

# DNR Capital Australian Emerging Companies Fund

## Performance Report – February 2022

### Performance

The DNR Capital Australian Emerging Companies Fund increased 0.33% (net of fees) in February, outperforming the S&P/ASX Small Ordinaries Accumulation Index by 0.34%. Over the last 12 months the Fund increased by 15.33%, outperforming the Index by 10.31% (net of fees).

### Market review

Key headlines in February centred around heightened geopolitical tensions, building inflationary pressures and the domestic reporting season. The Russian invasion of Ukraine saw risk assets fall and a flight to safe haven assets such as bonds and gold. The western world has imposed sanctions on Russia for its actions, placing pressure on Russia's key exports and creating instability in commodity markets. Inflation in the US rose to its highest level in 40 years, coming in at 7.5% compared to a year ago. The US Federal Reserve (Fed) has changed its rhetoric since the start of the year around inflation being 'transitory' with the bond market pricing in several rate hikes, the first expected in March.

The small caps benchmark closed flat, yet under the surface we saw wide divergences between stocks and sectors. The top performing stocks came from value segments of the market such as mining contractors and commodities. While the bottom performing stocks came from the growth segments of the market such as technology. In particular, profitless companies with no visibility for cash flow generation were severely punished. In prior months we discussed the valuation dispersion between high price earnings (PE) and low PE multiple stocks. Although this valuation gap has adjusted, it is still large, suggesting this shift in market leadership has further to run. Previous winners such as technology and long duration growth stocks that benefited from low interest rates may struggle to repeat this level of outperformance in a rising interest rate environment. On the other hand, the more cyclical areas of the market where valuations are cheap and earnings are growing strongly, appear more attractive investments.

The reporting season highlighted that the market is becoming more discerning over valuations given the prospect of higher interest rates. In fact, a number of quality growth companies delivered strong fundamental results yet were met with subdued share price reactions given the high valuation levels they were trading on. The Fund was not completely immune from this rotation with quality companies such as IDP Education (IEL) underperforming. The result lagged market expectations and the anticipated sell down of Education Australia's remaining 12.5% stake in IEL further weighed on the shares. IEL is an industry leader, and we believe the long-term earnings power of the business is underestimated by the market. In what could be perceived as a high multiple stock, the fast-fashion accessories retailer Lovisa Holdings (LOV) produced an impressive set of results and was one of the Fund's top performers. New CEO Victor Herrero delivered his first results, highlighting the impressive cash generation of the business by doubling the dividend to 37c per share. Store openings also exceeded expectations. LOV ended the period with 586 stores and has ample

### Fund overview

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 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% Cash - 0-20%
Risk level	High
Number of securities	Min 20 - max 45
Minimum suggested investment timeframe	5 years
Buy/sell spread	+0.25% /- 0.25%
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

## Net active return as at 28 February 2022

	1mth %	3mth %	6mth %	1yr % p.a.	2yr % p.a.	3yr % p.a.	Incep.* % p.a.
Emerging Companies Fund	0.33	-5.14	-5.62	15.33	27.07	18.85	15.41
S&P/ASX Small Ordinaries Accumulation Index	-0.01	-7.71	-9.14	5.02	10.93	7.74	5.66
<b>Excess return</b>	<b>0.34</b>	<b>2.57</b>	<b>3.52</b>	<b>10.31</b>	<b>16.14</b>	<b>11.11</b>	<b>9.75</b>

\* 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.

runway of growth, with the capability to grow more than 100 stores per annum in multiple geographies. This highlights the importance of focusing on bottom-up opportunities where the underlying fundamentals are improving.

The Fund benefited from the performance of Whitehaven Coal (WHC) after it announced \$480m in capital management (~15% of its market cap), comprising of \$80m in dividends and \$400m share-buyback. This sends a strong signal to the market on the board's focus on creating shareholder value. Given the cheap valuation of <2x earnings before interest, taxes, depreciation, and amortisation (EBITDA) it makes more sense for the company to buy back shares rather than develop new projects. We believe this is the right strategy, to run its assets as efficiently as possible, act as a good corporate citizen and return the excess cash to shareholders. We believe this cycle could have further to run, given many of the climate-related efforts to reduce carbon emissions. This makes it difficult to approve new mines, resulting in a market where higher prices are not incentivising material new supply. Thermal coal will remain an important transition fuel for the next decade(s) as it remains the cheapest source of energy. At the other end of the spectrum, the Fund is positive on a number of companies exposed to the de-carbonisation thematic such as IGO (IGO) and Lynas Rare Earths (LYC). These companies provide the critical minerals to enable the transition to a net-zero world.

Other key results came from PEXA Group (PXA) which upgraded its prospectus FY22 EBITDA forecasts by 15%, aided by strong property volumes. Pleasingly the company continues to make good progress on its UK rollout, having signed a number of UK lenders to test with the Bank of England. Revenues are expected by the end of CY22, with a material uplift expected from FY23.

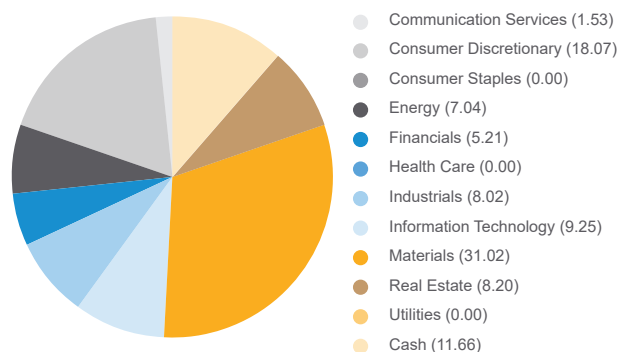
The Fund has become more concentrated over the past few months, diversified across 20 core positions. Such concentration may lead to short-term volatility in performance and against the benchmark, but we believe will serve unitholders well in the long-term. Key positions in the Fund include a number of industry leaders, which benefit from strong pricing power to pass through greater inflationary pressures. We are positive on a number of high quality commodity producers, generating strong cash flow and where the supply/demand outlook remains attractive. We also like a number of re-opening opportunities, where we expect earnings to bounce back sharply as the disruption from the pandemic recedes. We continue to look for strong bottom-up investment opportunities, in quality companies trading on attractive valuations. The Fund maintains a healthy cash balance of 11% which we will look to deploy as opportunities emerge in the coming months.

## Top 3 active holdings (alphabetical order)

IPH
Lovisa Holdings
PEXA Group

Source: Mainstream Fund Services and DNR Capital

## Sector weightings %



Source: DNR Capital

## Attribution

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

### Contributors

- Whitehaven Coal (WHC):** announced \$480m of capital management initiatives, representing 15% of its market capitalisation. High thermal prices have allowed WHC to pay off debt and return cash to shareholders.
- Lovisa Holdings (LOV):** grew earnings by 49% despite the ongoing challenges and disruptions faced from COVID-19. The company opened 42 stores during the first half in a difficult period and management expects to exceed this number of store openings in the second half. Operating cash flow was a highlight with the board almost doubling the dividend to 37c per share.
- Lynas Rare Earths (LYC):** delivered an impressive set of 1H22 results with earnings before interest, taxes, depreciation, and amortisation (EBITDA) more than doubling to \$190m. Strong customer demand for sustainable rare earths saw prices rise over US\$100/kg, levels not seen since 2011. The Kalgoorlie Rare Earth Processing Facility remains on budget and schedule.

### Detractors

- IDP Education (IEL):** shares fell as earnings came in lower than market expectations. Given the disruptions caused by COVID-19 it was an impressive result by the company to grow earnings before interest and taxes (EBIT) 61%. IEL is well positioned to capitalise on the pent-up demand for international student flows.
- Iress (IRE):** delivered a commendable result yet was met by a subdued reaction by the market. We are attracted to the defensive qualities with an incumbent position in the wealth management space which delivers high recurring revenue and little churn. The company is focused on generating shareholder value by buying back shares and realising value from its UK mortgage servicing business.
- Credit Corp Group (CCP):** delivered a strong result with net profit after tax (NPAT) up 8% which is at odds with its share price move which drifted lower. Expectations of tighter financial conditions should lead to increased credit card charge-offs and delinquencies. CCP is well positioned to participate in this increased supply, both domestically and offshore, with a strong balance sheet to deploy.

### Monthly - top contributors and detractors

#### Top 3 contributors

Whitehaven Coal

Lovisa Holdings

Lynas Rare Earths

#### Top 3 detractors

IDP Education Limited

Iress

Credit Corp Group

*\* 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.*

### Disclaimer

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### 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

#### Office address

Level 23  
307 Queen Street  
Brisbane QLD 4000

#### Postal address

GPO Box 3263  
Brisbane QLD 4001

#### Telephone

07 3229 5531

#### Email

[info@dnrcapital.com.au](mailto:info@dnrcapital.com.au)

#### Website

[www.dnrcapital.com.au](http://www.dnrcapital.com.au)