

DNR Capital Australian Emerging Companies Fund

APIR code: PIM4357AU

Performance Report November 2022

Performance

The DNR Capital Australian Emerging Companies Fund increased 2.01% (net of fees) in November, underperforming the S&P/ASX Small Ordinaries Accumulation Index by 2.91%. Over the last 12 months, the Fund increased by 1.27%, outperforming the Index by 15.30% (net of fees).

Net active return as at 30 November 2022

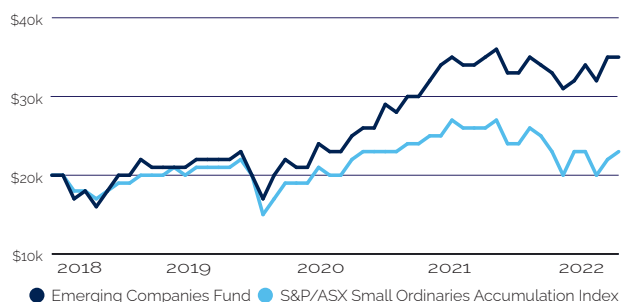
	1mth %	3mth %	6mth %	1yr %	3yr p.a. %	4yr p.a. %	Incep.* p.a. %
Emerging Companies Fund	2.01	2.30	5.39	1.27	16.51	18.87	14.26
S&P/ASX Small Ordinaries Accumulation Index	4.92	-0.81	-3.37	-14.03	2.57	5.92	2.91
Excess return	-2.91	3.11	8.76	15.30	13.94	12.95	11.35

* Inception Date—August 2018

Source: DNR Capital and Apex Fund Services

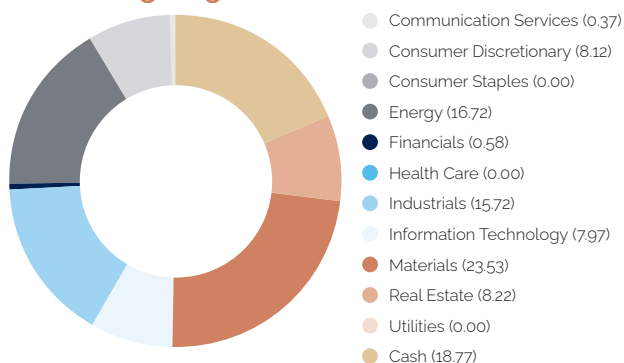
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Emerging Companies Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry/exit fees or taxation.

Growth of \$20,000 since inception



Source: DNR Capital and Apex Fund Services

Sector weightings %



Source: DNR Capital and Apex Fund Services

Top 3 active holdings (alphabetical order)

Security details

Beach Energy (BPT)

IPH (IPH)

PEXA Group (PXA)

Source: DNR Capital and Apex Fund Services

Monthly top contributors and detractors

Top 3 contributors

Whitehaven Coal (WHC)

Beach Energy (BPT)

Deterra Royalties (DRR)

Top 3 detractors

IPH (IPH)

PEXA Group (PXA)

Iress (IRE)

Source: DNR Capital and Apex Fund Services

A team with global experience



Sam Twidale
Portfolio Manager
CFA



Mark Sedawie
Portfolio Manager
CFA

Fund and market review

The Index followed up the previous months gain with another strong performance, finishing up 4.92% during November. The Fund underperformed the strong market, reflecting its overall more defensive positioning. This follows a strong period of outperformance, with the Fund significantly outperforming the Index over the past year in what has been a difficult period for the market.

During November the Fund's key outperformers came from the commodity related sectors, including Whitehaven Coal (WHC), Beach Energy (BPT) and Deterra Royalties (DRR). These companies remain on attractive valuations, generating significant free cash flow and with strong balance sheets. Detractors included the more defensive holdings like IPH (IPH) and Iress (IRE), which lagged the market gains. PEXA Group (PXA) also underperformed the market, with the recent sell down by Link Group weighing on its shares in the short-term.

Despite concerns around the outlook for the global economy, investors have been encouraged by recent signs that elevated inflation levels may have peaked, which could allow central banks to slow the pace and size of further interest rates hikes. This has seen the market recover strongly from the recent low in early October. Although we would caution that there remains considerable uncertainty surrounding the extent to which inflation will moderate, and the ultimate destination of interest rates.

Although valuations have adjusted lower, we believe there are still risks surrounding the outlook for certain sectors of the market. In particular, the downward pressure on earnings from more restrictive monetary policy and a slowing economy is still to play out. This has also not yet been reflected in market expectations in our view, presenting the risk of negative earnings surprises. As a result, we continue to take a more selective approach in the Fund, with more attractive opportunities likely to emerge as these risks become more evident.

During the past month an increasing number of companies have started to reveal more challenging operating conditions, with earnings downgrades resulting in material share price falls. For example, companies like Collins Foods (CKF) and Pact Group Holdings (PGH) have highlighted the difficulties dealing with higher cost inflation. This is likely to be a challenge for a wide range of companies, with margins coming under pressure from weaker revenue and inflated costs.

Poor capital allocation decisions are also coming to the surface, with risky acquisitions undertaken when liquidity was abundant, starting to unravel. This has recently included City Chic Collective (CCX), BWX (BWX), DGL Group (DGL) and EML Payments (EML) where share prices have fallen >80% from recent highs. Other companies like Bravura Solutions (BVS) have seen disappointing revenue, with management forced

into strategy resets as results fail to deliver on lofty expectations.

With liquidity being tightened and growth slowing, further downgrades are likely in our view. Companies with elevated debt levels look particularly vulnerable, highlighting the importance of focusing on companies with strong balance sheets at this point in the cycle. Excessive financial leverage compounds the cost of the mistakes of management teams, with shareholders left to pay a hefty price. Increasing cost of debt will also result in higher interest costs, further pressuring earnings growth. It is for this reason that all the Fund's holdings are either in a net cash position, or have very low levels of gearing.

We continue to observe a wide dispersion in valuations across the market, with investors once again prepared to pay significant valuation premiums for companies offering earnings certainty. It is also interesting that a number of growth stocks have recovered nearly all their losses since the start of the calendar year, despite the sharp increase in bond yields. For example, the medical imaging software company Pro Medicus (PME) is back to trading on forward price-to-earnings multiples of over 100x, and the automotive parts supplier PWR Holdings (PWH) has rebounded back to nearly 50x. We would caution that although these business models are attractive and earnings may be more resilient, there is limited margin of safety in the valuations with considerable optimism already being priced in.

We are also surprised at the number of highly speculative and early-stage companies trading on extreme valuations in the small-cap universe. For example, despite the recent market correction, BrainChip Holdings (BRN) still has a market capitalisation of \$1.3bn. This is for a company generating close to zero revenue. There are also a number of early-stage mining exploration companies with large valuations, despite being many years away from production and with considerable execution risk involved. In our view, this suggests that risk appetite is high, and investors haven't yet fully adjusted to an environment of tighter liquidity and higher interest rates.

Following the recent rally in the market over the past two months, we have been looking for additional opportunities to shift the Fund into the areas of the market offering the greatest mispricing. We have also reduced holdings which have recovered strongly and where valuation upside has reduced. These changes have seen the forward price-to-earnings multiple for the Fund fall back to 10x, which is well below the Index on 14x. It is also one of the lowest valuations since the inception of the Fund. The Fund remains concentrated in our best ideas, with key overweights across the materials, energy, and industrials sectors. The cash weighting is elevated, which provides flexibility to deploy into the ongoing volatility we expect going forward.

Performance attribution

Contributors

- **Whitehaven Coal (WHC):** shares recovered during the month despite initially selling off after downgrading production due to wet weather. Previous guidance for FY23 production of 20-22mt was reduced to 19-20.4mt.
- **Beach Energy (BPT):** submitted a proposal to acquire Warrego Energy (WGO) for \$246m. WGO has attractive assets in the highly prospective Perth Basin in WA. WGO would complement BPT's acreage position in the Perth Basin and provide further optionality to develop new gas supply.
- **Deterra Royalties (DRR):** shares rallied on the back of stronger iron ore prices on expectations that China will re-open its economy.

Detractors

- **IPH (IPH):** shares underperformed the stronger market. IPH provided a trading update at its AGM with both revenue and EBITDA up the first 4 months of FY23, compared to the prior year.
- **PEXA Group (PXA):** reaffirmed its FY23 outlook previously provided at its full year results. Link sold down 10% of its 43% holding in PXA, creating an overhang on the share price.
- **Iress (IRE):** IRE's more defensive characteristics saw its shares trail a stronger market.

Fund facts

Inception date: August 2018

Minimum initial investment: \$20,000

Risk level: High

Management fee: 1.15% p.a. of the NAV of the Fund

Performance fee: 20% of outperformance of the Fund relative to the Fund's Benchmark (after the management fee)

Entry/exit fees: Nil

Buy/sell spread: +0.25%/-0.25%

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.

About DNR Capital and the Fund

Concentrated: Investing in 20-45 highest conviction, quality small cap Australian listed equities.

Style neutral and quality focussed: A disciplined approach to quality and valuation. Concentrated portfolios of quality companies maximise the opportunity for outperformance.

Global & domestic investment experience: Portfolio managers with global and domestic research experience, helps to identify globally competitive emerging companies.

Aligned team: Portfolio managers are invested in the Fund.

Proven process: DNR Capital was established in 2001 and a consistent firm-wide investment process has delivered more than 19 years of investment outperformance.

Disclaimer

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