DNR Capital Australian Emerging Companies Fund

Performance Report – September 2020

Performance

The DNR Capital Australian Emerging Companies Fund decreased 3.20% (net of fees) in September, underperforming the S&P/ASX Small Ordinaries Accumulation Index by 0.38%. Over the last 12 months the Fund has outperformed its Index by 9.90% (net of fees).

September saw equity markets give back partial gains following a strong prior month on a better-than-expected earnings season. Despite the Fund slightly lagging the benchmark during the month, we were pleased with this outcome given the recent strong performance. There was a notable shift during September away from growth and momentum stocks towards the out-of-favour value stocks, particularly those directly impacted by COVID-19. The market continues to gyrate between COVID-19 'winners' and 'losers' depending on the latest vaccine headlines. As we have written previously, there had been an increasing valuation disconnect between many of these stocks and this had started to close during the month. The Fund benefited in this regard with holdings in Corporate Travel Management (CTD), Webjet (WEB) and Lovisa Holdings (LOV) outperforming at the expense of 'winners' like Breville Group (BRG) and Zip Co (Z1P).

We had been positioning the Fund into COVID-19 'losers' like CTD, IDP Education (IEL), and WEB given the valuation upside on recovered earnings. In our view industry leaders such as these will emerge from the pandemic in a much stronger position helping them to gain market share. We witnessed this during the month when CTD acquired US-based Travel & Transport for US$200m on an attractive valuation of 4.3x Enterprise Value (EV) / Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA) including synergies based on CY19. This is a significant transaction giving CTD scale in North America. CTD's capital-light business model and low gearing saw it avoid a dilutive equity raising in the midst of the pandemic, and instead raised $379m with 30% earnings accretion post synergies.

We are also positioned in companies that have been temporarily impacted by COVID-19 yet are well placed to benefit when the economy re-opens and are less dependent on a vaccine. This includes Credit Corp Group (CCP), LOV, Tyro Payments (TYR) and Domain Holdings Australia (DHG). For example, TYR has been impacted by the Victorian shutdowns, yet other states are growing +20% and we expect the overall group to return to this level of growth following the imposed lockdowns.

There is still considerable uncertainty around the timing and efficacy of the development of a vaccine, which reinforces the importance of maintaining balance within the Fund. This includes a focus on the highest quality COVID-19 recovery stories, long-term structural COVID-19 winners, and companies with strong bottom-up fundamentals.

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

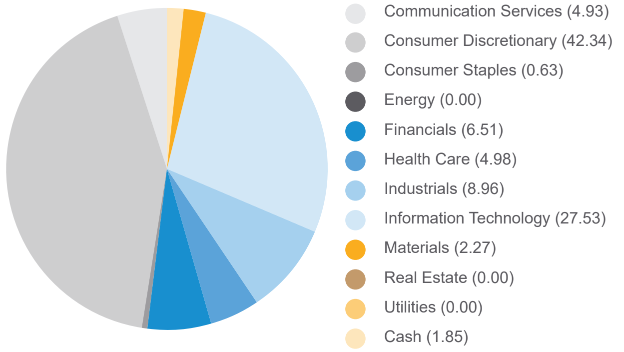
Net active return as at 30 September 2020

	1mth %	3mth %	6mth %	1yr %	2yr %	Incep.* %
Emerging Companies Fund	-3.20	8.61	39.18	6.57	7.07	6.87
S&P/ASX Small Ordinaries Accumulation Index	-2.82	5.67	30.93	-3.33	0.24	0.06
Excess return	**-0.38**	**2.94**	**8.25**	**9.90**	**6.83**	**6.81**

** 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.

Sector weightings %



Source: Mainstream Fund Services and DNR Capital

Monthly - top contributors and detractors

Top 3 contributors
Lovisa Holdings
ARB Corporation
Temple & Webster Group

Top 3 detractors
Zip Co
City Chic Collective
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)

ARB Corporation
Domain Holdings Australia
IDP Education
IPH
Lovisa Holdings

Source: Mainstream Fund Services and DNR Capital

Market review

September was a subdued month in terms of company news flow as the market digested the August reporting season. This month we review the key stocks contributing and detracting to the monthly performance, as well as discuss two companies we believe represent compelling value in the Technology sector.

Positive contributors to performance

Global fashion accessories retailer LOV continued to outperform after reporting a strong result the prior month. Given LOV has been hit hard during the pandemic with shopping centre foot traffic low and less consumer demand for fashion accessories, we believe it is well positioned to capitalise on the pent-up demand when the economy re-opens.

Four-wheel drive accessories provider ARB Corporation (ARB) is benefiting from the pandemic given border closures, encouraging consumers to travel domestically. While the company is experiencing a temporary boost that has benefited the share price near term, we are attracted to the bigger picture which is the progress in the US resulting from a range of new products and its Ford partnership.

Homeware and furniture e-commerce player Temple & Webster (TPW) is benefiting from the structural migration online. TPW has demonstrated its ability to trade profitably in a sector with low penetration rates (7%) and a large addressable market ($15b). It has been able to maintain its leading online market share thanks to its technology platform, which it acquired from US peer Wayfair, with a focus on product range and customer service.

Negative contributors to performance

Buy now, pay later (BNPL) provider Z1P saw its shares retreat after PayPal (NASDAQ:PYPL) announced its entry into the BNPL sector. We view PYPL's entry as providing further validation of the BNPL space and this will lead to greater adoption of BNPL at the expense of credit cards. It will be interesting to see how PYPL's product develops, given BNPL has proven itself to be a lead generator by partnering with merchants, rather than just offering a payment method.

Plus-size women's retailer City Chic Collective (CCX) shares fell as it announced it was unsuccessful in its acquisition of US-based e-commerce asset Catherines Inc. While disappointing, the company still has $112m cash on its balance sheet for further acquisitions.

Financial services and wealth management company Iress (IRE) continues to underperform the market. IRE increased its all-cash offer for OneVue (OVH) from 40c per share to 43c per share as it aims to enter the platform market.

Finding value in small cap technology

The current pandemic is clearly accelerating the structural trend of many technology-based companies. The market has swiftly re-rated the sector with the challenge being finding attractively valued companies. While the Fund is positively disposed to the Technology sector with an overweight exposure, it is important to be selective given the disparate business models and high valuations. The market has been gravitating toward e-commerce-based business models where customer adoption is high. This includes the BNPL sector where a customer can sign up and transact in less than a minute and online retailers like Kogan.com (KGN) and TPW.

Two companies that have lagged the sector and present compelling value long term are Bravura (BVS) and IRE. These companies have been impacted more directly by COVID-19 than other technology stocks given their sales cycle is long dated due to the cost and complexity in implementing its systems. For example, BVS's Sonata product allows financial services firms to administer products as well as automating middle and back-office functions. This requires the replacement of legacy systems, and with companies turning focus on day-to-day operations has led to a more elongated sales cycle. The current environment is making it difficult to win new clients but it also highlights how difficult it is to lose clients. We believe this is an important attribute being overlooked by the market. Its software is mission critical, with high-switching costs. Our discussions with both companies and clients indicates that the sales pipeline remains robust with opportunities deferred, rather than cancelled. While the near-term earnings outlook is challenging, we continue to see these two companies as attractive value opportunities in the technology sector.

Key metrics

	Bravura	Iress
FY21 PE	21x	23x (fully expensed R&D)
Free cash flow yield	8%	5%
Return on capital	16%	10%
Balance sheet	$100m Cash (no debt)	$49m Net Debt (0.3x Profit)
Recurring revenue	77%	90%

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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