

DNR Capital Australian Emerging Companies Fund

Performance Report – June 2021

Performance

The DNR Capital Australian Emerging Companies Fund increased 6.57% (net of fees) in June, outperforming the S&P/ASX Small Ordinaries Accumulation Index by 3.49%, which increased 3.08%. Over the last 12 months the Fund increased by 51.95%, outperforming the Index by 18.72% (net of fees).

Market review

The financial year finished strongly in June, with equity markets posting further gains. Significant fiscal and monetary policy support has certainly had the intended impact, supporting growth and boosting asset prices. The global economy is progressively emerging from the pandemic, leading to a strong rebound in earnings. With valuations having re-rated over the past year, this earnings recovery is now providing the next boost to share prices. This has seen the outperformance of many of the more cyclical and value-related shares, which generally have the most earnings leverage as volumes recover. Looking forward however, a key debate is how long this outperformance is likely to persist, especially as more signs of inflationary pressures emerge, and investors question the sustainability of the extremely accommodative policy support.

Given this backdrop, an interesting turning point during June was the Federal Reserve Bank meeting in the US. This highlighted that policy makers have potentially less tolerance to inflation than the market was expecting, indicating that interest rates could be set to rise through 2023. Investors reacted by unwinding the reflationary bias that has been driving relative sector performance, with the risk of a significant inflation overshoot receding. As a result, many of the more cyclical companies and those positively correlated to higher inflation underperformed the market during June. Instead, it was many of the more growth-exposed sectors like Information Technology that rebounded during the month after lagging during the cyclical rotation.

The Fund continued to post strong gains during the month, both in absolute terms and relative to the benchmark. With market leadership shifting back towards many of the more growth-orientated sectors following the US Federal Reserve meeting, the Fund benefited from recent changes to positioning. Over the past year, many of the Fund's key outperformers have been in the more cyclical sectors, and companies exposed to the reopening of the global economy. We substantially added to these opportunities last calendar year, when valuations were cheap given the considerable pessimism surrounding the outlook. However, given there is now greater optimism around the economic outlook, and with valuations having re-rated higher, we have been progressively reducing the Fund's exposure. This included reducing Corporate Travel Management (CTD) and Domain Holdings (DHG), where we believe the higher valuations are now starting to discount a meaningful earnings recovery for both companies.

In recent months, we have been taking advantage of the underperformance of a number of high-quality growth names to increase the Fund's holdings.

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 |

Many of these companies have seen material share price declines as the market rotated into the more cyclical and deflationary sectors, with valuations falling back to attractive levels. This includes companies across the Information Technology, Health Care and Consumer sectors, where we see positive long-term structural outlooks. For example, we substantially added to the Fund's holdings in Breville (BRG) following the recent share price decline. We are attracted to BRG's ability to reinvest at a high return on invested capital to drive high levels of organic growth, by investing in new product development and international expansion. In the Information Technology sector, we added to existing holdings and initiated a new position in the enterprise software company TechnologyOne (TNE). TNE is a high-quality business we have invested in previously. The company is a clear industry leader, providing essential software to the education and local government sectors. The company benefits from a high proportion of recurring revenue, an extremely strong balance sheet (\$100m net cash), and has excellent long-term growth potential. The shares have also underperformed the market given the focus on more cyclical/value shares, with its valuation falling back to attractive levels.

Although the wider market saw a shift back towards growth stocks from value, interestingly it was still a broad range of opportunities that contributed to the Fund's outperformance during June. We believe this highlights the importance of focusing on strong bottom-up investment ideas, rather than being too distracted by all the top-down news flow influencing the market. For example, we have been identifying a number of attractive opportunities in the resources sector over the past year, with fundamentals improving given rising demand and constrained supply. The market has been sceptical about the sustainability of recent commodity price increases, with valuation multiples across the sector still very low.

Two mining companies were strong contributors to the Fund's performance during June. This included Iluka Resources (ILU), a leading producer of industrial minerals used in the construction industry. The company is benefiting from price increases given the strength of demand and lack of investment in new supply. We also like management's disciplined approach to capital allocation, having demerged Detera Royalties (DRR), closed unprofitable mines, and invested in high returning rare earth projects where demand is growing strongly.

Whitehaven Coal (WHC), a low-cost/long-life producer of high-quality thermal coal, was also a leading contributor in June. Although the company has significantly higher ESG risks given the structural decline in thermal coal, we believe the depressed valuation more than compensates for these risks (FCF yield >30%). Demand for premium thermal coal is recovering strongly with prices doubling over the last six months. Given the ESG risks, thermal coal is a unique commodity in that higher prices are unlikely to incentivise new supply, supporting higher prices despite the long-term impact of the shift toward renewables. The distressed valuation raises an interesting question; does the valuation no longer matter for these types of opportunities? Should energy assets be ignored regardless of how cheap the investment becomes, even if investors are paying <50c in the dollar? At the current share price, whether the company exists in 10 years is not material to the valuation.

Other positive contributors included the more defensive holding IPH (IPH), which is a leading intellectual property firm. The shares rebounded strongly after lagging the market over much of the past year, mainly because of its more defensive attributes and lack of cyclicity in a recovering economy. We are attracted to the company's quality business model, with high levels of cash generation, clear market leadership and significant balance sheet optionality to pursue further bolt-on acquisitions.

Overall, we are currently taking a more balanced approach to managing the Fund and the types of opportunities we are investing in. There is considerable debate surrounding issues like; 1) the outlook for the economy, 2) whether inflation is transitory or structural, 3) the sustainability of fiscal and monetary policy support, 4) the long-term impact of COVID-19 and 5) whether growth or value sectors are likely to outperform. Given that we see compelling arguments for a range of scenarios to play out, we believe it is prudent to prepare for a range of outcomes. Rather than taking strong views on these topics (especially given the high levels of uncertainty), we have learnt over time that in the small-cap sector, we will add more value by focusing on the bottom-up. In particular, in high-quality companies that can deliver in a range of economic environments. Consistent with our style-neutral process, it also means staying flexible, focusing on where the mispriced opportunities in the market are at any point in time. We see market commentary regularly focusing on whether a stock is value or growth. We think this is overly simplistic in the small-cap sector, where the overriding focus should be on whether it is a quality business, and the degree to which it is mispriced.

Net active return as at 30 June 2021

| | 1mth | 3mth | 6mth | 1yr | 2yr | Incep.* |
|---|-------------|-------------|--------------|--------------|--------------|-------------|
| Emerging Companies Fund | 6.57 | 13.00 | 21.71 | 51.95 | 23.72 | 18.22 |
| S&P/ASX Small Ordinaries Accumulation Index | 3.08 | 8.50 | 10.76 | 33.23 | 12.10 | 8.57 |
| Excess return | 3.49 | 4.50 | 10.95 | 18.72 | 11.62 | 9.65 |

* 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.

Attribution

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

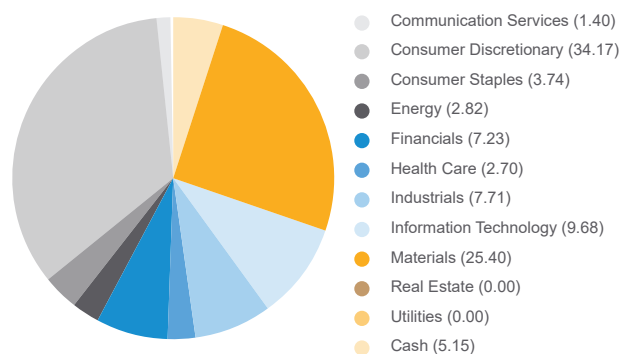
Contributors

- Iluka Resources (ILU):** Tightness in the mineral sands market was further exacerbated after Rio Tinto (RIO) ceased production and called force majeure on customer contracts from Richard Bay Minerals after another fatality at the site heightened security concerns for its employees. Richard Bay is a major producer of rutile and zircon in South Africa.
- Whitehaven Coal (WHC):** Provided a production update with Narrabri back on track after experiencing minor operational issues. Climate change risks appear reflected in WHC's distressed valuation with a free cash flow yield of 40% at current prices of ~\$130/t. During the month Canada was the latest country to announce it will immediately end investments in thermal coal mining or expansion projects. Coal is an interesting commodity in that higher prices will not incentivise new supply. This sector has attracted investment from the likes of US hedge fund Elliott Management and Glencore, both picking off BHP's coal assets at attractive prices. Existing producer WHC, with its long mine life and high-quality coal, is well positioned to generate significant free cash flow for shareholders.
- IPH (IPH):** Shares outperformed aided by the strength of the US dollar, which translates into higher IPH revenues. IPH shares have underperformed the past year as the market sought cyclical exposure at the expense of defensive earnings streams. IPH generates a 6% free cash flow yield and is well positioned to globally consolidate the patent filling market.

Detractors

- Pro Medicus (PME, no holding):** Announced a research collaboration with the Mayo Clinic. PME is a high-quality business, yet we struggle to justify the stratospheric valuation, with the PE multiple re-rating from 161x to 188x in the past month alone.
- Champion Iron (CIA):** Shares were lower as the iron ore price consolidates its recent gains. CIA is a high-grade producer of iron ore based in Canada with production set double to 15mtpa over the next year. Based on conservative iron ore price assumptions, we model CIA generating a double-digit free cash flow yield.
- IGO (IGO):** Shares lagged the benchmark as the market awaits the close of its Tianqi lithium acquisition, which is subject to regulatory approvals. Subsequent to the close of the financial year, regulatory approvals were received transforming IGO into a pure-play raw material stock for the electric vehicle and renewable energy industries.

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors

Iluka Resources

Whitehaven Coal

IPH

Top 3 detractors

Pro Medicus (no holding)

Champion Iron

IGO

* 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

Iluka Resources

IPH

Lovisa Holdings

Lynas Rare Earths

Source: Mainstream Fund Services and DNR Capital

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

- AMP MyNorth
- BT Panorama
- CFS FirstWrap
- HUB24
- Macquarie Wrap
- Mason Stevens
- Netwealth
- Praemium

Disclaimer

This document has been prepared by DNR Capital Pty Ltd, AFS Representative - 294844 of DNR AFSL Pty Ltd ABN 39 118 946 400, AFSL 301658. It is general information only and is not intended to be a recommendation to invest in any product or financial service mentioned above. Whilst DNR Capital has used its best endeavours to ensure the information within this document is accurate it cannot be relied upon in any way and you must make your own enquiries concerning the accuracy of the information within. The information in this document has been prepared for general purposes and does not take into account the investment objectives, financial situation or needs of any particular person nor does the information constitute investment advice. Before making any financial investment decisions you should obtain legal and taxation advice appropriate to your particular needs. Investment in the DNR Capital Australian Emerging Companies Fund can only be made on completion of all the required documentation. The Trust Company (RE Services) Limited ABN 45 003 278 831 AFSL No 235150 (as part of the Perpetual Limited group of companies) is the issuer of the PDS for the Fund. An investor should obtain and read the PDS and consider their circumstances before making any investment decision. The PDS is available at the Fund website at www.dnrcapital.com.au/invest, or a paper copy can be obtained, free of charge, upon request by calling DNR Capital Pty Ltd ('Manager'), the investment manager of the Fund. This material is general information only and not an investment recommendation. The Manager or The Trust Company (RE Services) Limited does not guarantee the repayment of capital from the Fund or the investment performance of the Fund. An investment in this fund is subject to investment risk including loss of some or all of an investor's principal investment and lower than expected returns.

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