DNR Capital Australian Emerging Companies Fund

Performance Report - January 2021

Performance

The DNR Capital Australian Emerging Companies Fund increased 0.13% (net of fees) in January, outperforming the S&P/ASX Small Ordinaries Accumulation Index by 0.38%. Over the last 12 months the Fund increased by 16.93%, outperforming the Index by 11.55% (net of fees).

Market review

Reviewing the outlook and key opportunities in the Australian small cap sector, our overriding focus continues to be on identifying high-quality, long-term investments trading on attractive valuations. As we have discussed previously, a key market observation has been the widening valuation dispersion between value/cyclicals and growth/defensive stocks. With considerable uncertainty around the macro environment due to the pandemic, the market has favoured many of the secular growth stories given their relative immunity to the economic outlook. However, following their strong outperformance over the past year, we now see a less favourable risk-reward profile for these opportunities. With valuations having re-rated significantly higher, and with growth expectations also more on the optimistic side, this implies limited room for error. That is not to say that we don't like certain growth-focused companies. Rather, at this point it has never been more important to stay disciplined on valuations. As a result, we have progressively reduced the Fund's exposure to growth holdings as valuation upside has reduced, retaining select exposure where we have a strong bottom-up thesis and where valuations are still reasonable.

In terms of where we see the more attractive opportunities looking forward, for long-term investors we believe it will be from positioning for the post-COVID-19 recovery. With the rollout of vaccines accelerating and some early signs of success being reported, we now have a potential line of sight towards a resolution to the pandemic. Although the road to recovery is unlikely to be smooth, global growth is likely to improve materially later this year and into 2022. Policy support also remains highly accommodative, with low interest rates and increased fiscal spending set to continue until we see clear evidence of self-sustaining recovery and a rise in inflation. This appears markedly different to the post-GFC environment, which was characterised by fiscal austerity and a faster withdrawal of supportive monetary policy. Overall, we believe this has positive implications for equities.

However, as the post-COVID-19 recovery accelerates, the sectors and companies that have been strong outperformers in recent years are unlikely to replicate this performance during the recovery. In our view it favours companies more sensitive to an improving growth outlook, especially the more value/cyclical areas of the market like materials, financials and consumer cyclicals. With valuations low and earnings set to bounce back sharply, we see significant valuation upside for a range of these opportunities. As earnings accelerate for these

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 31 January 2021

	1mth %	3mth %	6mth %	1yr %	2yr %	Incep.* %
Emerging Companies Fund	0.13	17.01	25.29	16.93	21.70	12.24
S&P/ASX Small Ordinaries Accumulation Index	-0.25	13.03	18.33	5.38	11.91	5.45
Excess return	**0.38**	**3.98**	**6.96**	**11.55**	**9.79**	**6.79**

** 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.

more operationally geared companies sensitive to the economic cycle, this could also be a catalyst for investors to closely scrutinise the more expensive sectors of the market where valuation discipline has been lacking.

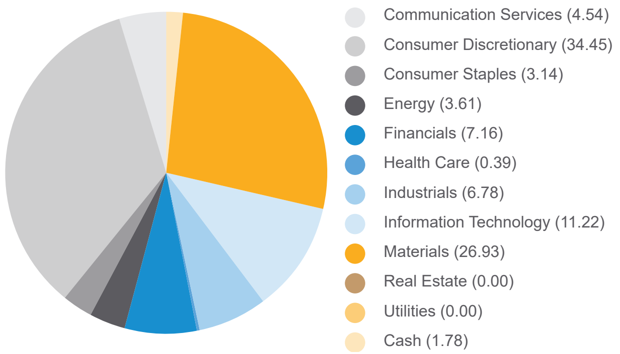
In recent months we have increased the Fund's exposure to sectors like materials and consumer cyclicals, which are key sector overweights. Resources companies look particularly attractive given the strong free cash flow and our positive outlook for commodity prices. Rising demand in a supply-constrained environment suggests that further upside to commodity prices is likely. We are also positive on many of the sectors worst hit by COVID-19, or the so called 'reopening beneficiaries'. We see significant pent-up demand for in-person activities, especially foreign university education, shopping in physical stores and corporate travel. Given the extent of the demand shock, we believe activity could bounce back more strongly than anticipated, with earnings exceeding previous peaks. We are particularly positive on those well-managed companies that haven't wasted the crisis, either by investing through the downturn, or by acquiring distressed competitors at the bottom of the cycle.

Top 5 active holdings (alphabetical order)

Corporate Travel Management
IDP Education
IGO
Lovisa Holdings
Lynas Rare Earths

Source: Mainstream Fund Services and DNR Capital

Sector weightings %



Monthly - top contributors and detractors

Top 3 contributors
Lynas Rare Earths
IDP Education
ARB Corporation

Top 3 detractors
Pushpay Holdings
Deterra Royalties
Zip Co (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

- **Lynas Rare Earths (LYC):** Signed a contract with the US Department of Defence to build a commercial light rare earths separation plant in the US. This contract highlights the strategic importance of LYC's Mt Weld asset being one of only two significant rare earth assets outside of China. Rising demand from the electrification of transportation and renewable energy investment is creating tightness in the rare earth markets, placing upward pressure on pricing.
- **IDP Education (IEL):** Shares benefited as the global vaccination rollout gathered momentum. IEL is well positioned to take market share in its core markets of Australia, UK and Canada when international borders reopen. Near-term pressures remain as Australia's borders remain closed, yet the UK and Canada remain open to international students where some of the student flows have been redirected.
- **ARB Corporation (ARB):** Provided an unaudited update for its 2H20 results with revenue of $284m, up 22% pcp. Profit before tax came in well above market expectations at $70-72m. The order book remains strong given the consumers focus on land-based travel. Despite a pull forward in demand, the long-term outlook for ARB remains strong as it continues to penetrate the large US market.

Detractors

- **Pushpay Holdings (PPH):** Shares continue to drift despite its second earnings upgrade in as many months with EBITDAF for year ending 31 March 2021 of between US $56m and US $60m, up from US $54m and US $58m. PPH announced its long awaited new CEO Molly Matthews, succeeding Bruce Gordon who has been interim CEO since June 2019. Matthews is currently Pushpay's chief customer officer.
- **Deterra Royalties (DRR):** Provided an operational review for the 4Q20. Mining Area C (MAC) production was in line with market expectations at 13.6 metric tonnes. MAC is operated by BHP and comprises the iron ore reserves of North and South Flank. DRR receives an ongoing royalty of 1.23% of revenue received from the MAC royalty area.
- **Zip Co (Z1P, no holding):** The Fund's no holding detracted from relative performance. Z1P provided an update for 4Q20 with revenue of $102m, up 88% yoy. The US business, Quadpay, continues to show strong operating momentum with US users now surpassing Z1P's ANZ users. We have concerns that the buy now, pay later category is becoming saturated and see more attractive investment opportunities in the market at present.

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

- BT Panorama
- BT Wrap
- HUB24
- Macquarie Wrap
- Netwealth
- Praemium

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