

DNR Capital Australian Emerging Companies Fund

Performance Report - February 2021

Performance

The DNR Capital Australian Emerging Companies Fund increased 8.26% (net of fees) in February, outperforming the S&P/ASX Small Ordinaries Accumulation Index by 6.71%. Over the last 12 months the Fund increased by 40.00%, outperforming the Index by 22.82% (net of fees).

Market review

During February, the Fund benefited from a strong reporting season, with a number of holdings reporting results ahead of expectations. With bond yields increasing in anticipation of stronger economic growth and a pickup in inflation expectations, February also saw a sharp rotation out of growth/defensive companies, into the more value/cyclical parts of the market. Given the Fund's overweight position in the more cyclical sectors like mining, consumer cyclicals and the reopening beneficiaries, this also contributed positively to the outperformance.

Overall, the February reporting season saw the majority of companies beating market expectations. Many of the lockdown beneficiaries like the domestic retailers, continued to report impressive growth rates, albeit aided by temporary measures like fiscal stimulus and one-off superannuation withdrawals. However, given the muted share price reaction for many of these, the market is clearly starting to differentiate between the recent winners and losers. This includes greater scrutiny over elevated valuations and the sustainability of higher levels of profitability. Companies that have thrived in a COVID-19-impacted economy (for example online versus physical retailers), are unlikely to experience the same tailwinds going forward. This means we need to be alert to companies where the market has been too optimistic in extrapolating recent trends, and we have reduced holdings where we believe this is the case.

We have previously discussed the significant valuation dispersion across the market, with many of the growth/defensive stocks priced for perfection. Not only are valuation multiples elevated, but growth expectations are also more on the optimistic side. This leaves limited room for error in our view, with the risk-reward weighted to the downside. It is for this reason that we substantially reduced the Fund's exposure to the more growth-orientated holdings in sectors like technology and payments, which have been some of the strongest performers over the last year. It is never easy selling quality companies that have been your winners, however if valuations become too excessive, then we believe it would be imprudent not to. This repositioning supported the Fund's relative performance during February, with many of the growth stocks coming under pressure as the market rotated into value and cyclicals.

Positively contributing to the Fund's performance during February was the recovery in a number of companies adversely impacted by COVID-19 in the short term, yet where results came in better than expected. This was especially the case for those higher quality companies that have navigated the downturn well. For example, the

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 28 February 2021

	1mth %	3mth %	6mth %	1yr %	2yr %	Incep.* %
Emerging Companies Fund	8.26	15.06	20.62	40.00	20.65	15.41
S&P/ASX Small Ordinaries Accumulation Index	1.55	4.08	12.05	17.18	9.13	5.91
Excess return	6.71	10.98	8.57	22.82	11.52	9.50

* 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.

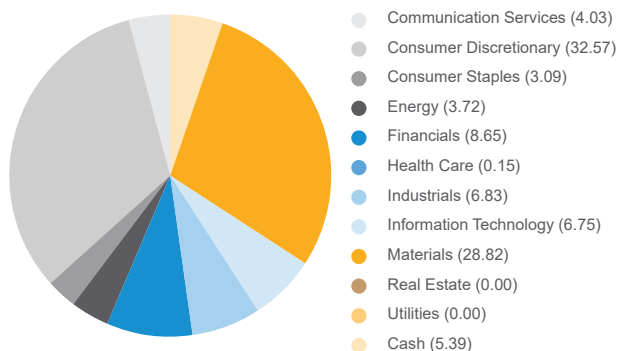
Fund benefited from its positions in Corporate Travel Management (CTD), Lovisa Holdings (LOV) and IDP Education (IEL). Shares in these companies recovered sharply with signs that the worse has passed, and with some early signs of recovery becoming evident. Given the opportunistic investments undertaken during the downturn, we believe these companies have positioned themselves very well to take share during the recovery.

The resources sector continues to be a key overweight for the Fund, with Lynas Rare Earths (LYC), IGO (IGO) and Iluka Resources (ILU) all contributing positively to the February performance. The commodities sector has been one of the key beneficiaries of the pickup in bond yields and higher inflation expectations, which remains a key risk given the significant monetary and fiscal stimulus. In fact, looking through history, commodities is one of the most effective ways to hedge increasing bond yields. We

are also positive on the sector given the strong bottom-up fundamentals. Supply across the commodities sector is generally tight given years of underinvestment. In addition, we expect demand growth will benefit from higher levels of fiscal spending and the transition towards renewables and electric vehicles.

Overall, our focus continues to be on ensuring the Fund has a concentrated exposure to the most attractively priced companies in the market that meet our quality criteria. Although the Fund has benefited from the recent rotation into resources stocks and reopening beneficiaries, we remain alert to high-quality companies left behind during the recent rotation, especially those that reported strong results and where our long-term investment thesis is intact. During the month, we added to these opportunities at extremely depressed valuations, like the intellectual property firm IPH (IPH) and the financial services software company Iress (IRE).

Sector weightings %



Monthly - top contributors and detractors

Top 3 contributors

Lovisa Holdings

Lynas Rare Earths

IDP Education

Top 3 detractors

Zip Co

Domain Holdings Australia

Iress

* 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)

Corporate Travel Management

IDP Education

IGO

Lovisa Holdings

Lynas Rare Earths

Source: Mainstream Fund Services and DNR Capital

Attribution

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

Contributors

- Lovisa Holdings (LOV):** Produced a solid set of results in the context of the COVID-19 impacts to the business. Comparable sales growth has turned positive with the first seven weeks of 2H21 up 12%. This indicates the level of pent-up demand once economies reopen. The European beeline acquisition remains on track to be completed by early May, providing LOV with a strong base to accelerate growth in this region. The board reinstated the payment of dividends, sending a strong signal on the health of the business with \$42.5m in net cash and access to a \$50m debt facility.
- Lynas Rare Earths (LYC):** The 1H21 result highlighted the accelerating earnings growth driven by strong rare earth prices with earnings before interest, taxes, depreciation and amortisation (EBITDA) almost doubling to \$81m. Rising demand from the electrification of transportation and renewable energy investment is

creating tightness in the rare earth markets, placing upward pressure on pricing. The business is well funded with over \$500m in cash and short-term deposits.

- IDP Education (IEL):** The 1H21 result highlighted the strength of the business model with IEL's global platform and digital initiatives offsetting Australia's border closure. Student volumes into Australia were down 47%, yet UK volumes were only down 12%. IELT (English language course) volumes have rebounded to pre-pandemic levels, which is a lead indicator for student placements when borders reopen. The business has a cash balance of \$293m, demonstrating sufficient liquidity to navigate the crisis.

Detractors

- Zip Co (Z1P, no holding):** Detracted from relative performance. The US listing of buy now, pay later (BNPL) provider Affirm showed the market's willingness to ascribe a high valuation to the business, which saw Z1P shares close some of the relative valuation gap. We have concerns the BNPL category is becoming saturated and see more attractive investment opportunities in the market at present.
- Domain Holdings Australia (DHG):** Shares retraced as the improved property listings cycle was overshadowed by higher costs. The higher costs reflect management's increased confidence in the improving property market and some cycling of government benefits. Property turnover remains below mid-cycle levels with DHG well positioned to capitalise on the improved housing environment. Longer term, an opportunity for stamp duty reform could provide a step change in transaction volumes.
- Iress (IRE):** Delivered a FY20 result ahead of reinstated guidance yet it was met with a lackluster response by the market. The results highlight the strength of the business model with recurring revenue of 90%, cash conversion >100% and a return on invested capital of 10%. The focus for the group is the integration of the OneVue acquisition, allowing them to participate in the \$3b annual revenue pool of retail investments. Shares are trading at the lowest price to earnings ratio (PE) relative to the market for the past decade.

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

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

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