

DNR Capital Australian Emerging Companies Fund

Performance Report – July 2021

Performance

The DNR Capital Australian Emerging Companies Fund increased 4.44% (net of fees) in July, outperforming the S&P/ASX Small Ordinaries Accumulation Index by 3.76%, which increased 0.68%. Over the last 12 months the Fund increased by 59.06%, outperforming the Index by 26.76% (net of fees).

Market review

The Fund posted strong gains versus the Index during July, with a range of companies contributing to the performance. Several of the Fund's holdings in the mining sector were particularly strong contributors, with the shares of Lynas Corporation (LYC), IGO (IGO) and Orocobre (ORE) all rising between 20-30% in the month.

We continue to be constructive on the investment case for owning a number of the higher quality commodity producers, with the supply/demand outlook remaining positive. Since investment in new supply last peaked in 2012, the mining companies have been prioritising returning cash flow back to shareholders, with dividends across the sector now at record high levels. This means there is still limited new supply starting-up, providing a supportive backdrop for commodity prices. In addition, there is now greater scrutiny of the environmental impact of mining, which is raising costs, and making it more difficult to expand supply.

The outlook for demand also remains structurally positive, especially those metals exposed to the decarbonisation thematic. This includes increased investment in solar and wind power, the transition to electric vehicles, and reducing the carbon intensity of steel production. We see the mining sector as a crucial enabler of the global push to reduce emissions, providing the essential commodities required for the electrification of the economy. We believe the market has yet to recognise the importance of the sector to this long-term thematic, presenting a number of attractive opportunities for investors. As a result, the Fund's mining exposure has a bias towards those companies that will benefit from decarbonisation.

Assessing the bottom-up opportunities in the Australian small-cap mining sector, our focus has been to identify the higher quality producers, which benefit from low production costs, strong balance sheets, long-mine lives and management which are disciplined allocators of capital. The sector is currently a key overweight for the Fund, with earnings risk to the upside and valuation multiples still attractive. Comparing the free cash flow yields in the mining sector to the wider market, we believe it still offers one of the standout opportunities in the market.

The level of merger and acquisition activity has certainly increased, with companies incentivised by low interest rates, attractive valuations and a more positive view on the outlook. During July, the Fund benefited from this activity, from both an acquirer and target perspective. IDP Education (IEL) announced a highly accretive and

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

strategic acquisition of its English language-testing competitor in India, a region that offers very promising long-term growth opportunities. We prefer investing in companies with strong net cash balance sheets, as it provides strategic optionality for management to pursue organic or inorganic growth opportunities, as in this instance. The Fund's holding in Iress (IRE) also increased following a takeover offer from private equity. Iress is a quality software company, benefiting from high recurring revenue, and with a number of opportunities to accelerate earnings growth in the coming years. Given the low valuation multiple and surplus cash on the balance sheet, it is not surprising that the company has attracted interest from private equity.

As we look ahead to the upcoming reporting season, we continue to focus on putting together a concentrated portfolio of quality companies that offer attractive valuation upside. There remains considerable uncertainty around a number of macro-economic issues, including the outlook for inflation, the speed of the economic recovery, as well as the risk of further lockdowns due to the spread of COVID-19 variants. Rather than taking strong views on these issues, we continue to spend our time researching strong bottom-up investment ideas, in companies that we believe can deliver in a variety of scenarios.

The Fund is currently positioned across a wide range of these opportunities, including companies that we believe will benefit as the global economy re-opens, in attractively priced growth stocks which are reinvesting at high rates of return, and in some of the more cyclical sectors of the market like the mining shares. Overall, the average return on invested capital for the portfolio is well above the benchmark, highlighting the superior quality characteristics and potential for long-term value creation. The balance sheets of the Fund's holdings are also significantly more resilient than the benchmark, with nearly all of the holdings sitting on excess cash.

Net active return as at 31 July 2021

	1mth	3mth	6mth	1yr	2yr	Incep.*
Emerging Companies Fund	4.44	12.49	26.95	59.06	25.59	19.42
S&P/ASX Small Ordinaries Accumulation Index	0.68	4.06	11.80	32.30	10.03	8.57
Excess return	3.76	8.43	15.15	26.76	15.56	10.85

* 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:

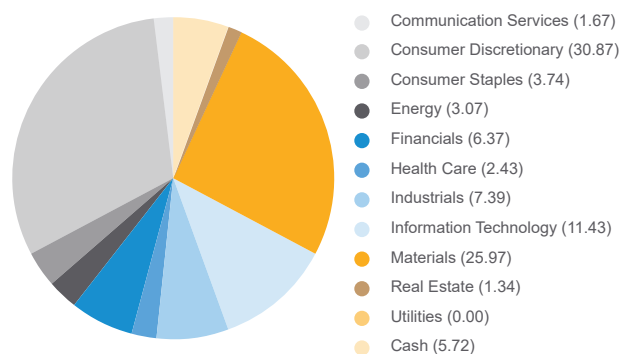
Contributors

- IDP Education (IEL):** announced the acquisition of British Council's IELTS operations in India. Currently IEL and British Council jointly distribute the English language tests in India. Post transaction IEL will be the sole distributor of IELTS in the Indian market. This is a strategic and financially compelling deal with EPS accretion of 13% (pre-synergies) on a pro-forma CY19 basis.
- Lynas Rare Earths (LYC):** benefited from a rebound in rare earths prices with NdPr strengthening in July to over US\$90/kg, after averaging \$US70/kg for the previous quarter. Demand for LYC products remain strong resulting in record cash generation with a net cash balance of \$515m at 30 June 2021.
- IGO (IGO):** completed the acquisition of Tianqi's Australian lithium assets, comprising the high quality Greenbushes Lithium mine and the Kwinana Lithium Hydroxide Refinery. Greenbushes is a large-scale, low cost, long life, Tier 1 hard rock lithium mine located in Western Australia. The quality of Greenbushes is underscored by it being the lowest cost producer and highest ore grade of any hard rock mine globally. IGO will be able to extract higher margins in the downstream process with Kwinana producing battery grade lithium hydroxide, sourced from Greenbushes spodumene concentrate.

Detractors

- Polynovo (PNV):** has been impacted by limited access to hospitals as a result of COVID-19. Notwithstanding these restrictions, PNV's BTM sales grew close to 50% in the June 2021 quarter compared to the prior corresponding period. The sales trajectory has improved in July as more than half of the hospitals are now re-engaging for business. Our discussions with surgeons continue to validate the superiority of the BTM product and continues to take market share from incumbent products.
- BWX (BWX):** shares consolidated recent gains. During the month BWX issued its second tranche of shares to the Chemist Warehouse Group, indicating the strategic partnership is tracking to expectations. BWX also completed the acquisition of Flora & Fauna, a leading Australian online retail platform exclusively focused on vegan, ethical and sustainable products.
- Pilbara Minerals (PLS, no holding):** detracted from relative performance, although was offset by other preferred lithium exposures such as IGO and Orocobre (ORE).

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors

IDP Education

Lynas Rare Earths

IGO

Top 3 detractors

Polynovo

BWX

Pilbara Minerals (no holding)

* 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)

ARB Corporation

Champion Iron

Iluka Resources

IPH

Lovisa Holdings

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

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