

DNR Capital Australian Emerging Companies Fund

Performance Report – July 2022

Performance

The DNR Capital Australian Emerging Companies Fund increased 5.88% (net of fees) in July, underperforming the S&P/ASX Small Ordinaries Accumulation Index by 5.55%. Over the last 12 months, the Fund decreased by 3.63%, outperforming the Index by 7.30% (net of fees).

Market review

The small-cap index bounced sharply during July, with companies that saw the brunt of the recent sell-off topping the leader board. Across sectors, it was a reversal of recent trends, with growth companies like technology and consumer discretionary outperforming. There were also signs of short covering, with many of the more speculative business models bouncing higher following the significant share price falls in prior months. With the Fund more exposed to value/defensive holdings that did not fully participate in the rally, and a higher cash weighting, this led to the underperformance versus the index during the month. This follows several months of material outperformance, with the Fund's drawdown significantly less than the index this calendar year.

The main catalyst for the rally appears to be the view that inflation has now peaked, allowing the major central banks to slow the pace of interest rate increases. Bond yields have already fallen in line with this view, with the 10 year yield in Australia falling more than 100bps from the high of around 4.25% in June. In the short-term, the path forward continues to remain uncertain in our view. Whether inflation reverts lower, or whether it stays more persistent given the structural changes to the economy post the COVID-19 pandemic, remains open for debate. There will be elements of cyclical inflation that unwind as the economy slows. However, across commodity markets we expect structural shortages to reappear as demand recovers, with a lack of investment in new supply still the critical issue. The focus on trends like decarbonisation, increasing self-sufficiency in supply chains and energy independence are all very inflationary in nature. As a result, we continue to look for companies that can deal with persistent inflation pressures.

Reviewing the performance of various sectors in the small-cap index, a key observation has been the widening dispersion in valuations between growth and value sectors, which is effectively a repeat of 2020. With concerns around an economic slowdown, the market is now crowding into defensive/growth companies with resilient earnings streams. Although we like these types of investments, the challenge is that valuations for many of these opportunities are now extremely elevated versus history and the market. Earnings may be more resilient, but the valuation may not.

Instead, we continue to look for companies with defensive characteristics overlooked by the market. The Fund's holding in Deterra Royalties (DRR) is an example of one such opportunity. DRR benefits from a long-term royalty agreement over BHP's Mining Area C iron ore operation in Western Australia, which is a low-cost and long-life asset.

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 July 2022

	1mth %	3mth %	6mth %	1yr % p.a.	2yr % p.a.	3yr % p.a.	Incep.* % p.a.
Emerging Companies Fund	5.88	-6.05	-1.70	-3.63	23.81	14.98	13.06
S&P/ASX Small Ordinaries Accumulation Index	11.43	-9.94	-6.63	-10.93	8.55	2.55	3.22
Excess return	-5.55	3.89	4.93	7.30	15.26	12.43	9.84

* 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.

Shareholders currently receive a fully franked dividend yield of around 8%, with the company well positioned to deploy further capital given its net cash balance sheet. In the current inflationary environment, royalty companies benefit from having virtually zero exposure to rising operating and capital costs. With all the uncertainty around iron ore prices affecting DRR's share price, this is providing an opportunity to buy a high quality asset at a discounted valuation.

We continue to see considerable risks in many of the more speculative business models in the small-cap index, with many investors still prepared to invest based on hope rather than bottom-up fundamentals. During the month we saw multiple examples of loss making companies valued greater than \$1bn with share prices up between 30-150% for the month. On one day, we noticed that the \$2bn market capitalisation of BrainChip Holdings (BRN) exceeded Iress (IRE). For reference, BRN generates virtually zero revenue and is extremely speculative in nature given its unproven technology. This compares to IRE with forecast sales greater than \$600m and a long track record of generating consistent cash flows. With central banks withdrawing liquidity from the market, excessive risk taking in some parts of the market is unravelling. However, in other parts, it is clearly still alive and kicking, which suggests that investors have not fully capitulated yet, and there could be further pain ahead.

As we approach the upcoming earnings season, the downside risks to earnings from a slowing economy is likely to be a key focus. Some companies have been significantly over earning in recent years, benefiting from a long period of low interest rates, limited cost pressure and strong revenue growth. These positive tailwinds are now reversing, with higher interest rates, rising costs and the impact of slowing growth on revenue. We expect this to lead to greater volatility going forward, which should provide opportunities to deploy capital into companies where both earnings expectations and valuations have adjusted lower.

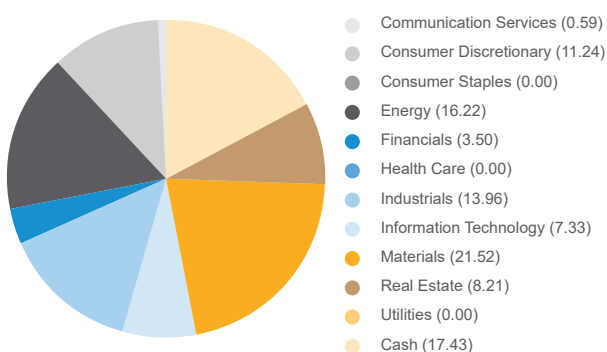
We continue to look for strong bottom-up investment opportunities, in quality companies trading at attractive valuations. Key positions include several industry leaders, which benefit from strong pricing power to pass through greater inflationary pressures. We are also positive on business models with recurring revenue streams, which can withstand an uncertain economic environment. We remain positive on several of the higher quality commodity producers, in particular, those generating strong cash flows, and where we expect significant capital to be returned back to shareholders. The Fund maintains a higher cash weighting, which we will look to deploy as opportunities emerge in the coming months.

Top 3 active holdings (alphabetical order)

- Beach Energy
- IPH
- PEXA Group

Source: Mainstream Fund Services and DNR Capital

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors

- Whitehaven Coal
- Lovisa Holdings
- Credit Corp Group

Top 3 detractors

- Champion Iron
- Iress
- Deterra Royalties

* 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):** released its June quarter 2022 production report achieving a record average coal price for the quarter of A\$514/t. WHC expects to report \$3bn EBITDA and a net cash position of \$1bn for FY22.
- **Lovisa Holdings (LOV):** rebounded during the month on limited news flow. Long duration growth stocks have been one of the hardest hit sectors during the year and saw some reprieve on lower interest rate expectations.
- **Credit Corp Group (CCP):** rebounded during the month on limited news flow. Shares have been soft this year given debt ledger purchasing remains subdued and weakening economic conditions.

Detractors

- **Champion Iron (CIA):** reported record production for its first quarter of FY23. The result was impacted by higher costs as the company begins ramping up its Phase 2 production from Bloom Lake to over 15 million tonnes per annum of high-grade iron ore. Concerns around economic growth and the impact of COVID-19 lockdowns in China on steel demand also weighed on the share price.
- **Iress (IRE):** announced the retirement of its CEO Andrew Walsh, after 13 years in the role. Andrew will be replaced by Marcus Price with over 25 years of experience in financial services and technology. Marcus was most recently the inaugural CEO of the digital property settlements business, PEXA Group (PXA). Iress reaffirmed the guidance range for FY22 segment profit of \$177m-\$183m remains on track.
- **Deterra Royalties (DRR):** closed flat during the month, lagging the strong benchmark. DRR earns a royalty over BHP's Mining Area C iron ore revenues, offering investors an inflation resilient investment.

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

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