

DNR Capital Australian Emerging Companies Fund

Performance Report – May 2021

Performance

The DNR Capital Australian Emerging Companies Fund increased 1.07% (net of fees) in May, outperforming the S&P/ASX Small Ordinaries Accumulation Index which increased 0.27%. Over the last 12 months the Fund increased by 36.33%, outperforming the Index by 9.60% (net of fees).

Market review

May saw markets close slightly up, led by a rebound in commodity and cyclical names as the market begins to look through to an end to the coronavirus pandemic. Vaccination programs are well advanced around the world, with signs of effectiveness against variants that could otherwise derail the recovery. After a short reprieve last month, many of the growth-related names sold off. We continue to have a cautious stance on the areas of the market where valuations and earnings forecasts are too optimistic. The Fund positioning continues to be overweight commodities, and quality cyclicals with earnings leverage to a reopening global economy. This positioning was rewarded during the month, with the Fund outperforming the benchmark.

Macquarie Group held its annual conference during the month where we heard from a range of companies. A key takeaway was the number of companies mentioning cost pressures and supply constraints as key risks. We have been concerned about this risk for some time given the inflationary pressures that are building. In our view, it highlights the importance of focusing on quality business models that can raise prices. We saw a number of lower quality cyclicals succumb to this pressure, particularly companies in the mining services sector (we have no exposure) like Perenti Global (PRN), where citing labour cost pressures shares fell 30%. It also supports the Fund's overweight in the Materials sector, which has historically been one of the key beneficiaries of a more inflationary environment.

We continue to be positive on the decarbonisation thematic, with the world on the cusp of a multi-decade transition away from fossil fuels towards renewable energy and electric vehicles. We continue to see a range of car manufacturers like VW, Ford and General Motors announce plans to cease production of the internal combustion engine and focus on electric vehicles by the next decade. Solar and wind energy have seen dramatic cost falls, with the majority of global utility investment now being directed here. This transition is transforming the outlook for essential commodities required for electrification like copper, nickel, rare earths and lithium. For example, lithium is a key commodity in the battery chemistry with demand set to increase tenfold over the next decade. We remain positive on the commodity sector, with supply-side constraints suggesting we are still very early in the cycle.

May saw a number of sizeable share price falls across small cap sector, which the Fund avoided. EML Payments (EML) fell 42% during the month as the Irish regulator announced a probe of its recent acquisition. This highlights the risk with opaque business models and large offshore acquisitions.

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 30 May 2021

	1mth %	3mth %	6mth %	1yr %	2yr %	Incep.* %
Emerging Companies Fund	1.07	5.36	21.22	36.33	20.15	16.10
S&P/ASX Small Ordinaries Accumulation Index	0.27	6.09	10.42	26.73	10.92	7.65
Excess return	0.80	-0.73	10.80	9.60	9.23	8.45

* 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.

Costa Group Holdings (CGC) fell 27% after downgrading expectations with the market underappreciating the agriculture risk inherent in the business. Kogan (KGN) issued a downgrade during the period, blaming excess inventory following the boom in online sales during the COVID-19 lockdowns. We have been cautious on COVID-19 beneficiaries on elevated valuations, where the market has been capitalising the short-term boost the pandemic has had on earnings.

We continue to review a number of initial public offerings (IPOs), however in general we have been disappointed by the quality and excessive valuations. When assessing IPOs, we believe in the importance of exercising prudence, which means they have a higher hurdle to clear given the limited financial history and track record of management. We have been surprised by the opportunistic valuation sellers are seeking, yet buyers should be compensated in the form of an IPO discount, which has been missing from the vast majority of IPOs. A number of high flying recent IPOs have unravelled with the latest being Nuix (NXL). We passed on the IPO after conducting due diligence on the company by talking to competitors and users of NXL's platform. While users validated its data processing engine, the user interface was not as strong as that of its key competitor. Our research highlighted users were looking to reduce their usage of NXL and with the product already well penetrated in large accounting and law firms, this raised question marks around its growth outlook. NXL has revised its revenue guidance down twice since listing at the end of 2020, with shares now trading at half the IPO price. This highlights the importance of having a robust investment framework, rather than getting caught up in the promotional hype surrounding many of the recent IPOs.

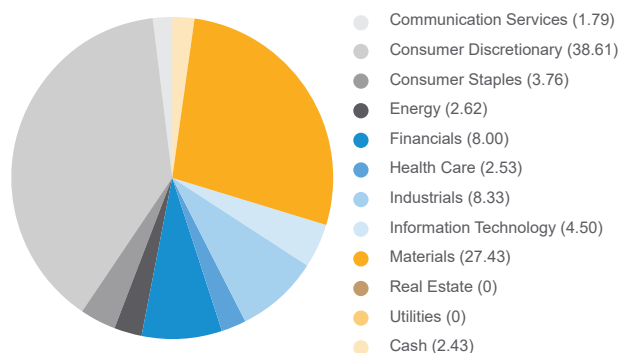
Overall, the Fund is positioned across a broad range of opportunities, including the more cyclical areas of the market like resources and consumer discretionary, reopening stocks that will benefit from a normalisation of the pandemic, and quality growth stocks that we believe are attractively priced. Although the macro-economic outlook is receiving a lot of attention given the debate around inflation/deflation and the direction of bond yields, we continue to search for strong bottom-up opportunities, with a preference for companies that can deliver value for shareholders regardless of the prevailing economic environment.

Top 5 active holdings (alphabetical order)

IDP Education
IGO
Iluka Resources
Lovisa Holdings
Lynas Corporation

Source: Mainstream Fund Services and DNR Capital

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors

Corporate Travel Management
Whitehaven Coal
ARB Corporation

Top 3 detractors

Domain Holdings Australia
Chalice Mining
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.

Attribution

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

Contributors

- Corporate Travel Management (CTD):** shares rallied as the vaccination programs in the US and UK are well advanced with people over 18 years of age expected to be fully vaccinated during the northern hemisphere summer. While Australia is lagging in terms of its recovery, CTD is benefiting from 70% of its revenue coming from the US and UK.
- Whitehaven Coal (WHC):** shares rebounded as thermal coal prices firmed over \$US120/t. WHC has a long mine life and is a low cost producer of high quality thermal coal (6000kcal). We acknowledge the ESG risk that coal

will become a stranded asset as the world transitions away from fossil fuels to renewable energy. However, this is more than factored into the distressed valuation with WHC delivering a free cash flow yield of over 40% at current spot prices (this implies shareholders could receive their capital back in a little over two years). Demand will remain solid in the medium term, and with no coal mines being developed or approved, this should lead to robust pricing.

- **ARB Corporation (ARB):** ARB's relationship with Ford continues as it announced that ARB-branded off-road accessories will be sold through participating Ford dealers in Australia. This follows the strategic collaboration with the new Ford Bronco in the US, which will see ARB develop a full suite of premium, aftermarket products for the Ford Bronco.

Detractors

- **Domain Holdings Australia (DHG):** provided a trading update for 3Q21 with total revenue up 2%. DHG will begin to cycle the April COVID-19 impacted base when listings reduced by half. Property indicators remain positive with low rates and easing lending conditions.
- **Chalice Mining (CHN, no holding):** we have spoken to management and a number of geologists, which validated the potential of the Julimar discovery in WA. Julimar is a significant discovery with the first real palladium resource in Australia, as well as containing high amounts of base metals like nickel, copper and cobalt. However the \$3b valuation the market has ascribed to the company is difficult to justify. The company is still in the exploration phase as the resource moves into reserves status, and it will take a significant amount of investment and time before the asset generates any cash flow.
- **Deterra Royalties (DRR):** shares pulled back as the iron ore price drifted below recent highs. 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/t and production at 140 million tonnes, which generates a free cash flow yield of >5%, particularly in the US market.

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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
- 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