

DNR Capital Australian Emerging Companies Fund

Performance Report – August 2022

Performance

The DNR Capital Australian Emerging Companies Fund increased 6.50% (net of fees) in August, outperforming the S&P/ASX Small Ordinaries Accumulation Index by 5.92%. Over the last 12 months, the Fund decreased by 1.51%, outperforming the Index by 13.15% (net of fees).

Market review

The Fund performed strongly during the August reporting season, increasing 6.5% versus the broadly flat result for the small-cap benchmark. Contributing to this performance were the Fund's holdings in the materials and energy sectors. These companies continue to benefit from robust demand for commodities, as well as a lack of new supply after many years of underinvestment. Management teams are also staying disciplined, with sensible capital allocation decisions seeing significant cash flow being returned to shareholders. Valuations remain attractive, especially relative to the wider market. Through the reporting season, the Fund also benefited from positive updates from its holdings in Lovisa Holdings (LOV), IPH (IPH) and Monadelphous Group (MND). These updates reinforced the strong bottom-up thesis for these opportunities, and we have provided a more detailed discussion on these companies below.

Reviewing the reporting season overall, there were several key takeaways. Despite concerns around a weakening global economy, consumer demand has generally been more resilient than feared. With revenue holding up well, and most companies having been successful at raising prices to offset inflationary pressures, the earnings crunch many investors had been expecting did not materialise. However, with central banks still committed to hiking rates to bring inflation rates down, we believe conditions could become more difficult going forward. This was reflected in more cautious outlook commentary from most management teams, with the next 6-12 months likely to be a key test for earnings.

Although valuations have adjusted lower during the recent market correction, we remain concerned that earnings expectations are still on the optimistic side for many sectors of the market. This is especially the case for companies which have been over earning during the period since the COVID-19 pandemic, or where there is limited pricing power to offset cost pressures. As a result, we continue to focus on opportunities where both valuations and earnings are on the conservative side. A feature of the market continues to be a significant dispersion in valuations, with growth stocks still trading on elevated valuations. Many companies with more defensive earnings are also richly priced, with the market paying a premium for earnings stability given the uncertain economic outlook. We believe this requires a more selective and benchmark agnostic approach to exploit the opportunities on offer, and to avoid the areas where we still see downside risks.

After reviewing the recent results for many of the mining and energy companies we have increased our conviction in

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 August 2022

	1mth %	3mth %	6mth %	1yr % p.a.	2yr % p.a.	3yr % p.a.	4yr % p.a.	Incep.* % p.a.
Emerging Companies Fund	6.50	3.02	4.35	-1.51	20.48	17.67	14.56	14.56
S&P/ASX Small Ordinaries Accumulation Index	0.58	-2.59	-6.08	-14.66	5.13	4.10	3.30	3.30
Excess return	5.92	5.61	10.43	13.15	15.35	13.57	11.26	11.26

* 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.

the long-term outlook for the sector. Although commodity prices are likely to remain volatile in the short-term, we believe that supply constraints are unlikely to be resolved quickly. With multiple commodity markets still in deficit, this is likely to increase the duration of the current commodity cycle. Capital cost inflation, and access to skilled labour remains a critical issue, with new projects likely to be more expensive and at risk of delays. As a result, we are focusing on the higher quality mining companies, generating strong cash flows and with lower-risk brownfield expansion opportunities. Commodity producers continue to demonstrate impressive capital discipline, with significant capital returns coming back to shareholders in the form of dividends and buybacks a key attraction.

LOV continues to exceed our expectations with a solid result on numerous fronts. The key highlight was the acceleration in the global store rollout. CEO, Victor Herrero has put his mark on the business with 85 new stores opened and targeting a significantly higher number over the next fiscal year. The company ended the year with 629 stores, 475 of these stores outside of Australia. Two new markets in Poland and Canada were entered during the period. Management is evaluating a number of new markets such as Spain and Italy as well as increasing the penetration of existing markets. The cash generation of the business was a highlight with operating cash flow of \$96.7m (99% cash conversion) and a net cash position of \$24m. Trading for the first 7 weeks of FY23 has seen a strong continuation of the strong performance of FY22, with comparable stores sales up 21%.

The LOV result is in stark contrast to the performance of online retailers. Online retailers were significant beneficiaries during COVID-19 at the expense of physical retailers such as LOV. Many thought the structural trend in online penetration would continue to accelerate yet we have seen a reversal of fortunes for a number of online retailers:

- Temple & Webster Group (TPW), share price down 53% calendar year to date, July trading down 20% year-on-year.
- Redbubble (RBL), share price down 78% calendar year to date, earnings before interest, taxes, depreciation and amortisation (EBITDA) loss of \$11m, compares to \$53m profit prior year.
- Adore Beauty Group (ABY), share price down 62% calendar year to date, trading first 7 weeks of FY23 down 28% year-on-year.
- Kogan.com (KGN), share price down 61% calendar year to date, EBITDA loss of \$21.8m, compares to \$22.5m profit prior year.

The Fund has no exposure to online retailers given our concerns around negative operating leverage resulting from higher costs and declining sales.

Engineering company MND produced a solid result driven by high demand from its resource and energy customers thanks to robust commodity prices. The two key divisions are Maintenance and Industrial Services, and Engineering Construction. Maintenance and Industrial Services accounted for 60% of the groups' revenue and has more resilient earnings given the planned maintenance work and sustaining capex of its customers. The Engineering Construction division is more lumpy driven by the timing of awards and commencement of new major projects. High levels of global demand for battery metals for electric vehicle adoption and renewable energy such as solar and wind farms will require significant investment in lithium, copper, nickel and rare earths. We also believe traditional fossil fuels will play an important part given the transition to a carbon neutral world will take decades instead of years. The oil and gas sector has been starved of capital for the past decade with MND the main casualty of this with earnings down a third from the prior peak in early 2010s. This lack of investment is a contributing factor to the higher energy prices globally. The main solution to solving the current energy crisis is an increase in capital expenditure to bring on new supply sources. MND is well placed to benefit from a sustained period of rising capital expenditure. The main challenge facing the company is a lack of skilled labour, with management focused on optimising the workforce to take advantage of high margin projects.

Intellectual property firm IPH delivered underlying EBITDA growth of 11%. We like the cash generation of the business with EBITDA of \$137.4m delivered with only \$7.2m of capital expenditure and minimal working capital requirements. The more exciting news was the acquisition of leading Canadian IP firm Smart & Biggar for \$387m. Smart & Biggar was established in 1890 and holds the leading market share position with 16%. The transaction is 10% earnings accretive but more importantly the strategic nature of the acquisition gives them a foothold to pursue further value accretive opportunities in Canada. IPH has a strong track record of successfully integrating IP services firms into its network. Smart & Biggar principals will enter a four year employment agreement and will receive IPH shares as part of the upfront payment consideration that will be escrowed for 2 years.

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

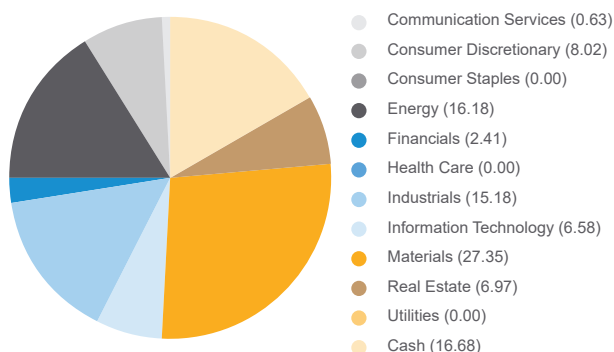
environment. We remain positive on several of the higher quality commodity producers, in particular, those generating strong cash flows, and where we expect significant capital to be returned back to shareholders. The Fund maintains a higher cash weighting, which we will look to deploy as opportunities 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
Monadelphous Group
IPH

Top 3 detractors

Beach Energy
Credit Corp Group
Liontown Resources (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):** reported EBITDA of \$3.1bn for FY22, a significant increase on the \$204.5m of EBITDA in the prior year. The company is undertaking a shareholder friendly capital management approach via fully franked dividends and upsizing its share buy-back programme.
- Monadelphous Group (MND):** grew net profits by 11% to \$52.2m, driven by strength in its maintenance services division. The company is seeing a large number of significant projects across iron ore, oil and gas and battery materials. The key challenge for the business is attracting skilled labour to fulfil its pipeline of work. While this capacity constraint may weigh on top line growth, management are focused on optimising margins.
- IPH (IPH):** acquired Smart & Biggar, Canada's leading intellectual property agency. The transaction will be 10% earnings accretive. Importantly, this transaction gives IPH a foothold to further consolidate the Canadian market.

Detractors

- Beach Energy (BPT):** shares declined 5% for the month. The FY22 result highlighted the strong cash generation of the business with \$1.2b in operating cash flow and a net cash position. This puts BPT in a strong position to deliver growth projects and consider capital management initiatives.
- Credit Corp Group (CCP):** FY22 results came in at the top end of the guidance range at \$96.2m, although guidance for FY23 came in below markets expectations at \$90-\$97m. Management have historically proven conservative in setting full-year guidance.
- Liontown Resources (LTR, no holding):** detracted from relative returns. We have a preference for lithium producers rather than developers/explorers.

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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