DuPont Capital

EQUITY STRATEGY REVIEW
JULY 2022

International Equity

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The reality of tighter liquidity conditions and the looming prospect of economic fragility in many regions have set the stage for a wide-ranging, valuation-based tug of war over perceived structural winners in traditionally cyclical end markets.

It is axiomatically perilous to ignore near-term pressures on, and risks to, revenues and earnings; no investor should be so inflexible as to disregard these factors entirely. However, it is important to consider, on the balance of probabilities, how severely a given company's underlying earning power or relative competitive position could be derailed by the economy's fluctuations.

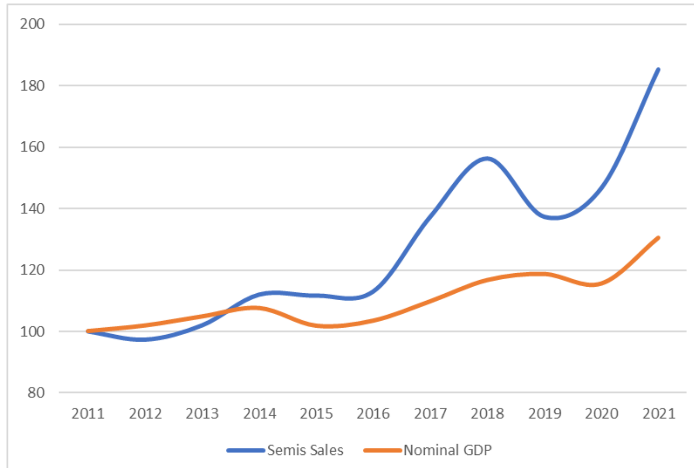
Depending on industry structure, some segments of the economy have demonstrated improved economic resilience through time, In such cases, sequential peak and trough profit margins have maintained an upward trend, often accompanied by lower amplitude through time. As always, sector context is an important determinant of potentially diverging fortunes at the individual company level, and an important part of our research process. Further, inherent or sustainable corporate advantages, including market share-based scale, deep financial firepower, or innovative vigor, can prove to be a more valuable differentiator during downturns than less challenging, “rising tide” upswings.

A good case in point is the semiconductor industry. The proliferation of microchips is an apparently unabated global phenomenon, as evidenced by supply chain shortages among "newer" customer verticals in autos and industry. Smarter smartphones rely on data-processing enhancements at the nanometer level and 5G connectivity will fuel demand for factory floor and remote applications. Advances in Artificial Intelligence are fueled by semiconductors and, at the geopolitical level, rising Tech nationalism has seen China announce aggressive plans to bolster self-sufficiency. These tailwinds are not, however, completely gravity-defying. Even accounting for the recent supply disruptions, downside scenarios, demand deferral, and inventory cycles need to be considered.

The data shows that over the last decade, total semiconductor sales have shown marked outgrowth relative to the overall economy (Exhibit 1). Still, there are discernable periods of acceleration and even retrenchment, often tied to the direction of aggregate GDP. It is worth noting that the 2019 drawdown in semi sales was skewed by a sharp normalization in the more commoditized memory chip segment, which is more prone to overcapacity.

While Europe and Japan account for only approximately 10% each of both semiconductor production and consumption, they are home to some key industry sub-supplier and partners to the dominant fabrication plants in Taiwan, Korea, and elsewhere.

EXHIBIT 1: SEMICONDUCTOR SALES AND NOMINAL GDP (INDEXED)



Source: BofA, SIA, IMF

Our semiconductor-exposed holdings are skewed toward firms with strong niche dominance that are key enablers of the Moore's Law "arms race" of miniaturization and architectural complexity in chip manufacturing. Among semiconductor equipment suppliers, lithography specialist ASML is a familiar story to many (late last year the company ranked second to only Nestle in terms of market capitalization in Europe) but their technological advantages in leading-edge EUV (Extreme Ultra-Violet) processes currently provide a de facto monopolistic position for relevant state of the art foundry capex. We expect this advantage to persist, underpinning demand for several years and allowing earnings to compound in tandem. On a multi-year horizon there is a strong probability that the valuation premium proves to be sustainable.

High precision Japanese cutting tool leader Disco dominates in other essential components for the manufacturing process. The company maintains a strong market share of over 60% for dicing, grinding, and polishing tools. Although their business is more sensitive to production volumes and mix effect, a high degree of recurring revenues from consumables (the razor and razor blade model) is supportive. As long-term holders, we are also comfortable with Disco management's capital deployment and dividend policies across the cycle; in light of these characteristics valuation multiples appear undemanding.

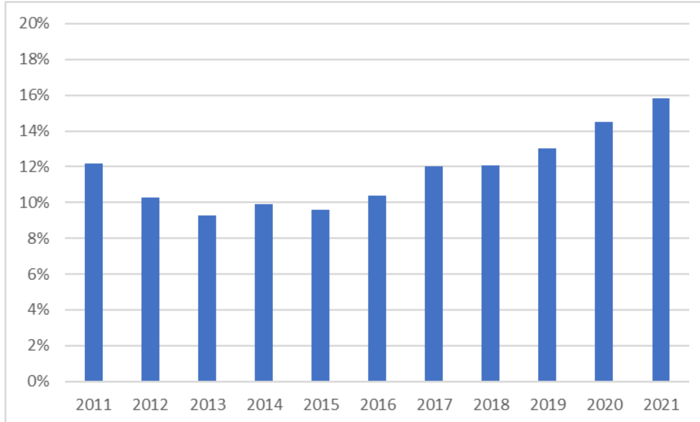
Exhibit 2 illustrates how equipment providers have steadily gained wallet share (measured as % of total production capex) over the past two to three cycles. There are reasons to believe that the future intensity will be sustained at closer to the 15% level than the long-term historic average of 12%.

We also hold a position in chip-maker Infineon given their relative focus on higher voltage power semiconductors. Demand will be tied to underlying trends in cars (content per vehicle and EV adoption) and manufacturing (capex plans for Industrial Internet of Things). Infineon has identifiable capabilities to ramp production profitability and, as a former spin off from Siemens, strong customer relationships across European channels and beyond.

Exposure to the theme need not come via pure plays. In Health Care, Japanese optical and lens specialist Hoya has done an impressive job deploying their knowledge and intellectual property around photonics as a provider of high-end mask blanks for wafer etching. Though not their core market, their proven ability to leverage technology into adjacent markets has helped to diversify their revenue profile.

In every instance, these fundamental factors and relevant economic cross currents need to be triangulated with valuation multiples (our Valuation-Quality-Momentum trifecta) to ensure that individual risk-reward estimates maintain a favorable skew.

EXHIBIT 2: WAFER FAB EQUIPMENT INTENSITY (% OF TOTAL SEMI SALES)



Source: BofA ets, Gartner

Markets are contending with the unstoppable thematic forces of the last several years (digitization, demographics, stimulus) hitting a potentially immovable and recessionary object. At times of maximum cyclical uncertainty, the ability to identify and ultimately add to all-weather quality names will remain as important as ever.

ABOUT OUR FIRM:

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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IMPORTANT DISCLOSURES: