DNR Capital Australian Emerging Companies Fund

Performance Report – May 2022

Performance

The DNR Capital Australian Emerging Companies Fund decreased 2.87% (net of fees) in May, outperforming the S&P/ASX Small Ordinaries Accumulation Index by 4.14%. Over the last 12 months the Fund increased by 10.89%, outperforming the Index by 15.45% (net of fees).

Market review

Equity markets sold off further during May, with central banks continuing to signal the need for tighter monetary policy to bring down elevated levels of inflation. With the era of abundant central bank liquidity now ending, a painful correction is unfolding as excessive risk taking from recent years unravels. Investors have been pushed dangerously up the risk curve following a long period of low interest rates. This resulted in equity valuations reaching extremely elevated levels, and an insufficient focus on the quality of underlying business models. During May, it was once again the more expensive and speculative areas of the market that were worst hit. Even quality business models came under downward pressure, with the starting valuations too high. The Fund outperformed its benchmark during the month, benefiting from its more defensive positioning, greater allocation towards cheaper value sectors like materials and energy, and a higher cash weighting.

With valuations now falling following the recent correction, the obvious question is whether opportunities are starting to emerge in some of the worst hit sectors of the market. The challenge is that the starting point for valuations was extremely elevated. In many cases, the recent correction has only taken earnings multiples back to levels considered more reasonable, rather than outright cheap. Although the valuation dispersion between cheap and expensive sectors has narrowed, it is still wide by historical standards, suggesting that the rotation into value stocks could have further to go.

The valuation multiple is also only half the equation. Consensus earnings forecasts for many companies appear vulnerable, especially as the economy slows due to higher interest rates. Many companies have seen margins reach historically high levels, as they benefited from positive operating leverage from growing revenue and limited cost pressure. This has certainly been the case for sectors like Consumer Discretionary, which has been one of the key beneficiaries of the recent surge in consumer spending. We are conscious that operating leverage also works in reverse, with downside risks to earnings as revenue falls on inflating costs. This does not appear factored into consensus forecasts, which increases the risk of negative surprises during the upcoming results season. Once earnings expectations are rebased lower on cheaper valuations, we will be on the lookout to buy quality companies where we still see promising long-term outlooks.

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 31 May 2022

	1mth %	3mth %	6mth %	1yr % p.a.	2yr % p.a.	3yr % p.a.	Incep.* % p.a.
Emerging Companies Fund	-2.87	1.30	-3.91	10.89	22.96	16.98	14.70
S&P/ASX Small Ordinaries Accumulation Index	-7.01	-3.58	-11.02	-4.56	9.98	5.50	4.25
Excess return	**4.14**	**4.88**	**7.11**	**15.45**	**12.98**	**11.48**	**10.45**

** 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.

We also continue to see risks in many of the loss-making growth companies in the small-cap benchmark. To raise capital from investors, these companies have been promoting the upside potential of large addressable markets, and the promise of positive cash flow long into the future. Investor appetite for these investments is quickly evaporating, which raises questions around their future viability. To reduce cash outflows, difficult decisions will have to be made, as management teams look to lower growth targets and cut costs. To attract investors back to these types of companies, we believe a clear path to profitability will need to be demonstrated. This will allow for valuations to be assessed using more traditional metrics, like free cash flow rather than applying a simple sales multiple. We look back to previous cycles, where the high-flying growth stocks ultimately had to fall to levels where value investors were prepared to buy them. We are comfortable waiting patiently for these opportunities to emerge, as these levels have still not been reached in our view.

The area of the market where we continue to see opportunities is in the more value related sectors like materials and energy. Valuations are inexpensive, balance sheets are strong, and management teams are returning substantial amounts of surplus cash flow back to shareholders via dividends or buybacks. Following a long period of underperformance since the last commodity super-cycle, we continue to believe that we are still in the early phase of this current commodity cycle. With the exception of some of the battery related commodities like lithium, we see deficits across multiple commodities, with supply still not sufficiently responding to higher prices. In-fact, we see considerable challenges with bringing on new supply, which could extend the duration of the current cycle. This includes cost inflation, skills shortages, and challenges with getting new mines approved due to a greater focus on environmental, social and governance (ESG) related issues, which are increasing the replacement value of existing producing assets.

Lithium is one commodity where our positive view has been moderating in recent months. When we first invested in several of the Australian lithium producers nearly two years ago, it was close to the trough of its commodity cycle. Valuations were extremely depressed, investors were mostly disinterested in the sector, and there was very little new capital coming into the sector to expand supply. In fact, capital was being withdrawn from the sector with mines being placed on 'care and maintenance'. Although conditions were difficult at the time for the lithium producers, we took the view that demand would recover strongly, and that prices were well below the levels required to incentivise new production.

Over the past year, this investment thesis has largely played out. Lithium prices have recovered well ahead of expectations given the growth in electric vehicles, especially this calendar year with prices increasing over 500%. Significant new capital is also entering the sector, a reversal from several years ago when new capital was scarce. This means that supply is set to expand significantly in the coming years. Although demand continues to grow strongly, we are becoming increasingly concerned that industry forecasts could prove to be too optimistic, especially considering the higher costs and the impact of slowing growth on consumer demand. Consequently, we have reduced the Fund's exposure to lithium in recent months, retaining only small positions in several of the high quality producers.

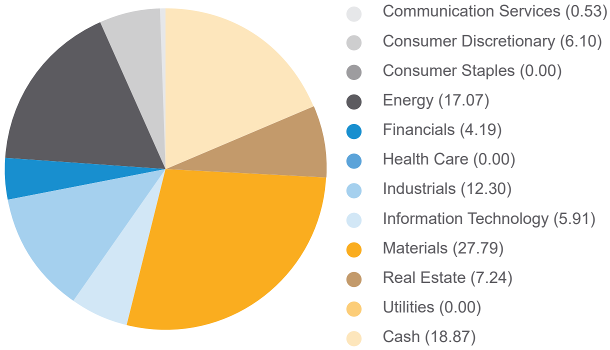
We continue to focus on positioning the Fund for higher inflation, higher interest rates and a gradual normalisation of the COVID-19 pandemic. The Fund's key sector overweights are Resources and Energy, which are historically the main beneficiaries of an environment of higher inflation. The Fund's allocation to cash remains elevated, 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 9.5x, which is the lowest since the inception of the Fund and a 30% discount to the Index.

Top 3 active holdings (alphabetical order)

IPH
PEXA Group
Whitehaven Coal

Source: Mainstream Fund Services and DNR Capital

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors
Whitehaven Coal
IPH
Beach Energy

Top 3 detractors
PEXA Group
Credit Corp Group
NIB Holdings (No Holding)

** 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.*

Attribution

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

Contributors

- **Whitehaven Coal (WHC):** outperformed as thermal coal prices remain buoyant above US$400/t. WHC is almost half way through its on market buy-back, having purchased 48 million shares as of the end of May (~5% of shares outstanding).
- **IPH (IPH):** defensive characteristics saw its shares outperform against the broader market sell-off. IPH continues to demonstrate stable earnings and cash flow generation.
- **Beach Energy (BPT):** benefitting from tightness in energy markets, particularly the domestic east coast gas market where it supplies 12% of demand. BPT remains net cash and fully funded to support future projects from operating cashflows.

Detractors

- **PEXA Group (PXA):** weighed down by negative sentiment towards property as interest rates increase. During the month PXA held an investor day highlighting the progress the company is making in its UK expansion.
- **Credit Corp Group (CCP):** weaker as debt ledger purchasing remains subdued and weakening economic conditions presents some risk on its ability to collect. The business is well managed under CEO Thomas Beregi with a debt free balance sheet and conservative accounting.
- **NIB Holdings (NIB, No Holding):** outperformed, detracting from the Fund's relative return.

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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