DNR Capital Australian Emerging Companies Fund

Performance Report - March 2021

Performance

The DNR Capital Australian Emerging Companies Fund decreased 0.63% (net of fees) in March, underperforming the S&P/ASX Small Ordinaries Accumulation Index by 1.42%. Over the last 12 months the Fund increased by 72.34%, outperforming the Index by 20.19% (net of fees).

Market review

After a strong reporting season during the prior month, the Fund remained broadly flat in absolute terms in March. Underlying sectors and stocks painted a different story however, with bouts of volatility driven primarily by the direction of bond yields. There has been a meaningful pickup in bond yields since the start of the year, with the US 10-year dropping as low as 0.90%, before rising to over 1.7% during the month. Higher yields have posed a concern for highly rated growth stocks, with the market questioning current valuations where profits will not materialise for some time. We saw some of these growth-related stocks bounce back during the month, as bond yields consolidated the recent move higher. The Fund has benefited in the past few months by positioning in the more value-oriented sectors of the market like commodities and cyclicals. While the valuation gap between highly priced stocks compared to lowly priced stocks has closed slightly, these measures are still at extremes suggesting the rotation could continue particularly as economies reopen and fiscal stimulus is unleased.

Renewed spikes in COVID-19 cases saw several reopening beneficiaries like Corporate Travel Management (CTD) and IDP Education (IEL) pare gains. Despite some near-term uncertainty surrounding the speed of vaccine rollout, the US and UK should see a large proportion of the population vaccinated by the middle of the year. We refer to Israel as a good test case, with over 60% of the population vaccinated and new COVID-19 cases dropping significantly.

The prospect of inflation remains a key market concern with unprecedented fiscal stimulus, loose monetary policy, high savings rates, and significant pent-up demand due to lockdown restrictions. Although our primary focus continues to be on identifying strong bottom-up opportunities, we are mindful of this macro backdrop with our Fund positioning. It is for this reason the resources sector continues to be a key overweight, ensuring we have exposure to the highest quality miners with strong bottom-up fundamentals. For example, our collection of commodity exposures range across lithium, rare earths, iron ore, nickel, gold, mineral sands and coal. In aggregate these exposures yield attractive characteristics, on average, such as 25-year mine life, bottom quartile of the cost curve, operating in Tier 1 mining jurisdictions, double-digit free cash flow yields (11%) and net cash on the balance sheet (gearing; ND/EBITDA -0.4x). 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.

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 March 2021

	1mth %	3mth %	6mth %	1yr %	2yr %	Incep.* %
Emerging Companies Fund	-0.63	7.71	23.82	72.34	19.29	14.60
S&P/ASX Small Ordinaries Accumulation Index	0.79	2.09	16.20	52.15	9.62	6.04
Excess return	**-1.42**	**5.62**	**7.62**	**20.19**	**9.67**	**8.56**

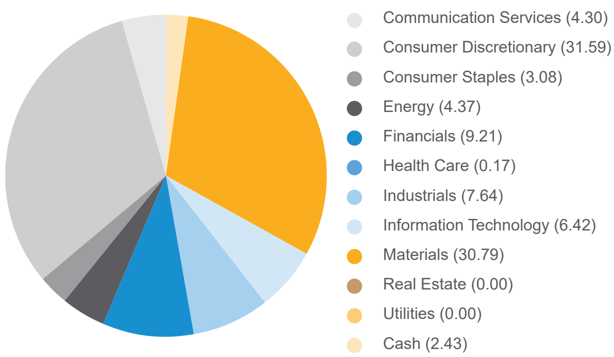
** Inception Date—August 2018*
Source: Mainstream Fund Services and DNR Capital

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.

The markets' gyration between value and growth stocks have left a number of high-quality companies behind that don't necessarily fit into these buckets. We have increased exposure to a collection of businesses generating strong cash flows on attractive valuations, like IPH (IPH) and Iress (IRE), to name a few.

Overall, the Fund's positioning remains unchanged, that is, ensuring the Fund has a concentrated exposure to the most attractively priced companies in the market that meet our quality criteria. We are positive on stocks set to benefit from a reopening of economies with a preference for those companies that made bottom of the cycle acquisitions/ investments, which will enable them to gain market share during the recovery.

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors
Zip Co
Whitehaven Coal
IPH

Top 3 detractors
IDP Education
IGO
Deterra Royalties

** 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)

IDP Education
IGO
Iluka Resources
Lovisa Holdings
Lynas Corporation

Source: Mainstream Fund Services and DNR Capital

Attribution

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

Contributors

- **Zip Co (Z1P, no holding):** No holding in Z1P added to relative performance. The buy now, pay later sector came under pressure following Commonwealth Bank's entrance into the space. Although this is not the bank's first foray into the sector with its investment in Klarna, it highlights the low barriers to entry.
- **Whitehaven Coal (WHC):** Shares benefited as thermal coal prices traded close to US$100/t. The risk–reward opportunity for WHC is compelling, with coal prices recovering from a cyclical trough, and a free cash flow yield of over 30% at current prices. Despite the long-term risk to thermal coal as the world looks to decarbonise, we believe this has been more than reflected in the depressed valuation.
- **IPH (IPH):** Shares found support during the month as the AUD/USD exchange rate stabilised, which had been a key concern overhanging the stock. Currency aside, the fundamentals for the business remain attractive with a growing free cash flow yield of 6%, a return on equity of 18% and trading at close to a 20% discount to the ASX Small Ordinaries Index.

Detractors

- **IDP Education (IEL):** Pared recent gains after it provided an update on the Education Australia shareholding. Education Australia announced that its 38 Australian university shareholders are considering a proposal to take direct ownership in IEL through a restructure of Education Australia's 40% holding in IEL. Under the proposal 15% of IEL shares will be facilitated via a market sell-down. Although this has created an overhang for the shares in the near term, the underlying business fundamentals and attractive long-term opportunities have not changed.

- **IGO (IGO):** Shares drifted lower as commodity-related stocks consolidated recent gains. Completion of the Greenbushes lithium mine (expected to close by the June quarter), will see IGO have pure-play exposure to the increasing demand for battery materials to support the expected growth in electric vehicles and renewable energy.
- **Deterra Royalties (DRR):** Shares have been soft which can be attributed to higher yields, given the iron ore royalty stream has bond-like characteristics. DRR is a unique asset to list on the ASX. It offers investors exposure to an iron ore royalty stream over one of the premier iron ore mines globally operated by BHP Group (BHP). The asset is long life (+30 years), high grade and low cost. BHP has plans to increase the iron production to 145 million tonnes from 2023, up from 60 million tonnes currently. DRR is a high-quality resource exposure given there is no operational risk or capital contribution to fund growth, resulting in attractive free cash flow characteristics. We value the business on a long-term iron ore price of US$60/tonne and production at 140 million tonnes, which generates a free cash flow yield of >5%.

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

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