

DNR Capital Australian Emerging Companies Fund

Performance Report - September 2021

Performance

The DNR Capital Australian Emerging Companies Fund decreased -2.83% (net of fees) in September, underperforming the S&P/ASX Small Ordinaries Accumulation Index by 0.69%.

Market review

After posting strong year to date gains, equity markets experienced a more difficult month during September, with the ASX Small Ordinaries Index falling 2.14%. Following a period of rising optimism towards the post-COVID-19 recovery, investor sentiment has recently turned more negative in the short-term, with several issues weighing on the outlook. Firstly, following the significant policy support from the major central banks, the market is starting to anticipate the gradual withdrawal of stimulus measures. Slowing growth in China is affecting certain commodity prices, with iron ore in particular experiencing a sharp sell-off in response to falling steel production and concerns around the property market. Following the strong recovery in corporate earnings following the recession last year, there are also signs of greater inflationary pressures impacting margins. This includes increased raw material costs, labour shortages and supply chain challenges from border closures. Given the scale of the shock to the global economy from COVID-19, and the subsequent bounce back, clearly the normalisation of the economy post COVID-19 will be far from smooth. The positive however, is that vaccination rates continue to increase in the advanced economies, with positive signs for growth as countries progressively emerge from the pandemic.

Reviewing the Fund's performance, the sell-off in the Materials sector was one of the largest detractors, with Champion Iron (CIA), Iluka (ILU) and IGO (IGO) all giving up recent gains. Although certain commodity prices like iron ore have fallen from unsustainable levels of late, valuations using conservative assumptions are attractive and balance sheets are well positioned. Although volatility could persist in the near-term, we remain confident in the long-term opportunities. In many cases, assets are trading well below replacement cost, compounded by the rising inflationary pressure on wages and capital costs. This highlights the value on offer in the sector currently, and we would not be surprised to see balance sheets becoming deployed in the sector, given it is cheaper in many cases to buy rather than build.

Positive contributors to the Fund's performance came from a mix of sectors. IDP Education (IEL) shares climbed higher, with the company set to be one of the key beneficiaries of borders re-opening, and a resumption of foreign university students travelling to key destination markets like the UK and Canada. Shares in Whitehaven Coal (WHC) continued to advance higher, defying market sceptics towards fossil fuels. Thermal coal prices have increased to record high levels given the significant market tightness. Supply is tight given the lack of investment in new mines, yet demand has recovered strongly given the pick-up in global growth.

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 (net of fees) 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	+0.30% / -0.30%
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 September 2021

	1mth %	3mth %	6mth %	1yr %	2yr %	3yr %	Incep.* %
Emerging Companies Fund	-2.83	5.75	19.49	47.96	25.57	19.26	18.75
S&P/ASX Small Ordinaries Accumulation Index	-2.14	3.44	12.23	30.41	12.28	9.43	9.03
Excess return	-0.69	2.31	7.26	17.55	13.29	9.83	9.72

* 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.

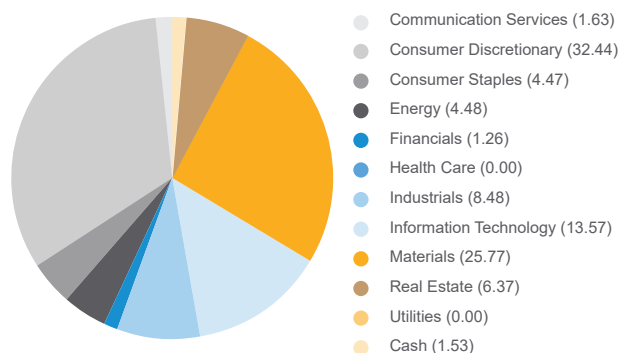
With rising grid instability, the market is also starting to reassess the role of fossil fuels during the transition period towards renewable energy. This is coming at a time when Energy has been one of the worst performing sectors in the market, leaving valuations amongst the cheapest in the market.

In terms of recent position changes, we recently sold out of the Fund's holding in Corporate Travel Management (CTD). The shares have rebounded significantly over the past year, and we believe the valuation now prices in the anticipated earnings recovery as travel restrictions are lifted. We have also noted a regular flow of updates from large multi-nationals, announcing that work from home arrangements are likely to remain permanent in a post COVID-19 world. We used the proceeds to add to existing holdings during the month, especially those opportunities where we believe the market has overly reacted to short-term news flow. This includes companies in the more cyclical and value areas of the market, like resources and consumer cyclicals.

Our focus continues to be on building a concentrated portfolio of the highest quality and most attractively priced companies in the Australian small cap sector. The Fund is currently positioned across a range of these opportunities, including companies that we believe will benefit as the global economy re-opens, in attractively priced growth stocks which are reinvesting at high rates of return, and in some of the more cyclical sectors of the market such as materials and consumer cyclicals. Rather than becoming too caught-up in the short-term uncertainty in the market, we believe investors should continue to focus on the attractive long-term opportunities in the market, staying disciplined on valuations given the backdrop of bond yields potentially rising higher.

Overall, the average return on invested capital for the Fund's holdings is well above the Index, highlighting the superior quality characteristics and potential for long-term value creation. The balance sheets of the Fund's holdings are also significantly more resilient than the Index, with nearly all of the holdings sitting on excess cash. Valuation multiples have also fallen to low levels, with the forward price earnings (PE) multiple now sitting at one of the lowest levels since the inception of the Fund. Both of the DNR Capital Portfolio Managers have recently added to their personal holdings in the Fund in recent weeks.

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors

IDP Education

Whitehaven Coal

Technology One

Top 3 detractors

Champion Iron

Iress

Temple & Webster 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.

Top 5 active holdings (alphabetical order)

Breville Group

IDP Education

Iluka Resources

IPH

Pexa Group

Source: Mainstream Fund Services and DNR Capital

Attribution

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

Contributors

- IDP Education (IEL):** IEL shares rallied as sentiment improved towards COVID-19 re-opening stocks as vaccination rates increase globally. IEL has a record pipeline of students willing to study abroad and is well positioned to capitalise on this strong demand as international borders reopen.
- Whitehaven Coal (WHC):** WHC benefited from surging thermal coal prices due to instability in the energy grid as renewables have failed to keep up to rising demand as economies reopen. Thermal coal prices have risen to over US\$200/tonne and Asian and European gas prices have risen to between US\$30-35/mmtbu, representing a 10-fold increase over 12 months. WHC's high quality thermal coal will play an important role during the transition period away from fossil fuels to renewables.
- Technology One (TNE):** TNE acquired Scientia, a leading UK software provider to the Higher Education sector. This is TNE's first offshore acquisition and expands its ERP solution for the Higher Education sector by providing advanced academic timetabling and resource scheduling capabilities.

Detractors

- Champion Iron (CIA):** CIA shares fell as the iron price retreated on the back of concerns Chinese developer Evergrande will face bankruptcy. The valuation of CIA is compelling trading at half its replacement value and offering attractive free cash flow yields on long run marginal cost iron ore price assumptions.
- Iress (IRE):** IRE advised that discussions with private equity firm EQT have failed to reach a binding transaction. IRE will focus on accelerating growth in earnings per share (EPS), improving return on invested capital (ROIC) and optimising its capital structure, commencing with an on-market share buyback of \$100m and potential divestment of its UK mortgage sales and originations business.
- Temple & Webster (TPW):** TPW shares traded lower despite a strong start to the financial year with sales up 49%. The company continues to reinvest to cement its market leadership position in the large and fragmented furniture and homewares market.

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

- Ausmaq
- BT Panorama
- Colonial First State FirstWrap
- HUB24
- Macquarie Wrap
- Mason Stevens
- Netwealth
- Praemium