

DNR Capital Australian Emerging Companies Fund

APIR code: PIM4357AU

Performance Report December 2022

Performance

The DNR Capital Australian Emerging Companies Fund decreased 5.75% (net of fees) in December, underperforming the S&P/ASX Small Ordinaries Total Return Index by 2.02%. Over the last 12 months, the Fund decreased by 6.74%, outperforming the Index by 11.64% (net of fees).

Net active return as at 31 December 2022

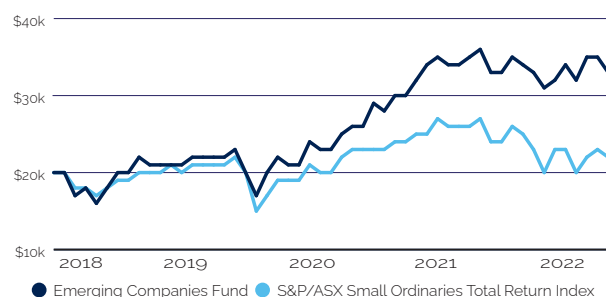
	1mth %	3mth %	6mth %	1yr %	3yr p.a. %	4yr p.a. %	Inception* p.a. %
Emerging Companies Fund	-5.75	2.80	8.73	-6.74	14.41	19.29	12.41
S&P/ASX Small Ordinaries Total Return Index	-3.73	7.54	7.03	-18.38	1.38	6.04	1.95
Excess return	-2.02	-4.74	1.70	11.64	13.03	13.25	10.46

* Inception Date - August 2018.

Source: DNR Capital and Apex Fund Services

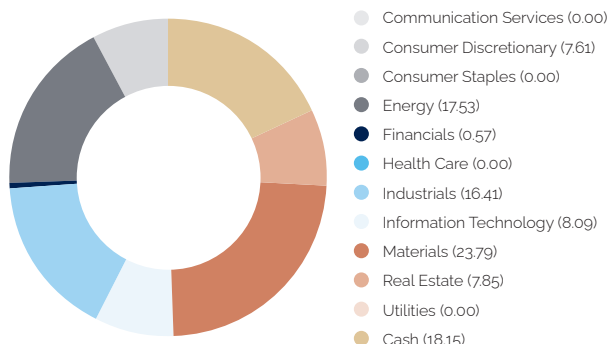
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Emerging Companies Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made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

Liontown Resources (LTR, no holding)

Stanmore Resources (SMR)

Iress (IRE)

Top 3 detractors

PEXA Group (PXA)

Allkem (AKE)

Beach Energy (BPT)

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

Equity markets came under pressure during the final month of the calendar year, with concerns around a deteriorating growth outlook as the risk of a recession increases, and the negative impact this will have on earnings going forward. Despite the elevated cash weighting (18.15%), the Fund underperformed the Index during December, with weakness in the more cyclical holdings weighing on the relative performance.

The materials and energy sectors were the main detractors during the month, including Allkem (AKE), IGO (IGO) and Lynas Rare Earths (LYC), which partially gave back the strong gains posted over the past year. Although commodity prices are likely to remain volatile in the short-term, we continue to see positive long-term outlooks given the growing demand and tight supply for decarbonisation exposed commodities. PEXA Group (PXA) also fell, with the distribution of Link Communications 43% holding in the company impacting the shares in the short-term, as well as concerns around weaker property transactions due to higher interest rates. Positive contributors included Stanmore Resources (SMR) which trades on an extremely low valuation, and the Fund's more defensive holdings like Iress (IRE) which outperformed the falling market.

Over the past year equity markets have corrected sharply lower, primarily due to the impact of tighter monetary policy and higher interest rates on equity valuations. With the risk of a recession increasing as the global economy feels the effect of this tighter policy, the focus is now firmly turning to the deteriorating outlook for earnings during a potential recessionary environment.

This downside risk to earnings has been a concern of ours for some time, with earnings expectations for a range of sectors too optimistic in our view. In the post-COVID period many companies saw margins reach peak levels, with bumper profitability supported by low interest rates, high levels of consumer spending and limited cost growth. For many companies we have seen these elevated earnings extrapolated long into the future, usually to justify the high valuations that investors have pushed share prices to. With revenue growth now falling and costs remaining elevated, this strong period of corporate profitability is now coming under pressure. As we have been recently highlighting, evidence of this is starting to emerge in recent company updates, and we expect this to continue as we approach the February reporting season. Weaker business models that have been too aggressive during the boom years appear most vulnerable.

Although equity markets are likely to remain volatile, we expect this environment to start providing more attractive opportunities to deploy the Fund's elevated cash holding. With valuation multiples correcting lower, and earnings expectations also now starting to come down, equity valuations are progressively being de-risked from the priced for perfection conditions we described a year ago (peak valuations on peak margins left no room for error). Although we are unlikely to time the bottom in share prices, for long-term focused investors we should start seeing a much more attractive environment to start deploying capital. Once both valuations and earnings have rebased lower, the risk return profile will be significantly more compelling for quality business models where we still see promising long-term outlooks. Identifying these types of opportunities will be our key focus during the coming months.

In terms of where we expect opportunities to emerge, as we have been discussing over the past year, we believe the market is still transitioning through a period of leadership change now that the long period of low interest rates and low inflation has seemingly come to an end. Certain companies and sectors that thrived in this environment could struggle to repeat this period of outperformance, with the next decade likely to see new sources of market leadership emerge. For example, we continue to see opportunities emerging in the more tangible side of the economy like materials and energy, which have been underinvested in over the past decade as investors allocated more capital to growth related sectors that were primarily intangible in nature. Furthermore, this underinvestment is only likely to become more pronounced when the global economy eventually passes through this period of weaker growth.

We are also looking for de-rated quality companies that are being indiscriminately sold down on short-term concerns, yet where the long-term structural outlook remains very positive. We believe that PEXA Group (PXA) is one such opportunity, and we have been taking advantage of the recent share price weakness to add to the Fund's holding.

PXA is the leading digital property settlements exchange in Australia, with a dominant industry position given the lack of a major competitor. It generates high levels of margins and cash flow, and can protect these margins during a period of higher costs by raising prices. The company has multiple sources of future growth, by monetising its large amounts of data, and by expanding into international markets like the UK, where the company is investing heavily to launch the first digital property exchange. Although earnings face some near-term challenges from higher interest rates and lower property transactions in Australia, we believe this has been more than reflected in the current valuation.

Overall the Fund remains positioned in the more value sectors of the market, with the forward price-to-earnings multiple for the Fund below 10x, which compares to the Index on 13x. 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 remains elevated, which provides flexibility to deploy into the ongoing volatility we expect going forward.

Performance attribution

Contributors

- **Liontown Resources (LTR, no holding):** no holding in LTR added to the Fund's relative outperformance, as shares declined on weaker lithium prices.
- **Stanmore Resources (SMR):** benefitted from robust coking coal prices. SMR is rapidly delveraging its balance sheet with scope to reinstate dividends and/or pursue further consolidation opportunities. .
- **Iress (IRE):** outperformed the market given its defensive characteristics. IRE has high levels of recurring revenue given its technology is entrenched in its customers operations.

Detractors

- **PEXA Group (PXA):** declined as higher interest rates weigh on the property market. An expected surge in the mortgage refinancing as fixed rate loans expire should alleviate some of the cyclical slowdown in property listings.
- **Allkem (AKE):** underperformed as lithium prices retreated on concerns around slower electric vehicle growth given the uncertain economic environment.
- **Beach Energy (BPT):** fell in tandem with the oil price on growing recession fears and the potential impact on oil demand.

Disclaimer

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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.

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

dnrcapital.com.au