# DNR Capital Australian Emerging Companies Fund
## Performance Report – August 2021

### Performance

The DNR Capital Australian Emerging Companies Fund increased 4.21% (net of fees) in August, underperforming the S&P/ASX Small Ordinaries Accumulation Index by 0.77%, which increased 4.98%.

### Market review

At the end of August, we are pleased to report that the Fund marked its three-year anniversary since inception. Over this period it has generated a return of 20.48% per annum (net of fees), outperforming the Index by 10.39% per annum. With the Fund offering a concentrated exposure to high quality attractively priced small cap companies, the composition of the Fund is likely to differ significantly from the Index over time. The Fund is diversified, currently across 28 holdings, with the top ten highest conviction ideas accounting for around half the Fund. With less than 20% overlap versus the Index, this means that the Fund's short-term returns could look quite different from the Index, and we would guide investors to focus on longer-term returns in-line with the investment objective of the Fund.

Equity markets posted strong gains during August, even with the backdrop of the Delta variant of COVID-19, which is raising concerns around the trajectory of the economic recovery. Although the spread of the Delta variant continues to weigh on the short-term outlook, investors are looking through this period of uncertainty, towards the re-opening of the global economy and a post-COVID-19 environment. During August, small caps significantly outperformed large caps in Australia, with the small cap index increasing 4.98%, versus 1.7% for the S&P/ASX 100 Index.

Domestically the Australian economy is still experiencing the disruption of lockdown measures to contain the virus. Although vaccination rates in Australia are increasing which is encouraging, the lesson internationally suggests that even with a high proportion of the population vaccinated, the impact of COVID-19 is likely to be long lasting. This clearly clouds the outlook in the near-term, with corporates having to contend with a variety of issues. These include border closures, material shortages, and disruptions to supply chains and labour markets. Given this backdrop, August was an interesting month to understand how corporates are dealing with these challenges, as it included the end of financial year reporting season comprising a significant number of company updates and meetings.

Overall, the reporting season was positive, with corporate earnings bouncing back sharply from the COVID-19 induced recession last year. Given the various disruptions facing the global economy, corporates and households have shown remarkable resilience. Balance sheets are generally in a strong position, with management teams talking optimistically regarding the outlook as lockdown measures are lifted. We have been particularly impressed

### Fund overview

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|---|---|
| APIR Code | PIM4357AU |
| Investment bias | Style neutral with a quality focus |
| Designed for | The Fund is designed for investors seeking a medium-longer term investment focused on achieving growth, with less focus on generating excess income. The investor is prepared to accept higher volatility in pursuit of higher growth. |
| Investment objective | The Fund's investment objective is to invest in a portfolio of Australian emerging companies that aims to outperform the Benchmark (net of fees) over a rolling five-year period. The investment objective is not a forecast of the Fund's performance. |
| Benchmark | ASX/S&P Small Ordinaries Accumulation Index |
| Investable universe | Australian equities and cash |
| Investment constraints | The Fund will not invest in derivatives |
| Investment guidelines | Maximum exposure to an individual security is 15% of Fund NAV |
| Asset allocation | Australian Equities - 80-100%<br>Cash - 0-20% |
| Risk level | High |
| Number of securities | Min 20 - max 45 |
| Minimum suggested investment timeframe | 5 years |
| Buy/sell spread | +0.30% / -0.30% |
| Management fee | 1.15% p.a. of the NAV of the Fund (inclusive GST and RITC) |
| Performance fee | 20% of outperformance of the Fund relative to the Fund's Benchmark (after the management fee) |
| Minimum initial application amount | $20,000 |
| Minimum further application amount | $5,000 |
| Minimum withdrawal amount | $5,000 |
| Valuation and unit pricing frequency | Each business day |
| Distribution frequency | Semi-annual |
| Responsible entity | The Trust Company (RE Services) Limited as part of the Perpetual Limited group of companies |
| Entry/exit fees | Nil |

by companies that have taken positive action during this crisis, with a focus on creating long-term value for shareholders. For example, by reinvesting back into the company to drive high levels of organic growth and/or to capture market share. This may have included a step-up in product development, marketing or geographic expansion. Alternatively, it includes companies that have undertaken opportunistic acquisitions at the bottom of the cycle at distressed prices. In both cases, we expect shareholders will reap the rewards from this action in the years to come. The Fund has investments in a number of these types of opportunities, and we are very excited about their long-term prospects.

Highlights for the Fund during the reporting season were in a mix of sectors. Shares in IPH (IPH) bounced sharply after underperforming when investors rotated into the more cyclical sectors. The company is a more defensive holding in the intellectual property industry, with the recent result highlighting the leading industry position and high levels of cash generation. Along with a conservative balance sheet, this is enabling management to take a key role in the consolidation of the industry. The fashion accessories retailer Lovisa Holdings (LOV) climbed higher, with the company highlighting the significant recovery potential. This is especially the case in regions like Europe and North America, where the company has been investing heavily in recent years to expand its store footprint. Temple and Webster Group (TPW) shares also positively contributed to performance, with the online retailer continuing to disrupt the furniture and homeware industry, as it takes market share from traditional bricks and mortar retailers.

With increasing concerns around the Delta variant of COVID-19 impacting growth, some of the more cyclical holdings like resources lagged the market during August. With the Fund overweight the Resources sector, this explains the relative underperformance versus the Index during the month. The Fund's holdings in Champion Iron (CIA), Lynas Rare Earths (LYC) and Deterra Royalties (DRR) were the largest detractors from the Fund's relative performance. Overall, we remain positive on the outlook for a number of companies in the Resources sector. We are particularly attracted to those companies exposed to the decarbonisation thematic, including the shift towards renewable energy, electric vehicles, and reducing the carbon intensity of steel production. This accounts for the majority of the Fund's holdings in the Resources sector, and we used the recent weakness to add to several holdings.

Our focus continues to be on building a concentrated portfolio of the highest quality and most attractively priced companies in the Australian small cap sector. The Fund is currently positioned across a range of these opportunities, including companies that we believe will benefit as the global economy re-opens, in attractively priced growth stocks which are reinvesting at high rates of return, and in some of the more cyclical sectors of the market like mining shares. Overall, the average return on invested capital for the Fund's holdings is well above the Index, highlighting the superior quality characteristics and potential for long-term value creation. The balance sheets of the Fund's holdings are also significantly more resilient than the Index, with nearly all of the holdings sitting on excess cash.

## Net active return as at 31 August 2021

| | 1mth | 3mth | 6mth | 1yr | 2yr | 3yr | Incep.* |
|---|---|---|---|---|---|---|---|
| Emerging Companies Fund | 4.21 | 15.99 | 22.20 | 47.39 | 28.62 | 20.48 | 20.48 |
| S&P/ASX Small Ordinaries Accumulation Index | 4.98 | 8.95 | 15.58 | 29.51 | 14.97 | 10.09 | 10.09 |
| **Excess return** | **-0.77** | **7.04** | **6.62** | **17.88** | **13.65** | **10.39** | **10.39** |

** Inception Date—August 2018*
*Source: Mainstream Fund Services and DNR Capital*

*Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Emerging Companies Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry fees or taxation.*

## Attribution

The key stocks contributing to the Fund's monthly relative performance include:

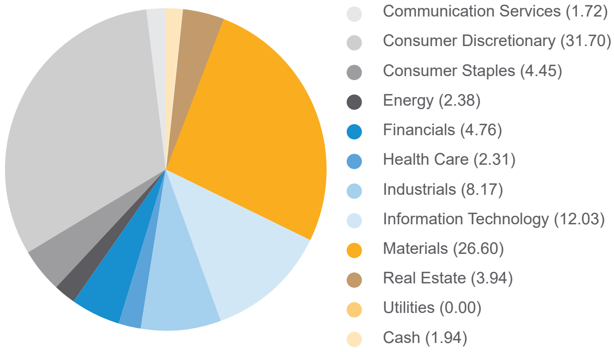
**Contributors**

- **Lovisa Holdings (LOV):** delivered a strong FY21 result with earnings up 42% despite the impact of COVID-19 which saw a number of its retail stores closed during the year. Trading for FY22 has started strong with comparable sales growth for stores open up 37.8% on FY21. With a strong balance sheet and a global footprint, LOV is well positioned to deliver strong earnings growth over the coming years.
- **IPH (IPH):** grew underlying FY21 EBITDA by 10% after adjusting for adverse foreign exchange impacts. Patent filings into Asia were the highlight up 8% and continue to be the main growth driver for the business. IPH is in a solid financial position and its strong cash generation ability positions it well to consolidate international IP markets.
- **Temple & Webster Group (TPW):** continues to cement its market leadership position in the online furniture and homewares market. Revenue grew 85% to $326m and EBITDA grew 141% to $20.5m. COVID-19 has accelerated the adoption of online shopping due to structural and demographic shifts. FY22 has started strongly with revenue growth of 49% for the first 8 weeks of trading.

**Detractors**

- **Champion Iron (CIA):** shares fell as China's efforts to reduce carbon emissions by clamping down on steel production resulted in the iron ore price selling off. Champion's high-grade iron ore is a solution to this problem as steelmakers look to decarbonise. Steel production accounts for 7% of the world's carbon emissions and high-grade iron ore is a key feedstock in the steel production process to reduce carbon emissions. CIA offers compelling value with a double-digit free cash flow yield on conservative iron ore price assumptions.
- **Deterra Royalties (DRR):** shares pulled back as the iron ore price retreated for the reasons mentioned above. DRR earns a royalty of 1.232% over BHP's Mining Area C in the Pilbara, with production expected to increase to 139 million tonnes of iron ore over the coming years. DRR is a high-quality resource exposure given there is no operational risk or capital contribution to fund growth, resulting in attractive free cash flow characteristics.
- **Lynas Rare Earths (LYC):** produced a strong FY21 result delivering EBITDA of $235m, materially above the prior year of $60m. The business has been impacted by temporary operational challenges in Malaysia due to COVID-19, with capacity remaining at 75%.

## Sector weightings %




*Source: DNR Capital*

## Monthly - top contributors and detractors

| **Top 3 contributors** |
| --- |
| Lovisa Holdings |
| IPH |
| Temple & Webster Group |

| **Top 3 detractors** |
| --- |
| Champion Iron |
| Deterra Royalties |
| Lynas Rare Earths |

** Alpha is the fund return less benchmark return. These tables represent the stocks contribution of alpha to overall fund alpha and is determined by the stocks active weight relative to the benchmark and share price return relative to the benchmark.*

## Top 5 active holdings (alphabetical order)

| |
| --- |
| Champion Iron |
| IDP Education |
| Iluka Resources |
| IPH |
| Lovisa Holdings |

*Source: Mainstream Fund Services and DNR Capital*

## Investment strategy

DNR Capital's security selection process has a strong bottom-up discipline and focuses on buying quality emerging businesses at reasonable prices. The process involves comprehensive company and industry research, company visits and meetings, and detailed valuation analysis and modelling. This information is used to assess the quality of a business, and the expected return.

The portfolio construction process considers stock weightings based on the risk versus the expected return. It is also influenced by a top-down economic appraisal, sector exposures and liquidity considerations.

The investment strategy of the Fund is intended to result in a concentrated portfolio that is high conviction and invests for the medium to long-term.

## Investment philosophy

DNR Capital believes a focus on quality will enhance returns when combined with a thorough valuation overlay. DNR Capital seeks to identify good quality emerging businesses that are mispriced by overlaying DNR Capital's quality filter, referred to as the 'quality web', with a strong valuation discipline.

## Platform access

- AMP MyNorth
- BT Panorama
- CFS FirstWrap
- HUB24
- Macquarie Wrap
- Mason Stevens
- Netwealth
- Praemium



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