server rack as possible. Advanced liquid cooling has enabled this set-up to become a reality. Instead of connecting all the chips and memory with optical interconnects, as was largely assumed to be needed due to their speed, NVIDIA has worked out that it's more effective to use passive copper interconnects. Given the sheer volume from interconnects needed, this is set to increase demand for copper within the data centre by around 50%. As a result, we think data centre demand for copper could rise to around 1.08 million tonnes, or around 4.3% of global demand.

In addition to these demand factors, if electric vehicle demand increases by around half the pace of the previous year, then copper demand should rise another 0.5% from this source. The increase in the number of wind farms and solar farms the world is building may increase the demand for copper by another 0.5% to 1.0%. There's further demand from the missiles and tanks that are being destroyed in Ukraine.

Altogether, now that Chinese demand is stabilising, we believe there is a very real pathway for copper demand to increase by around 8%. That would represent a historic rise.

Alongside this potential increase in demand, the supply side looks challenged. It takes around 2.5 years to expand an existing mine. Most of the brownfield changes were made by Chinese-owned projects in the Democratic Republic of Congo (DRC) in 2024 and not a lot more are in motion. The Panama government recently reclaimed the 10th largest mine from a Canadian producer that reduced supply by 1%. Additionally severe weather in the DRC, Zambia and parts of South America have delayed or prevented brownfield additions to supply. South American copper ore grades have been declining quickly and, without extra investment, supply will continue to fall.

It's within this context that we believe there will be a shortage of copper in the order of around 8% of global demand. Historically a 4.5% shortage of copper, which has happened 3 times since 1960, has always led to at least a doubling to tripling of the price.

Kind Regards,
Fawkes Capital Management

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