February 2024

Monthly Report

Dear Investors,

In this monthly report, we:
(1) Review our investment theses and positioning;
(2) Update our performance for February.

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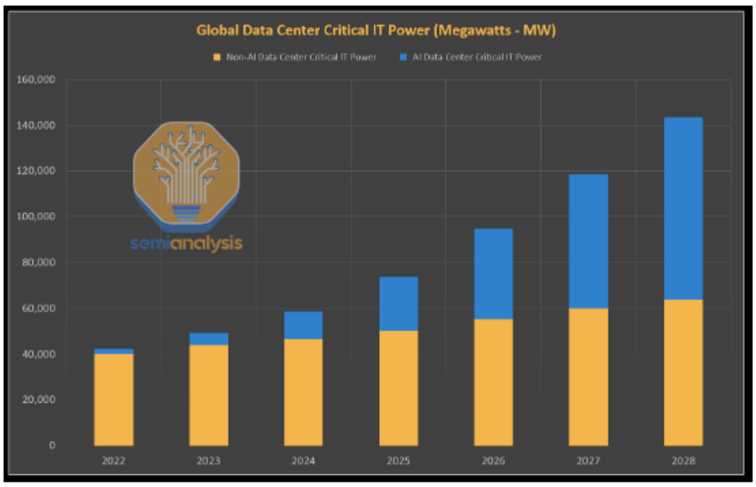
Positioning:

As at the time of writing, we favour the following investment concepts:

(1) AI and Energy Infrastructure (Including Renewables)

In this section, we highlight the interaction between AI and the increased need for renewable energy infrastructure. The boom in demand for GPU accelerators has resulted in a significant increase in demand for data centres. These data centres need a consistent power source. Energy forms the biggest cost of running servers and cooling systems. GPUs are significantly more power-hungry than their CPU counterparts. An AI server stacked with GPUs consumes around 10kW per hour, whereas traditional CPU or storage servers consumes just 1kW. Increased power intensity of AI workloads combined with an increase in demand for data centres is resulting in more need for power.

Notwithstanding the impact on the electrical grid from renewable energy and reshoring of manufacturing, can AI single-handedly have a significant impact on the demand for energy infrastructure? In short, we believe so. What kind of magnitude impact can AI have on the grid? Based on the announced and expected rollout of data centres and GPU purchases, we estimate that data centres are likely to go from consuming 4.5% of US power supply to 9.5% by 2026. AI workloads are expected to account for around 90% of the increase:



Source: SemiAnalysis

To put this change into perspective, the Energy Information Administration (EIA) estimates that between 2014 and 2022, power consumption in the US increased by about 3% over 8 years. In just the next 3 years, AI demand is expected to increase overall US energy consumption by around 5%. AI will more than quadruple the historic rates of growth in electricity demand. Because of this change, Elon Musk concludes, “It was very easy to predict that the next shortage will be voltage step-down transformers…the next shortage will be electricity.” When other trends such as the electrification of the oil and gas industry, transition towards renewable energy sources and reshoring of manufacturing facilities are added on top of this AI demand for electricity, we think it makes a lot of sense to be invested in transformers and switchgear.

We continue to remain invested in Hammond Power Solutions (the largest manufacturer of dry-type transformers in the US) and Powell Industries (a manufacturer of switchgear) as well as familiar names in AI infrastructure that we’ve described previously.

(2) Shipping

As we’ve predicted, a long-term negotiated settlement to permanently end the Israel-Hamas War (as opposed to a temporary ceasefire) appears a long way off. The Netanyahu administration released their blueprint for a post-Hamas Gaza which included a lengthy occupation. Given this set-up, we think it’s highly unlikely the Houthis will refrain from disrupting vessels transiting the Suez Canal. The shortage of water in the Panama Canal has also fallen roughly in line with our initial forecast. Over time, we’ve taken profit on most of our shipping positions and have now left our exposure to this theme in the form of BDRY. Given the seasonality of dry bulk rates and the peak of the dry season in Panama, we’d expect to close out our call option position at its maturity around late May.

(3) Macro

As we’ve taken profit on our view that the Fed is still some time off from cutting interest rates, we’re left in macro with our European Euro vs Swiss Franc (EURCHF) view. This position has become a reasonably large contributor to our overall performance. We believe this currency opportunity (where we see significant monetary policy and economic growth divergence combined with a material change in currency flows) comes around once every few years. The last time it came around was the major surge in USDJPY. A detailed thesis explaining our EURCHF investment concept will be sent out in a separate research note.

(4) Immigration Reform

While major changes to immigration in the short-term are on hold until the November US Presidential election, there are signs that change is coming regardless of which party wins power. For a start, the problem consistently ranks as the top issue in the polls, including the exit polls from Super Tuesday. Additionally, the compromise deal struck in the Senate contained changes to electronic monitoring that, if passed, would supercharge GEO’s earnings. We continue to monitor how events unfold and will adjust our positioning as necessary.

(5) ARQ

We've been following the developments in the changing regulatory environment for the use of forever chemicals for some time now. The ability of forever chemicals like polyfluorinated substances (PFAS) to damage our health is gaining widespread attention. The movie Dark Waters explained the impact of forever chemicals in the context of drinking water. The Environmental Protection Agency (EPA) is now very close to concluding new rules that would limit the maximum amount of pollution drinking water can contain. The rules are stringent and would require a significant number of water utilities to fix the problem. The rules will affect even the largest of water utilities such as American Water Works, which has set aside one-quarter of its annual revenues in forthcoming capex to deal with it.

The most common way to reduce the concentration of forever PFAS in drinking water is to pass it through treatment plants that filter the water via granular activated carbon (GAC). There are only 3 producers of activated carbon in the US and ARQ is the third largest. ARQ is currently in the process of building a 25 million pound per year GAC plant in the US.

Over the next couple of years, the demand for GAC is set to far outstrip supply. It is, perhaps, one of the most extreme imbalances we've ever seen in a commodity before. Management finally quantified the impact of the EPA's change in the company's latest quarterly earnings call. They believe that the EPA's changes will cause the current 170 million pound per year demand for GAC to increase by between triple and quadruple. That means, over the next few years while the rules come into effect, the demand for GAC will increase by between 510 to 680 million pounds per year. It takes around 2 to 3 years from final investment decision for a new plant to first production of GAC. So far, only 80 million pounds of new GAC supply has been previously announced to come online by early 2025. As far as we can tell, only a further estimated 25 million pounds of GAC supply has passed a final investment decision to come online throughout 2025. By the start of 2026, demand for GAC may have increased by around 600 million pounds per year, but supply may have only increased by 105 million pounds per year. It's perhaps one of the biggest divergences between supply and demand we've ever seen.

The journey of how we end up at that point is unlikely to be in a straight line. This is because the EPA's rules have enforcement impact by the end of 2026. But from management's commentary, we're starting to see the demand come through already. Management believes that, should they wish to, they could farm out the entire supply from their new Red River plant today. The company has already received enquiries amounting to around 90 million pounds of demand, and that was after Calgon's new 55 million pound per year plant came into operation. Some water utilities have said that the majority of capex spend needed to build water treatment plants will be spent in 2025 and 2026. So, while the EPA's rule doesn't get enforced until late 2026, we're already starting to see the signs of shortage in the US and in Europe. And while the journey towards a major shortage won't be in a straight line, we estimate that the imbalance between supply and demand in the GAC market is one of the biggest we've ever seen.

(6) China – Europe – US Trade War

We continue to monitor developments in the global tariff war. Momentum is building towards increased tariffs on various trade around the world. At a recent campaign rally, Republican-nominee Trump said that, if he were elected, he would place a 100% tariff on all Chinese car imports. Secretary Raimondo continues to tell China that she will inhibit them from obtaining the latest cutting-edge technology. Europe's tariff review into Chinese EVs continues. While Biden's EV targets may slip somewhat in time, we're getting closer to bifurcated commodity supply chains and pricing.

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Performance:

The Fund has started the year off well, delivering a net return of 5.1% in February, as we've begun to see some of our theses come to be recognised by other market participants. More specifically, the Fund's macro positioning in EURCHF currency exposure accounted for approximately half of the returns for the month. In addition to this, performance was supported by investments in Powell Industries, GEO Group, Hammond Power Solutions, and BDRY, although no single investment among these stood out markedly from the others.

Feb-24	1 Mth	3 Mth	1 yr	2 Yrs	SI (ann)	SI (cum)
Fund (Net)	5.1%	16.7%	9.4%	2.1%	8.8%	26.8%
Blended Index	0.8%	5.4%	7.8%	6.1%	5.2%	14.8%
All Ords	1.2%	9.9%	11.3%	8.6%	7.5%	22.6%
RBA Cash	0.3%	1.1%	4.1%	3.0%	2.1%	6.1%

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.

As noted, we've been encouraged to observe some of our investment theses beginning to get recognised in the market. Despite this, we continue to remain highly selective about all our investment positions and will not hesitate to make changes should we see any signs that bring our views into question.

Important notice

With effect from 26 March 2024 the trustee of the Fund changed to One Fund Services Ltd (ACN 615 523 003, AFSL 493421).

Kind Regards,

Fawkes Capital Management

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