

Why We Own Applied Materials

The material science behind more efficient AI

The cloud begins in a cleanroom. Before an AI model can answer a question, precisely deposited, etched, measured and polished layers have to be built into the chips that move data and memory. Each new generation must do more work, fit into a workable physical system and use energy more efficiently.

That is the hidden industrial problem behind Applied Materials. It does not design the AI model or run the data centre. It makes many of the tools and processes that allow chipmakers to manufacture advanced logic, memory and packaging at scale.

On 13 August 2026, Applied reported record fiscal third-quarter revenue of \$9.115 billion, 25% above the prior year. GAAP operating margin reached 33.7%, operating cash flow was \$3.04 billion and the company guided to \$10.25 billion of revenue, plus or minus \$500 million, in the fourth quarter. Those numbers show that AI demand is reaching the companies that build the physical equipment behind it.

They also sharpen the investment question. Can Applied convert an exceptional spending cycle into durable earnings, cash and customer value – and can shareholders still earn an attractive return when expectations are already high?

Structural demand: more computing meets an energy limit

AI demand is not weightless. The International Energy Agency projects global data-centre electricity consumption to rise from about 485 terawatt-hours in 2025 to roughly 950 TWh in 2030. The range remains uncertain because adoption, model capability, infrastructure bottlenecks and efficiency are all moving quickly.

That uncertainty makes efficiency commercially valuable. Data-centre owners do not only need more processors. They need more useful computing from every watt, rack and dollar invested. Chipmakers therefore have to improve transistor performance, connect processors to high-bandwidth memory and stack several specialised dies into one package without sacrificing yield.

These transitions require more materials-engineering steps. They also make failures expensive: a process problem can reduce the proportion of usable chips from a wafer, delay a factory ramp or leave costly cleanroom space underproductive. Applied earns when customers pay to solve those constraints.

What Applied Materials actually does

Applied's equipment adds, removes, modifies and measures material on a silicon wafer. Deposition systems build extremely thin films. Etch tools remove selected material. Chemical-mechanical polishing makes a surface flat enough for the next layer. Inspection systems find

defects that are too small for optical tools alone. Advanced-packaging equipment helps connect logic and memory chips in a single system.

This breadth matters because the problem is no longer simply making each transistor smaller. New chip architectures rely on unfamiliar materials, three-dimensional structures and tighter integration between different components. Applied can work across several process steps and help customers move a design from research into high-volume manufacturing.

Its Applied Global Services business supports installed equipment with parts, subscriptions, monitoring and engineering. In its Q3 prepared remarks, management said more than 37,000 chambers were connected to its Alx software for monitoring, diagnostics and predictive analytics. That installed base can create recurring revenue and deepen customer knowledge, although retention and service attachment still need to be tested rather than assumed.

Where it fits. Applied Materials sits primarily within Delta's Climate Action theme because its products can improve the energy efficiency of computing and the resource efficiency of chip production. Nature Innovation is relevant to water, chemicals, materials and waste inside fabrication plants, while Human Advancement reflects what better computing can enable in health, safety and knowledge. We use one primary classification because theme membership alone does not make a share attractive.

Why the company may win

Applied's advantage rests on accumulated process knowledge, a broad portfolio and deep customer collaboration. A tool must deliver repeatable results in a customer's actual production line, not only in a laboratory. Once a process is qualified, changing equipment can threaten yield and delay a technology roadmap. This creates trust and switching costs.

The company is trying to deepen that position through its EPIC Center, where chipmakers, universities and suppliers can work together earlier in the development cycle. Eleven engagements have been announced, including Broadcom, TSMC, SK hynix, SCREEN and UC Berkeley. The thesis is that earlier co-development should help Applied become designed into new architectures, shorten commercialisation times and direct research spending toward problems customers will pay to solve.

That is promising, but it is still a test. Collaboration announcements do not establish market share, pricing power or returns. The evidence will be faster customer ramps, higher yields, repeat orders and attractive cash returns on Applied's own research and capacity investments.

How adoption becomes earnings

The earnings chain is increasingly visible. Leading-edge logic, DRAM and advanced packaging require more complex deposition, etch, inspection and packaging processes. Applied sells the systems, then earns service, spares and subscription revenue as customers operate them. Better yields and factory output can support value-based pricing; a larger installed base supports recurring services.

In Q3, Semiconductor Systems revenue rose 27% to \$7.04 billion and its non-GAAP operating margin reached 38.0%. Applied Global Services revenue increased 22% to \$1.781 billion, with

a 30.1% operating margin. Free cash flow was \$2.33 billion. Management expects advanced-packaging revenue to grow more than 70% in calendar 2026 and is preparing capacity to double quarterly system output by 2028. Those forecasts are not outcomes, but they explain where management believes growth and reinvestment will come from.

A financially strong business, not just a good story

A compelling theme only matters if the company behind it can actually turn demand into durable profit, cash and returns. Before getting carried away with the AI story, we ask a simpler question: is this a genuinely well-run, profitable company through the cycle, not only at its peak? On the numbers, the answer is substantially yes – with one honest qualification: the record we are testing includes a real cyclical soft patch as well as the current boom.

Profitability. Applied's margins are high by any industry standard and have kept improving through a cyclical downturn, not just during the current boom: non-GAAP gross margin has now expanded for 13 consecutive quarters, reaching a record 50.4% in the most recent quarter, and non-GAAP operating margin reached a record 34.0% over the same period. The balance sheet is similarly conservative – a debt-to-capital ratio of just 3.3% and a net cash position – giving the company room to keep investing in capacity through the cycle rather than being forced to time it.

Earnings growth. Over the four years to fiscal 2025, revenue grew at an annualised rate of about 12% while non-GAAP earnings per share grew faster still, at roughly 20% a year, reaching \$9.42 in fiscal 2025 – profit compounding faster than sales is the marker of quality we look for, and it held even through the semiconductor industry's recent, more subdued years. That pattern has now stepped up again: fiscal third-quarter non-GAAP earnings per share rose 41% year on year to a record \$3.50, and management's own guidance for the fourth quarter of around \$4.02 implies 85% year-on-year growth, with a raised full-year outlook and management commentary pointing to another record year in calendar 2027. These are guided expectations, not settled outcomes, and they depend on the AI-linked upcycle continuing broadly as management currently expects.

Shareholder returns. Applied's shares have been strong performers but volatile ones, which is the more important lesson for how we hold the position: after more than doubling so far in 2026 on the back of the AI-driven re-rating – briefly trading above \$739 in June before easing back – the stock still fell around 5% in the session immediately after this quarter's results, even though both revenue and earnings beat expectations. That reaction is a reminder that already-high expectations, not the underlying fundamentals, are increasingly the swing factor for the shares in the near term. This is a high-quality business inside a genuinely cyclical, sentiment-driven end market – not a defensive compounder – and that distinction matters for how we size the position.

Taken together, this gives us confidence that Applied combines an elite level of underlying profitability and improving margin discipline with a business that is now visibly reaccelerating – though the volatility in both the demand cycle and the share price is a structural feature of this end market that we must underwrite, not a temporary anomaly we can assume away.

Leadership we can trust

A good business also needs to be well led. The roles of Chief Executive and Chairman are held by separate people, giving proper checks and balances at the top rather than concentrating power in one individual. Every director stands for re-election each year, so shareholders get a regular say over who governs the company, the board conducts an annual self-assessment of its own effectiveness, and there is only one class of share, so no shareholder carries outsized voting power over the rest. Executive pay is weighted heavily toward variable, long-term awards rather than fixed salary, with annual bonuses tied to earnings performance and long-term incentives split between multi-year economic profit and total shareholder return relative to the broader market – directly linking pay to the same profitability and return measures we test elsewhere in this document.

One caveat is worth stating plainly rather than glossing over: several directors, including the chair, have served on the board for a long time, and on a strict independence test the board's tenure profile and refreshment fall short of the standard we look for elsewhere in the portfolio. The board has begun to add new independent directors, but this is an area we continue to engage with the company on rather than treat as resolved. Set against that, capital allocation has been genuinely disciplined: the dividend has been raised every year since 2018, the company targets returning 80–100% of free cash flow to shareholders, and it returned \$860 million to shareholders in the most recent quarter alone through buybacks and dividends, with a large buyback authorisation still outstanding. Taken together, this gives us confidence that management is incentivised correctly and has a genuine, multi-year record of disciplined capital return, while board refreshment remains a live governance question rather than a settled strength.

Why Delta owns it – and why price still matters

Delta owns Applied Materials because three things now line up: a durable, structural exposure to the materials engineering that AI-driven computing depends on; a genuinely high-quality business behind it, with elite and improving margins, a rapidly reaccelerating earnings profile and a strong – if volatile – record of shareholder returns; and a board and remuneration structure that separates the chair and chief-executive roles, ties pay tightly to long-term performance and has a disciplined record of capital return, even as board refreshment is a governance question we continue to engage on. Few companies offer this combination of conviction across impact, financial quality and governance at once.

But a strong company is not automatically an attractive investment at any price. The current result reflects exceptional AI-related demand and rising margins, and after such a sharp rally the shares now demand a valuation that assumes much of that growth continuing smoothly, leaving less room for anything short of continued strong execution. Our conviction therefore rests on what earnings and cash flow look like through a normal semiconductor cycle, not only at the peak of this one, and on whether the new research and manufacturing capacity Applied is building now earns adequate returns once the current surge in demand normalises. Valuation discipline, not enthusiasm for the AI theme, is what ultimately governs how much of that conviction we translate into position size.

What could break the chain

A number of things could weaken this thesis, and we watch for all of them:

- Cyclicity and customer concentration. Semiconductor equipment spending is cyclical: customers can order aggressively when capacity is scarce and cut spending when demand, memory pricing or utilisation falls. Applied's 2025 filing shows two customers represented about 19% and 15% of annual revenue.
- Trade-policy and export-control risk. China represented 26–28% of combined Semiconductor Systems and Applied Global Services revenue in the most recent quarter, down from around 35% a year earlier, as export rules reshape the business. In February, the US Bureau of Industry and Security announced an approximately \$252 million settlement over unlicensed shipments routed through Korea to a Chinese company on the Entity List; the penalty is historical, but the continuing question is whether controls, culture and board oversight are now strong enough.
- Financial-quality durability. The elite margins and returns achieved through fiscal 2023–2025's downcycle, and the sharp reacceleration now guided for fiscal 2026–2027, still need to be proven through a full cycle. If the AI-linked upcycle cools before the capacity being built is fully utilised, margins and returns on invested capital could retrace from their current highs.
- Governance refreshment. Several long-serving directors, including the chair, raise genuine questions about board independence under a strict tenure test. Continued board refreshment, not just formal separation of the chair and chief-executive roles, is something we will keep testing rather than assume is resolved.
- Impact-case durability. Efficiency gains of 17% per wafer pass since 2019 could be outweighed by absolute growth in fab electricity and water use as the business scales – total water withdrawal rose 4% in fiscal 2025 – and EPIC Center co-development wins have not yet been shown to translate into higher yields, market share or pricing power.

The thesis would weaken materially if order growth failed to convert into durable margin and cash-flow gains, if China or export-control developments cut into revenue faster than the rest of the business can grow, if board refreshment stalled, or if verified customer outcomes failed to support Applied's own efficiency claims.

Measurable outcomes as evidence

Applied's 2025 Impact Report says average energy consumption per wafer pass across its semiconductor products improved 17% from a 2019 baseline. It also reports that 75% of electricity used in its global operations was matched with renewable sources. These are useful indicators, but they are company-reported, apply to defined boundaries and do not prove the energy saved by a customer's finished chip or data centre.

The counter-evidence matters too. Total water withdrawal rose 4% in fiscal 2025 as business activity and laboratories expanded. A credible Climate Action case must therefore monitor efficiency and absolute resource use, chemical impacts and supply-chain emissions as production grows.

The best outcome test is not a slogan about greener chips. It is evidence that Applied's tools help customers produce more functioning, energy-efficient computing from the same factory, material and electricity inputs – while Applied earns attractive returns without recurring compliance failures.

We own Applied Materials because impact, financial quality and governance genuinely line up: the equipment need is structural, the underlying economics are excellent even through a cyclical trough and are now visibly reaccelerating, and the people running the business are incentivised to compound that advantage responsibly, even as we keep pressing on board refreshment. That is what ownership represents: a stake in the physical innovation required to make the digital economy work, combined with discipline about the cycle, valuation, governance and evidence.

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