FAWKES CAPITAL MANAGEMENT

26 February 2025

January Monthly Report

Dear Investors

We are pleased to provide you with the January 2025 Monthly Report for the Fawkes Capital Fund ("Fund"). In this monthly report, we:

(1) Update our performance; and
(2) Discuss current investment positions.

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Performance Update

Despite a significant sell-off in AI stocks following the emergence of DeepSeek, the Fund posted a 0.7% gain in January. While the portfolio's AI holdings were negatively impacted given the exposure to the theme, our perspective on DeepSeek is becoming clearer. First, despite having better, more efficient models that are cheaper to serve than DeepSeek, Google has decided to increase its capex on AI infrastructure by more than 50% for 2025. In the competitive landscape of institutional survival, this decision signals that other Big Tech companies will likely follow suit, ensuring continued investment in AI infrastructure. Second, it's becoming increasingly evident that the copycat methods DeepSeek employs – known as data "distillation" – to generate its model are insufficient to reach general artificial intelligence (AGI). Innodata, a company which provides data and model training services to enterprise and Big Tech, recently stated:

> *"DeepSeek relied heavily on data distillation. That's why in the last few weeks we're seeing more and more of the limits of what their model can do. We're also seeing Big Tech companies putting in place the technologies to effectively shut the back door to future data distillation."*

This suggests that while DeepSeek's approach has disrupted AI markets in the short term, its long-term viability is uncertain, particularly as larger AI firms move to protect their proprietary training data.

Despite this setback, our Fund's growth in January was supported by strong performance in Optical Cable Corporation and select aerospace investments. On balance, we remain confident in the continued expansion of AI infrastructure demand, which we discuss in detail in the next section.

Jan-25	1 Mth	3 Mth	1 yr	2 Yrs	3 Yrs	SI (ann)	SI (cum)
Fund (Net)	0.7%	2.2%	11.2%	9.2%	4.8%	7.3%	30.2%
Blended Index	2.4%	3.0%	9.8%	7.8%	7.3%	6.3%	25.1%
All Ords	4.4%	4.9%	15.1%	11.1%	10.9%	9.3%	39.5%
RBA Cash	0.4%	1.1%	4.5%	4.3%	3.3%	2.7%	10.4%

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.

Investment Positioning

Below we provide an update on our favoured investment themes, as well as taking a deeper look at some of the companies that we're invested in:

Immigration:

During the last month, the House Budget Committee released its version of the reconciliation bill. This bill laid out how it will guide spending and taxation plans for the year ahead. The House plan would allocate roughly an extra

$150 billion of spending on the border for the next 10 years, presumably with much of it front-loaded. The Trump administration's discussion with Republican leaders in Congress were coalescing around needing $175 billion in border funding urgently and the Senate's plan accommodates this figure. We suspect Trump favours the House plan because it gives overriding policy authority to the executive, but either of these plans would represent a significant step-up in funding.

- We have taken profit on our holding of *GEO Group* for two reasons: the first is because finding and catching many of the illegal immigrants is hard. The pace at which the Trump administration has been able to export illegal immigrants has dropped below the rate at which the Biden administration was able to. The second reason is because the deterrent effect is working and the number of encounters at the border has dropped dramatically. When combined with the House plan to immediately turn away migrants at the border and Trump's threats of tariffs on Mexico (whose exports to the US make up about 20% of GDP) if they don't house prospective applicants in their own territory, the need for more privately-operated detention centres isn't necessary as much as market participants initially thought.
- As we analyse the HR 2 Border Bill of 2024 passed by House Republicans, a significant proportion of money is going to be spent on equipment at the border to protect against intruders and border patrol staff. This is where we believe companies will experience the most torque.
  - *Lightpath Technologies* has recently acquired a business called G5 Infrared, which makes infrared cameras that can see up to ranges of 40 miles. From our discussions with industry, it has the longest-range camera for border patrol. While approximately 5,000 border cameras are currently in operation, with G5 manufacturing about one-third of them, we anticipate a significant increase in this number. G5's cameras are also being rolled out onto every single Navy ship to protect against drone attacks. We believe Lightpath's revenues could double in 2025 on higher margin product.
  - *OSI Systems* produces scanning equipment that you may interface at airport security. Their scanning equipment allows operators to see inside of bags to detect forms of contraband. However, that is not the only use case for their equipment. Their equipment is often used at ports and the border to detect drugs such as fentanyl or other illicit substances. The company is already in discussions with CBP to deploy more equipment at both American land borders. As global trade regulations tighten and tariff enforcement becomes more stringent, the demand for high-resolution scanning and AI-driven anomaly detection is expected to rise. Governments and border agencies worldwide are ramping up their investment in such technologies to ensure compliance, prevent smuggling, and enhance national security.

Tariff Beneficiaries:

While we are on the lookout for a potential deal, there are some signs that the tariff war is starting to heat up. While Canada and Mexico have significant interests in avoiding a war (since 20-25% of their GDP comes from exports to the US), Europe and China are far less exposed (without about 3-4% of China's GDP coming from exports to the US). In this section, we lay out some beneficiaries from our most recent publication:

- The U.S. has imposed a 25% tariff on aluminium and steel, with no clear indication that exemptions will be granted, even for allied nations. While some countries have lobbied for exceptions, the prevailing signals suggest that a hardline stance will be maintained. One of the strongest cases for an exemption is Bluescope Steel. As an Australian company exporting relatively small volumes of steel to the U.S., its shipments would complement, rather than compete with, domestic production. A Bluescope delegation recently visited the U.S. to advocate for an exemption, but so far, no progress has been reported. Similarly, Rio Tinto made a lobbying effort last week, yet no media reports have surfaced suggesting any policy changes.

  We believe the U.S. is likely to maintain a strict approach to steel and aluminium tariffs for several reasons. First, former trade advisor Peter Navarro, a key architect of protectionist policies under Trump, faces little internal opposition this time around, especially with Commerce Secretary Howard Lutnick aligned with his stance. Second, Trump remains indebted to the industrial base that supported him during the election, reinforcing his commitment to trade barriers that favour domestic producers.

  Of the two metals, the U.S. is far more dependent on aluminium imports, sourcing between 50-70% of its annual consumption from foreign producers. Century Aluminium stands to be a key beneficiary of these tariffs, as they

will drive up domestic prices and enable the company to restart previously shuttered smelters. In its recent earnings report, Century Aluminium estimated that the price impact of the 25% tariff alone would more than double its profitability. Additional tariffs or further capacity expansions would provide further upside.

We've seen firsthand how protective trade policies transformed Bluescope Steel, ultimately allowing it to trade at around 20x earnings due to the durability of its improved economics. In contrast, Century Aluminium currently trades at just 9x earnings—before the full effects of the new tariff regime have even materialised—suggesting significant potential for further upside.

- *Antimony and gold:* we believe both of these metals will continue to benefit from imbalanced supply/demand equations that will continue to result in a change of equilibrium.
  - *Mandalay Resources* is one way we have invested in this theme. The company operates one of the only high-grade antimony-gold concentrate producing mines in the West. It trades at around a 3x enterprise value to free cash flow yield. We believe this kind of yield would be justified if its mines were near reserve depletion, but new drilling of land adjacent to their existing Costerfield mine in Victoria suggests they have higher grade material for mining into the future. Given where we believe spot prices of both gold and antimony are likely to end up, we believe Mandalay trades at an even lower price to free cash flow multiple into the future.
  - *Larvotto Resources* owns one of the few antimony and gold projects expected to come online within the next four years. As the company navigates the final stages of development, we believe the stock has significant re-rating potential. Based on our estimates of future Western antimony prices, the company currently trades at a 40-60% free cash flow yield. While China has announced measures to de-risk its local solar industry by increasing equity requirements for projects, the existing supply-demand imbalance in antimony remains substantial, even at current levels of solar cell production.

Artificial Intelligence Energy Solutions:

One of the clearest challenges emerging in the data centre sector is the growing disconnect between construction timelines and energy availability. Data centres are being built far faster than they can be connected to the grid or supported by new gas power plants. We are increasingly hearing that interconnection companies are limiting the energy allocations for new data centre projects, many of which are set for completion later this year.

As a result, there is rising demand for on-site power generation. Bloom Energy, which converts gas to electricity via proprietary fuel cells, has noted that in its survey of data centre operators, approximately one-third expect to require their own power source in the future – up from virtually none today. These mobile solutions generate electricity at around 10-15c per kWh, compared to approximately 5c per kWh from the grid. While this cost is prohibitive for many independent co-location data centre operators, it remains viable for Big Tech. This is why companies like Microsoft have restarted nuclear power plants to secure large-scale energy at around 15c per kWh.

These solutions are particularly economic as a temporary bridge until projects can be fully integrated into the grid. As a result, gas turbines have become a bottleneck, with GE Vernova's order backlog now stretching into 2028 and 2029. Given that data centres will likely continue to outpace grid interconnections, and considering the long lead times for gas power plant construction, we expect demand for these alternative power solutions to keep increasing.

- *Solaris Energy Infrastructure* has acquired one of the largest mobile gas power generation fleets in the U.S. and is currently deploying approximately 250MW. However, with additional fleet purchases and rising behind-the-meter electricity prices, its planned expansion to 1.7GW by the end of 2026 is expected to be highly profitable. We estimate that, once fully utilized, the company's contracted fleet will generate an annualised net income of approximately $320 million. This compares to a market capitalisation of around $1.25 billion at the time of our initial investment, highlighting significant upside potential.

- *Duos Technologies* has undergone a significant transformation, driven largely by management's strategic connections. Previously focused on scanning technology for detecting illegal substances in trains crossing borders, the company has since leveraged its leadership's experience in the energy sector. Management previously operated APR Energy, one of the largest mobile gas power producers in the U.S., with approximately 800MW of current capacity. Duos has now entered into management agreements to operate APR's fleet under its new ownership. As part of this arrangement, the company secured a 5% stake in the joint venture that owns the fleet—an interest that, based on Solaris' valuation metrics, would be worth around $100 million, roughly

equivalent to Duos' diluted market capitalization. The revenues from the management agreement provide stable profitability, but the real strategic value lies in Duos' ability to control immediate power generation. This control positions the company to capitalise on the rapidly growing demand for high-density data centres, as seen in its recent agreement with the Texas City Pampa Energy Centre. The impact of data centre expansion on valuations is evident in cases like Total Site Solutions Inc., and we believe Duos Technologies is poised to experience a similar re-rating.

Artificial Intelligence Infrastructure:

Rather than reiterating the fundamental reasons why AI infrastructure demand will continue to surge, we will focus on the latest developments that reinforce our bullish stance.

The rise of "AI Agents"—workers that autonomously execute tasks based on user instructions—is a pivotal shift in automation. These agents are rapidly improving, with the key challenge being ensuring consistency across various contexts. However, AI's evolution has already expanded automation beyond what was previously possible using deductive logic alone.

At this year’s CES, NVIDIA emphasised that achieving AI consistency at scale requires extensive training and instruction. The company believes that the first industries to see large-scale AI automation will be driving and robotics, as both operate in structured environments with well-defined behavioral rules. NVIDIA CEO Jensen Huang expects these applications to ramp up in the near future. If he is correct, several key implications follow:

1. **Enhanced AI Consistency** – Autonomous driving demands near-perfect accuracy for user adoption, as human tolerance for machine errors is significantly lower than for human mistakes. This implies that data scientists will have developed techniques to ensure AI reliability across complex scenarios.
2. **Regulatory Adaptations** – Widespread AI deployment in industries like autonomous driving will necessitate legislative changes, particularly in insurance and liability frameworks, to clarify responsibility in case of accidents.

Beyond these near-term applications, AI's broader trajectory is becoming clearer. As outlined in Innodata’s recent earnings call, Big Tech’s current strategy for achieving general artificial intelligence (AGI) involves expanding from probabilistic text generation to capturing and modelling human reasoning. The idea is that if language models can generate text probabilistically based on vast datasets, then a similar approach can be used to map human reasoning patterns, allowing AI to probabilistically "think" through problems.

The main challenge remains context. In structured, rule-based environments—such as chess, road navigation, or warehouse logistics—AI can be trained with all the necessary constraints (e.g., physics, spatial boundaries) to function autonomously. However, multi-faceted real-world problems require significantly more context, which is currently limited by constraints like HBM (High Bandwidth Memory). That said, recent breakthroughs by DeepSeek suggest new methods that could address part of this issue.

As AI models become increasingly capable, their applications will continue to expand. While some automation will be marginally beneficial (e.g., voice-controlling a bank transfer instead of using an app), others will meaningfully enhance efficiency, such as tax software that proactively identifies potential errors based on pre-trained financial data. The more AI-driven solutions improve real-world decision-making, the greater the demand for the infrastructure needed to support them.

- We continue to favour companies like *Vertiv, Celestica, Argan and Innodata* which we’ve discussed previously. One of our largest investments in AI is now in a storage memory company called *Western Digital.* This company makes hard drives that store data. Traditionally, this business has been driven by scale, with products evaluated primarily on cost efficiency. Big Tech firms typically increase the price of cloud storage for end users while capturing underlying cost savings, making operational efficiency a key competitive factor. In our view, demand for memory storage is set to grow significantly for several reasons. First, AI models are increasingly being trained on video data, which requires exponentially larger storage capacity. Second, society is not yet capturing all the data it generates. While much of this data was once considered worthless, it is now highly valuable, with the right datasets yielding gross profit margins of over 40%. As price signals incentivise greater data retention, the volume of stored information will continue to rise. Third, AI inference outputs will increasingly be saved for further training, driving additional long-term storage needs. We believe this shift has structurally accelerated

storage demand growth, yet the market continues to view these businesses as cyclical. With some of these companies trading at around 10x earnings, we see a disconnect between market expectations and the transformation already taking place in other data centre component providers – one that is now unfolding in memory storage.

- To triangulate these views, we draw from the insights of a few companies. Satya Nadella, the CEO of Microsoft, recently said in an interview that the ratio of how much storage we need relative to compute will remain the same. As inference picks up due to AI agents, he expects the localised need for all the other supporting infrastructure to pick up in a linear relationship. On Microsoft's last quarterly earnings call, Nadella said that they are starting to see a pick-up in the demand growth rates for storage memory. Alongside this, the CEO of Innodata, a provider of data and pre-training services to hyperscalers and enterprise, commented that:

  > *"an industry analogy to explain where we are in capturing data is to imagine the realm of all useful data to be the size of a football. By comparison, today's best-performing LLMs have been trained with data sets that are probably the size of a dime. What's even more interesting is that much of this is uncaptured useful data that does not exist explicitly today, such as how to execute a multi-step process using a series of websites or how to reason through complex domain-specific problems…When we peel that back a bit, we see lots of different things. We see expert data, reasoning data, multilingual data, multimodal data, meta-learning…so there's a ton of data that needs to be captured and that needs to be addressable in order for the models to learn from it."*

- Regular readers of our monthly notes may observe that we have not yet written about another theme mentioned in past updates – "**Drill Baby Drill**." As we have investigated and researched this thesis more, we have closed out our positions. While President Trump can encourage more energy investments in the US, he can't force them. We have learnt through our research that the energy companies are not going to go wildly prospecting for more oil. Gas production will very likely increase naturally as electricity demand increases from AI and reshoring with time.

Other opportunities:

We won't list all the other opportunities that we currently have invested in, but we will provide some highlights of select opportunities that demonstrate very favourable risk-reward characteristics:

- *SkyX Platforms* has developed a smart ceiling receptacle, a product that functions similarly to a smart power plug like Tapo or a smart light like Philips Hue. The receptacle allows for remote and voice control of smart home devices such as Google Home, Nest, Alexa, and Siri. It offers several advantages, including safer installation and removal of connected devices, greater flexibility for changing indoor fixtures, and enhanced convenience for tenants in multi-family apartment complexes. Hotels can also benefit by streamlining renovations and optimising power usage in unoccupied rooms. Additionally, the receptacle can integrate with smoke detectors to meet U.S. regulatory requirements, while simplifying repairs, replacements, and fixture installations.

  To establish a new industry standard, the company has introduced two new electrical codes for ceiling receptacles. Currently, wall plugs must adhere to strict electrical standards, with additional safety regulations for bathroom outlets. Initially, we were sceptical of the product's adoption, assuming builders would resist the added cost, given that not all consumers favour smart plugs or recessed lighting. However, two key factors have alleviated these concerns.

  First, SkyX can sell the receptacle at cost to drive adoption, ensuring builders face no additional expenses. Multi-family developers who lease out properties would no longer need to provide fixtures, resulting in cost savings. The company can then generate profits from the fixtures attached to its receptacles. In the U.S., tenants have little choice but to accept what developers provide – evidenced by the growing trend of builders omitting recessed lighting in apartments. SkyX can further incentivise adoption by offering builders rebates or a share of fixture profits.

  Second, the concept is gaining traction, with the company recently securing two major apartment complex deals. Its competitive edge lies in its distribution network and razor-and-blade business model. A competing product would require widespread stocking, yet SkyX has already locked in distribution agreements with Home

Depot and Wayfair. Industry support is strong, with former CEOs of Home Depot, GE Power Systems, and the American Lighting Association among its advisors.

The business is scaling rapidly, signing deals at an increasing pace and approaching profitability. Unlike traditional industries, SkyX can use technology to ensure only licensed fixtures are compatible with its receptacles. Becoming a standard in the electrical industry typically takes a decade, and once established, there is little need for a competing standard. With management actively purchasing millions in stock and debt, we see an extremely favourable risk-reward profile, further skewed in SkyX's favour over time.

- *ACM Research*: ACM Research is a U.S.-listed company that owns approximately 80% of ACM Shanghai, which trades on the Shanghai Stock Exchange. The valuation disconnect here is striking – ACM Research is valued at around $1.5 billion, while its stake in ACM Shanghai is worth approximately $5 billion at current market prices. These types of situations often arise due to investor scepticism toward U.S.-listed Chinese companies, particularly concerns over governance and financial transparency. However, we believe ACM Research's value is more secure for several reasons.

  First, unlike many Chinese companies listed abroad, ACM Research is not structured as a Variable Interest Entity (VIE). Instead, it holds a direct equity stake in ACM Shanghai, reducing structural risks. If the Trump administration mandates the delisting of Chinese firms from U.S. exchanges, we expect a re-listing in Hong Kong or Singapore to serve as a catalyst for price revaluation. Alternatively, if Congress forces a sale to a U.S. entity, similar to the ongoing situation with TikTok, the sale price would likely unlock significant value for shareholders.

  Second, ACM Research is a fundamentally strong business. Its credibility is reinforced by the fact that its semiconductor cleaning equipment has been qualified by industry leaders such as SK Hynix in South Korea and Intel in the U.S. The company is also engaged with TSMC, further validating its technology. Within China, ACM Research is already embedded with the country's two largest semiconductor manufacturers, SMIC and Changxin Memory.

  Third, the company is gaining domestic market share and is actively supported by the Chinese government, which remains committed to developing its domestic semiconductor industry amid U.S. restrictions on chip exports. This strategic positioning is likely to accelerate revenue growth, particularly as Chinese AI giants like Alibaba ramp up capital expenditures following DeepSeek's advancements. Notably, Alibaba recently announced plans to invest more in capex over the next three years than it did in the past decade.

  Given its asset value and earnings potential, we believe ACM Research is significantly undervalued and should trade at least 3x its current share price.

- *Freddie Mac and Fannie Mae:* The investment thesis for Freddie Mac and Fannie Mae is based on the expectation that a second Trump administration will complete the process of privatising these entities, removing them from conservatorship – a process that began under the first Trump administration but was left unfinished due to time constraints. We believe a renewed effort is highly likely, driven by the need to generate revenue to offset Trump's tax cuts. Floating Freddie and Fannie into the private markets could yield approximately $300 billion in profit for the government, covering an estimated 10-15% of the net budget deficit.

  Historically, Republican-led efforts to fund tax cuts have relied on auctioning off spectrum to telecom companies. However, as the available supply of spectrum diminishes, privatisation of Fannie and Freddie presents an alternative revenue source.

  A key factor in valuing these businesses is the regulatory capital requirement imposed on their insurance operations relative to their asset base – a metric somewhat analogous to a capitalisation rate in real estate. It is likely that the administration will target a capital requirement of around 2.5%, a level that is more practical than the current 4% requirement but still significantly higher than the pre-GFC standard of 0.45%. A major reason these entities now require less capital protection is that they are no longer obligated to hold the mortgage-backed securities they package.

  At a 2.5% capitalisation rate, Fannie and Freddie would need to raise approximately $20 billion in equity capital through an IPO. This aligns with statements made by the new Housing and Urban Development Chief, Scott Turner, who recently told *The Wall Street Journal* that "a cross-government effort to privatize Fannie Mae and Freddie Mac will be a priority" and that the companies would likely raise $20-30 billion as part of the IPO.

Additionally, Trump himself reinforced this view in a 2021 letter to Senator Rand Paul, stating that his administration would have privatized Freddie and Fannie, selling the government's common stock at a significant profit. He described the continued conservatorship as "socialism" and blamed it on unconstitutional restrictions that prevented him from firing Mel Watt, the then-director of the FHFA. Since then, the now conservative-leaning Supreme Court, as well as Federal District Judge Christopher Cooper, have effectively ruled that Trump has the authority to remove department heads with minimal delay.

At a 2.5% capitalisation rate, we estimate that the fair value of Freddie and Fannie shares is approximately $35. This presents a compelling 7-to-1 asymmetric risk-reward opportunity for an event that we believe is highly likely to occur.

- *Southern Cross Electrical Engineering (SCEE Group):* The electrification trend currently underway in the U.S. is making its way to Australia, albeit with a slight lag due to slower capital formation and a more extended regulatory approval process. However, the data centre build-out is already beginning. For example, NextDC, one of Australia's largest data centre developers, is forecasting a near doubling of its operational data centres over the next few years.

  At the same time, Australia's clean energy transition is accelerating, supported by the federal government's $19 billion *Rewiring the Nation Fund*. The necessity of such an initiative underscores the broader push toward electrification—there would be no need to rewire the country unless there were substantial electrical infrastructure requiring integration.

  SCEE Group, one of Australia's largest electrical services providers, is well positioned to benefit from these developments. The company's revenue from data centre projects has already begun to scale, growing from an annualised run rate of approximately $20 million in 2023 to an estimated $125 million in the next fiscal year. Additionally, as existing coal plants retire, demand for renewable energy infrastructure will continue to rise, ensuring further opportunities for companies supporting grid expansion and clean energy adoption.

  Australia's commitment to the green energy transition appears structurally more certain than in the U.S., where Trump's rollback of the Inflation Reduction Act has slowed momentum. In response, Australia's Labor and Green parties have actively sought to implement policies that are insulated from political reversals, reinforcing long-term investment in renewable energy.

  SCEE Group remains attractively valued, trading at only around 8x enterprise value to free cash flow. Even with a tripling in its stock price, the company would still trade below the levels of global peers in which we have previously invested.

We continue to monitor each of our theses for potential flaws or new developments that would invalidate them.

Kind Regards,
Fawkes Capital Management

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