

DNR Capital Australian Emerging Companies Fund

Performance Report – April 2022

Performance

The DNR Capital Australian Emerging Companies Fund decreased 2.23% (net of fees) in April, underperforming the S&P/ASX Small Ordinaries Accumulation Index by 0.73%. Over the last 12 months the Fund increased by 15.39%, outperforming the Index by 12.48% (net of fees).

Market review

Positioning for an environment of higher inflation and higher interest rates is one of the key challenges now facing equity investors. The persistent inflationary pressure evident across the global economy, is a risk we have been highlighting for some time. Labour markets have continued to tighten, with historically low unemployment rates pushing wages higher. Commodity prices have increased to multi-decade highs, with supply shortages and strong demand. Some of the key structural drivers of inflation are also reversing in a post COVID-19 world, with a much greater focus on security of supply and self-sufficiency across supply chains. The conflict in Ukraine and Russia is only compounding this issue, tightening supply chains further.

With inflation levels in the major economies running well above target levels, central banks are now well and truly in catch-up mode, with monetary policy settings appearing inappropriate. To reduce aggregate demand and bring inflation levels down, extremely accommodative monetary policy support is set to be unwound. Following a long period of low inflation and declining interest rates, this marks an important turning point for equity markets. Corporates and investors have become accustomed to low inflation and declining interest rates for a long time. It will be a test of business models, especially the extent to which cost inflation can be passed through to consumers. It will be also a test for investors, with excessive risk taking exposed as the tide of excessive liquidity is withdrawn.

In terms of the implications for Fund positioning, the main beneficiaries of low inflation/interest rates are unlikely to be the same winners during a period of high inflation and rising interest rates. This change in market leadership has been evident since the start of 2022, with a sharp rotation out of the more expensive growth-related stocks, in favour of cheaper value-related sectors. Rather than being rewarded for promoting a growth story with large addressable markets to grow into, it has been a return to more traditional valuation methods that has rewarded investors. The priority is now the certainty of near-term cash flows, rather than the uncertainty attached to forecast cash flows long in the future, which may or may not eventuate.

We expect this sector rotation to continue. The major central banks are still at the start of this latest interest rate hiking cycle. Many of the drivers of inflation also appear more structural in nature. The trend towards deglobalisation is likely to play out over many years, and commodity markets will require a long investment cycle for supply to respond. The valuation gap between cheap and expensive sectors is also still wide. Although many growth stocks have seen large share price falls, in many cases they were priced for perfection. This included a high valuation, with a high degree of optimism baked into earnings forecasts. As a result, growth stocks are seeing earnings downgrades as earnings disappoint versus high expectations. This compares to

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 30 April 2022

	1mth %	3mth %	6mth %	1yr % p.a.	2yr % p.a.	3yr % p.a.	Incep.* % p.a.
Emerging Companies Fund	-2.23	4.64	0.59	15.39	31.25	16.91	15.98
S&P/ASX Small Ordinaries Accumulation Index	-1.50	3.68	-4.61	2.91	19.94	7.64	6.44
Excess return	-0.73	0.96	5.20	12.48	11.31	9.27	9.54

* 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.

value stocks like resources and energy, which are seeing earnings upgrades on low expectations. For many of the more speculative growth stocks yet to generate a profit, management may have to cut costs and shrink the potential addressable market. To prevent further share price declines, a clear path to profitability will have to be demonstrated.

We continue to focus on positioning the Fund for higher inflation, higher interest rates and a gradual normalisation of the COVID-19 pandemic. The Fund's key sector overweights are Resources and Energy, which are historically the main beneficiaries of an environment of higher inflation. The sector benefits from being under-owned, inexpensive and is in an earnings upgrade cycle. Following a decade of underinvestment since the last commodity super cycle, the outlook for commodities remains positive in our view. In the past we have discussed our positive outlook for a range of commodities like nickel, lithium, and the rare earths, which are benefiting from the transition towards electric vehicles and increased investment in renewable energy. However, we are also positive on traditional forms of energy, like oil, natural gas, and high-quality coal. Investors have overestimated the speed with which this energy transition will occur, presenting opportunities to invest in the sector given the depressed valuations. Furthermore, management in these sectors are demonstrating impressive capital discipline, with attractive dividends and share buybacks now on offer. Overall, we continue to believe that the market underestimates the supply side challenges with bringing on new supply across the commodity sector, with challenges due to cost inflation, skills shortages and permitting. The bottom line is that the supply response will not be fast, lengthening the period of high prices.

We continue to remain cautious on low quality business models lacking the pricing power to deal with higher costs, as well as negative cash flow companies where valuations are vulnerable to higher interest rates. We are also cautious on many of the winners of low interest rates and the surge in consumer spending over the past few years, especially in an environment distorted by COVID-19 restrictions which saw a boom in durable good sales. For example, we have significantly reduced the Fund's exposure to the consumer discretionary sector over the last 6 months and are now underweight the sector versus the benchmark.

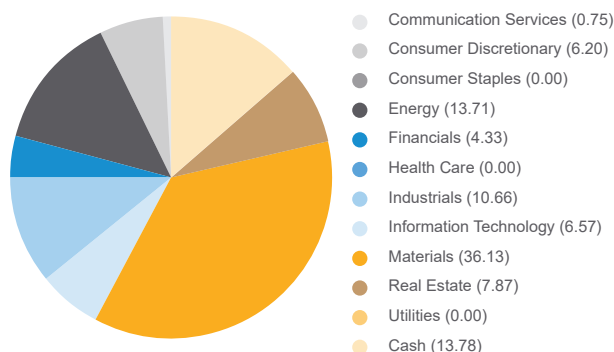
The Fund's allocation to cash remains elevated at nearly 14%, which provides flexibility to take advantage of the heightened volatility we anticipate going forward. We continue to focus on staying disciplined on valuations, having exited, or heavily reduced holdings where valuation upside has reduced. As a result, the average forward price-to-earnings multiple of the Fund has fallen to just 11x, which is the lowest since the inception of the Fund.

Top 3 active holdings (alphabetical order)

IPH
PEXA Group
Whitehaven Coal

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):** delivered its March 2022 quarter production achieving 5.2m volumes and record coal prices of A\$315/t. After buying back \$67m shares and paying \$80m in dividends in March, WHC has a net cash position of \$161m. MD and CEO Paul Flynn commented, "coal prices increased to record levels during the March quarter and remain very well supported in an environment of strong demand and constrained supply".
- Ailkem (AKE):** held a strategy day highlighting future production growth from its key assets. AKE more than doubled its lithium reserves and is targeting higher production from Sal Da Vida and flagged a potential stage 3 expansion at Olaroz.
- Megaport (MP1, No Holding):** shares fell as high expectations for Megaport Virtual Edge client wins failed to materialise.

Detractors

- Lynas Rare Earths (LYC):** delivered a record March quarter with strong demand from the automotive sector and solid production volumes generating sales of \$327m, up 60%. The market price for NdPr moderated from record highs during the month.
- Lovisa Holdings (LOV):** shares declined as long duration growth stocks were impacted by both higher inflation and interest rates.
- Hipages Group Holdings (HPG):** HPG reported its 3Q22 results with revenue of \$15.9m (+11% pcp) and operating cash flow of \$2.9m. The result was impacted by the challenges of lockdowns and the subsequent high demand for tradies, resulting in less demand for advertising platforms such as HPG.

Monthly - top contributors and detractors

Top 3 contributors

Whitehaven Coal

Allkem

Megaport (No Holding)

Top 3 detractors

Lynas Rare Earths

Lovisa Holdings

Hipages Group Holdings

** 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.*

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

Disclaimer

This document has been prepared by DNR Capital Pty Ltd, AFS Representative - 294844 of DNR AFSL Pty Ltd ABN 39 118 946 400, AFSL 301658. It is general information only and is not intended to be a recommendation to invest in any product or financial service mentioned above. Whilst DNR Capital has used its best endeavours to ensure the information within this document is accurate it cannot be relied upon in any way and you must make your own enquiries concerning the accuracy of the information within. The information in this document has been prepared for general purposes and does not take into account the investment objectives, financial situation or needs of any particular person nor does the information constitute investment advice. Before making any financial investment decisions you should obtain legal and taxation advice appropriate to your particular needs. Investment in the DNR Capital Australian Emerging Companies Fund can only be made on completion of all the required documentation. The Trust Company (RE Services) Limited ABN 45 003 278 831 AFSL No 235150 (as part of the Perpetual Limited group of companies) is the issuer of the PDS for the Fund. An investor should obtain and read the PDS and target market determination and consider their circumstances before making any investment decision. The PDS and target market determination are available at the Fund website at www.dnrcapital.com.au/invest, or a paper copy can be obtained, free of charge, upon request by calling DNR Capital Pty Ltd ('Manager'), the investment manager of the Fund. This material is general information only and not an investment recommendation. The Manager or The Trust Company (RE Services) Limited does not guarantee the repayment of capital from the Fund or the investment performance of the Fund. An investment in this fund is subject to investment risk including loss of some or all of an investor's principal investment and lower than expected returns.

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

Website

www.dnrcapital.com.au