DNR Capital Australian Equities High Conviction Fund

Performance Report – August 2022

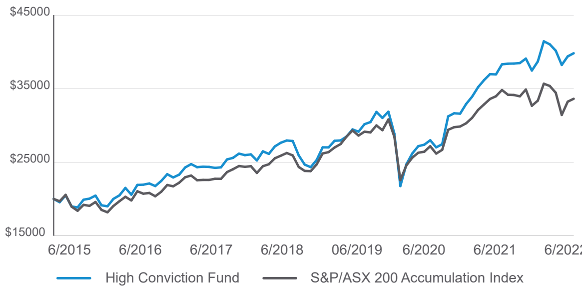
Performance

The S&P/ASX 200 Accumulation Index was up 1.18% during the period.

Energy (+7.4%) was the best performing sector, with majors Woodside Energy Group (WDS +7.1%) and Santos (STO +8.1%) benefitting from the continued surge in energy prices, resultant from a period of underinvestment in supply and Russian retaliation to Western sanctions. Materials (+3.9%) also outperformed, increasing despite the outlook for a weaker global economy, with strong results from BHP Group (BHP +5.0%) and South32 (S32 +8.9%). Property (AREITs) (-3.6%) was the worst performing sector, as bond rates moved higher and property values came under pressure. Consumer Staples (-2.7%) also underperformed, with defensive names trading at higher multiples failing to deliver convincing results (Woolworths Group (WOW) -3.8%), Coles Group (COL) -6.4%).

DNR Capital Australian Equities High Conviction Fund underperformed the Index for the month. Key stock contributors were Woodside Energy Group (WDS), Commonwealth Bank of Australia (CBA, no holding) and QBE Insurance Group (QBE). Key stock detractors were Domino's Pizza Enterprises (DMP), SEEK (SEK) and TPG Telecom (TPG).

Growth of $20,000 since inception



Source: Mainstream Fund Services and DNR Capital

Top 10 active holdings

Security details	Active weight %	Actual weight %
The Lottery Corporation	4.00	4.47
CSL	3.80	10.65
National Australia Bank	3.75	8.46
Woodside Energy Group	3.51	6.71
Lendlease	3.40	3.74
QBE Insurance Group	3.08	3.95
Scentre	2.98	3.72
ALS	2.81	3.09
SEEK	2.80	3.16
Domino's Pizza Enterprises	2.79	2.98

Source: Mainstream Fund Services and DNR Capital

Fund overview

APIR Code	PIM0028AU
Investment bias	Style neutral with a quality focus
Designed for	Investors seeking a medium-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	To invest in a high conviction portfolio of Australian equities that aims to outperform the Benchmark by 4% p.a. over a rolling three-year period. The investment objective is not a forecast of the Fund's performance.
Benchmark	S&P/ASX 200 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 Minimum exposure of 80% of the Fund NAV to be invested in the S&P/ASX 200
Asset allocation	Australian Equities – 80-100% Cash – 0-20%
Risk level	High
Number of securities	Min 15 - max 30, typically 25
Minimum suggested investment timeframe	5 years
Buy/sell spread	+0.20% / -0.20%
Management fee	0.90% (inclusive GST and RITC)
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 August 2022

	1mth %	3mth %	6mth %	1yr %	3yr % p.a.	5yr % p.a.	Incep.* % p.a.
High Conviction Fund	1.09	-0.87	2.89	3.93	10.95	10.45	10.00
S&P/ASX 200 Accumulation Index	1.18	-2.39	0.75	-3.43	5.51	8.13	7.45
Excess return	**-0.09**	**1.52**	**2.14**	**7.36**	**5.44**	**2.32**	**2.55**

** Inception Date—June 2015*

Source: Mainstream Fund Services and DNR Capital

Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction 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

Attribution

The top stock contributors for the month were:

- **Woodside Energy Group (WDS):** outperformed during the period, as energy prices recovered from their setback last month. The outlook for energy markets remains tight, with Russian supply impacted by sanctions and an elongated period of underinvestment reducing the ability of the rest of the producing world to respond.
- **Commonwealth Bank of Australia (CBA, no holding):** result was in line with market expectations. The share price was at elevated levels before heading into the result and highlighted cost pressures and emerging competition.
- **QBE Insurance Group (QBE):** a strong result highlighting good top line growth, improving margin and repaired balance sheet.

The top stock detractors for the month were:

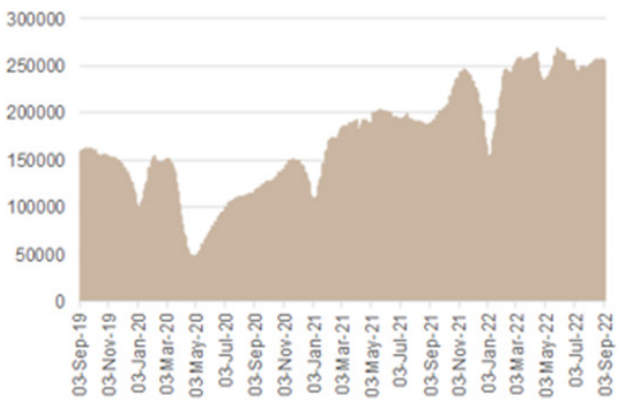
- **Domino's Pizza Enterprises (DMP):** released its FY22 earnings results which failed to meet market expectations, highlighting concerns with its European operations and broader inflation pressures. The group also announced the acquisition of new regions Malaysia, Singapore and Cambodia. Despite near term challenges we continue to see value in the long-term opportunity for compounding earnings growth through store rollout and capital recycling.
- **SEEK (SEK):** FY22 earnings were slightly lower than consensus but within the guided range. Whilst FY23e guidance was strong (EBITDA growth >15%), management provided a caveat that it is contingent on current job ad levels being maintained into FY23. Whilst likely to be conservative, such commentary appeared to be a glass half full view on the economic outlook.
- **TPG Telecom (TPG):** 1H22 result was ~6% lower than consensus. One off restructure costs accounted for half the miss. Other key drivers (e.g. mobile subscriber growth, fixed wireless subscriber growth, mobile ARPU's and roaming revenues) showed positive momentum, albeit at a slower pace than market expectations.

Market review

Market wrap

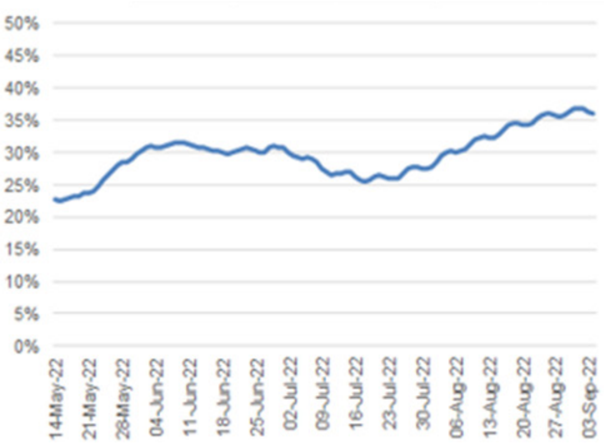
The market began to fade late in the month following the Federal Reserve's (the Fed) commitment to raising interest rates, which was seen as risking an economic slowdown. This month we touch on the continued macro concerns and look at the key highlights from reporting season. The macro environment remains as complex as it has done for some months. Inflation remains a key topic of concern. Very high electricity prices in Europe mean recession risk in that market is elevated. Furthermore, COVID-19 remains a problem in China, which continues to impact the supply chain. Finally, labour markets remain very tight. It is now a common occurrence to experience flight delays and restaurant closures due to labour shortages. The number of applicants per job remains very low, and wage pressure continues to build.

SEEK job listings daily



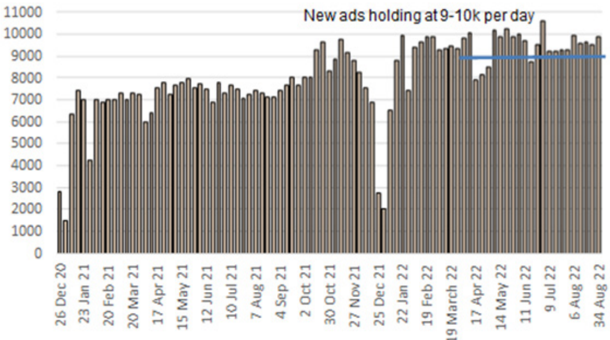
Source: MST tracker

SEEK job listings growth (2 week rolling vs pcp)



Source: MST tracker

SEEK new jobs posted per day



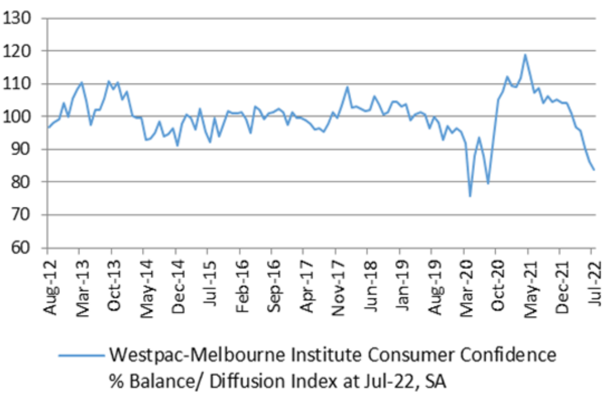
Source: MST tracker

The implications of higher inflation are two-fold.

1. Does the Fed have the resolve to kill inflation by lifting interest rates aggressively, thereby pushing the economy into recession? This will have implications for earnings.
2. Does long-term inflation settle higher than it has for the past decade, and therefore, bond yields and interest rates settle higher? This will have implications for valuations.

At this point, the Australian economy remains resilient. We have seen some signs of slowing consumer confidence, but retail sales remain robust.

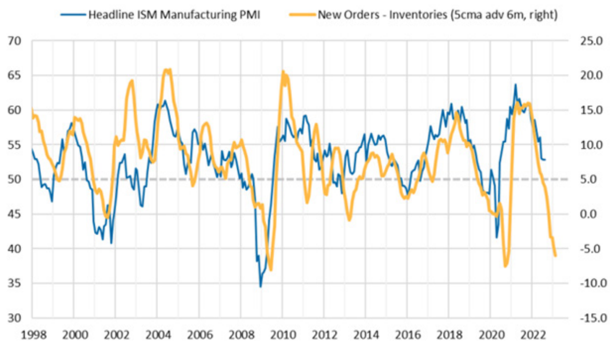
Australian consumer confidence



Source: FactSet

In the US, we have seen a slowdown in business confidence, resulting in a slowdown in new order purchases. Nonetheless, the US economy has held up remarkably well.

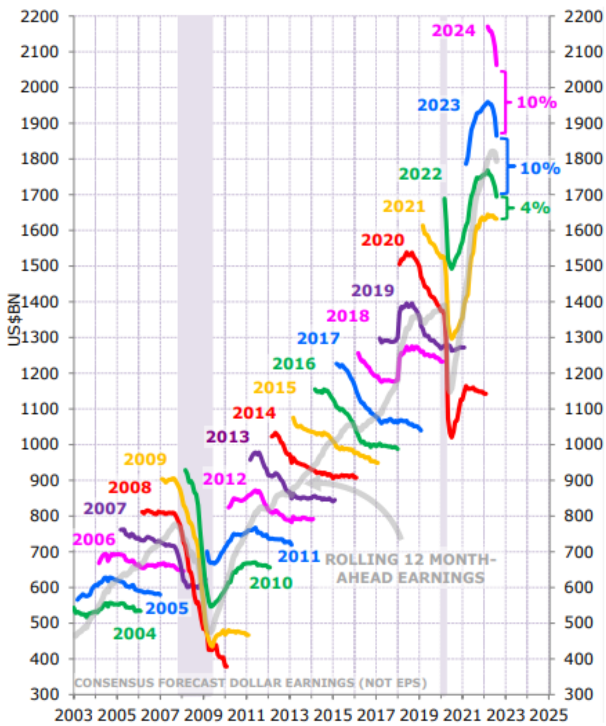
ISM manufacturing PMI vs new orders less inventories



Source: FactSet, Macquarie Research, September 2022

The consequence of the economic strength is that earnings expectations remain elevated. We expect to see further signs of the US economy slowing over the next six months, and we have noted that some of the optimism that has been reflected in market earnings expectations is starting to fade. We will become more comfortable with markets as earnings expectations ease. As noted in the chart below, the market continues to forecast 10% EPS growth for the US market (ex-energy), which seems optimistic.

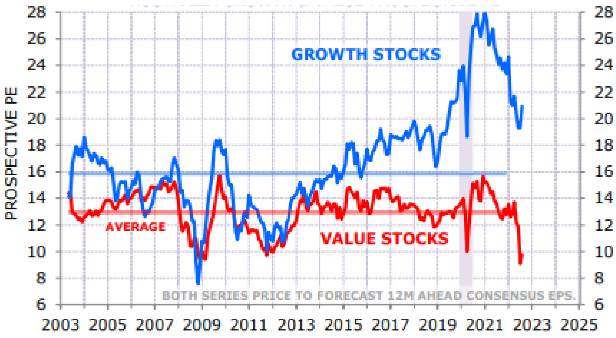
S&P500 ex-energy consensus earning forecasts



Source: Minack Advisors

Current valuations in the Australian market have pulled back and currently trade on a price to earnings (P/E) ratio of around 15x – in line with long-term averages. However, the composition is interesting. Mining stocks are trading on low valuations, reflecting uncertainty as to whether the current high prices will be maintained. Growth stocks remain elevated on a long-term basis and will be more sensitive to any sustained inflation.

Australia growth & value prospective PE



Source: Minack Advisors

Fund commentary

The 2022 financial year reporting season commenced in August, providing some of the more interesting sets of results in recent years. The second half of the year was the first earning period with no lockdowns in Australia, whilst at the same time, the economy was impacted by the highest inflation in 30 years and encompassed the first rate rises in over 10 years. The key themes of reopening demonstrated that the energy crises and inflation were well known to the market, however, many companies still surprised on costs, whilst others struggled to articulate their positions and outlook. In reviewing earnings results for our holdings, we discuss the positive and negative surprises and, the questions they've raised.

Resilient outlooks

CSL (CSL): COVID-19 materially interrupted the ability of the plasma collection industry to collect enough volume to meet demand. This impacted earnings which was reflected in full year results. Despite ongoing volatility, trends are now normalising and collection volumes continue to improve. The group was therefore able to provide guidance of 7-11% sales growth. When combined with internal efficiency initiatives, this should result in strong defensive earnings growth.

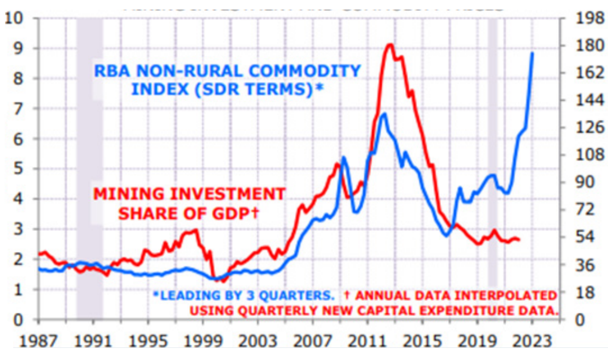
The Lottery Company (TLC): the monopoly operator of regulated lottery businesses delivered its first result as a separate listed entity following the spin off from Tabcorp Holdings (TAH). Despite no trading update, TLC noted a lack of jackpots but were "pleased" with underlying trading volumes. Trading volumes can fluctuate with jackpot sequences however, underlying trends continue to support strong defensive turnover growth. The individual licenses run for up to 50 years and the continued trend towards digital play supports incremental margin expansion.

Bottom-up opportunities

Qube Holdings (QUB): despite COVID-19 disruptions to staff, extreme weather events and other supply chain disruptions, QUB was able to post underlying EPS growth of ~32%. Management demonstrated that they were able to offset inflationary pressures through higher prices, which has been a key debate for the stock. FY23e guidance was for further growth across all operating divisions. Full year contributions from NAT, Bluescope and Harvest Co should benefit QUB, while pricing at the end of the period in Patricks appears to be improving at a high single-digit run rate. Additionally, volume outlooks for commodities and grain look solid and the potential reversal of one-off impacts should help bulk margins. After the remaining $300m of Moorebank proceeds are received, QUB's balance sheet will be geared below 20% versus its target gearing of 30-40%, providing the company significant flexibility.

Worley (WOR): results were up 18% on the prior year as its end market recovered from COVID-19. This was particularly evident in its chemicals division. Energy remained subdued but the outlook is improving with the geopolitical backdrop underpinning a balanced energy transition with traditional oil and gas/chemicals receiving a boost on energy security grounds and sustainability accelerating at the same time. There was 30% growth in its factored sales pipeline, staff numbers were up 8% and WOR continues to win a range of early-stage work which should lead to more substantial work down the track. The Biden Inflation Reduction Act should support a range of activities in sustainability, nuclear is making a comeback and gas is a major winner from the Ukraine dispute. Over the past ten years capex has declined to an unsustainable level. We have seen consolidation in the engineering space and WOR remains one of three leading global players in the complex engineering space and appears well placed to benefit on the structural tailwinds emerging.

Mining investment & commodity prices



Source: Minack Advisors

QBE Insurance Group (QBE): delivered a result which was well above expectations with premiums up 13% and a dividend 29% above consensus. Premium rates remain robust up 7% with volumes also growing at 6%. The portfolio appears reasonably settled for the first time in years and new management is seeking to add scale in chosen areas in the US and continue to drive growth in Australia and the UK. This will partially offset a desire to shed catastrophe exposure to reduce volatility of earnings, which have dogged QBE for years. The underlying margin is up circa 300 bps driven by higher investment yields. QBE's balance sheet remains robust, and reserves appear to be prudently allowing for elevated inflation. Strong interest rates support investment earnings, premium rate increases are expected to continue, and we expect steady margin improvement. Furthermore, the earnings are not particularly sensitive to the economic outlook. With earnings looking better than it has for years, the stock is trading well below global and domestic peers.

Questions

TPG Telecom (TPG): result was badly received and shifted the thesis and timeframes we originally envisioned. The 1H22 result was ~6% lower than consensus, operating costs were only down A$5m on pcp, despite the company targeting A$125-$150m of synergies. Mobile subscriber growth, fixed wireless subscriber growth, mobile ARPU's and roaming revenue recovery showed positive momentum, albeit at a slower pace than we and the market had hoped and expected. Despite limited changes to the medium-term outlook of the business, it is now clear this will likely play out over a longer horizon. Given TPG was a small position in the High Conviction Fund, we elected to exit this position to deploy across better risk / return opportunities.

SEEK (SEK): provided a strong update with the core Australia and New Zealand business delivering extremely strong revenue growth in FY22 of +53%. Volume growth was strong in Australia and New Zealand +40% year on year in 2H with job ads at all-time highs, and total yields contributing a further 14%. Margins were impacted, however, by higher costs to unify software platforms, and Latin American losses. Guidance was well ahead of market expectations but was based on existing volumes remaining at current levels and so was perceived as having downside risk. Australia and New Zealand volumes and revenues continue to exceed expectations, but so does the cost base, reflecting the groups ongoing commitment to investing. Questions exist around the size of the investment required to capitalise on SEK Asia's opportunity, which is a focus of management but hinges on execution. The main question for the market is the extent of a slowdown in job numbers. We believe SEK's core domestic monopoly can continue growing earnings over the longer term and is priced for slower job listings. We view its current valuation as the most attractive it has been in several years.

Domino's Pizza Enterprises (DMP): result was impacted on several fronts with normalisation of Japan and European markets and currency headwinds well flagged. The evolving energy crises creates significant uncertainty in European markets, with operating costs needing to be offset by price, to maintain franchisee profitability. The group's pricing strategy in Australia of "More for More" has been successful, but it remains unclear if this can be applied in Europe. Despite these acute pressures, we remain optimistic on DMP's ability to navigate inflationary challenges in the medium term given its scale and lower cost point compared to peers. It will continue to expand its store network. As a consequence we view the current valuation as highly attractive.

Fund positioning

We remain focused on identifying strong bottom-up investment opportunities in an environment of higher inflation, but a potentially slowing economy.

- Reduced our position in **diversified quality mining** companies but favour those exposed to a recovering China.
- Positive on **high quality industry leaders** with strong pricing power to offset inflation. We have been adding to quality names that have de-rated.
- Focusing on ensuring the **resilience of the earnings of the portfolio** in light of the slowing economy.
- **Overweight financials with leverage to higher rates** but underweight banks (given they have recession risk).
- **Cautious on low quality/negative cash flow** companies where higher interest rates will expose excessive risk taking.
- **Cautious on** companies that have experienced significant overconsumption during COVID-19.
- **Positive on** companies that have been under-earning due to COVID-19 restrictions.

Key risks

Key risks to the Fund include:

- **Political environment.** The crisis in Ukraine and sanctions against Russia are severely impacting commodities markets, with the potential to destabilise the region and cause global inflationary shocks. Regional tensions with China also continue to pose risks to trade.
- **COVID-19 disruption.** The development of vaccine-resistant COVID-19 variants or sustained supply chain impacts still poses risks, especially with government support mostly withdrawn.
- **Interest rates.** Low interest rates have been a primary driver of markets over the past few years. With markets now pricing monetary tightening, changes to this trajectory or further inflationary shocks would have a significant impact on valuations.
- **Global growth.** Sanctions against Russia are driving up energy prices and creating global energy security concerns. Historically, sustained price shocks in oil have impacted global growth and catalysed recessions.

Stock moves

Purchase of Santos (STO)

STO explores for, develops, produces, transports, and markets hydrocarbons for homes and businesses in Australia and the Asia Pacific. Its five principal assets are located in the Cooper Basin, Queensland and NSW, Papua New Guinea, Northern Australia and Timor-Leste, and Western Australia.

STO meets DNR Capital's five-point quality web:

1. **Industry structure:** STO operates in the competitive global energy market, with an emphasis on the APAC region. As a commodity producer, its competitive advantage lies in its low cost of production, as well as the location of its assets in relatively low geopolitical risk locations. STO's largest asset, the PNG LNG project is among the highest quality and lowest cost in the world, providing LNG predominantly for Asian markets, whose energy demand is an attractive long-term investment thematic.
2. **Earnings strength:** Earnings are a function of production and global energy prices; both of which have a favourable outlook. Projects expected to add to the Santos production profile include Pikka oil in Alaska, Papua LNG in Papua New Guinea and Dorado gas and oil off the coast of Western Australia. Global energy prices remain high, and are underpinned by a structural underinvestment in replacement hydrocarbons which will likely not resolve until a large commitment to fossil fuels capital expenditure is encouraged to take place.
3. **Balance sheet:** Gearing at STO stands at 22.5% as at the end of June 2022, within the target range of <25%. The favourable operating environment sees the company benefit from higher revenues, with the cash generation of the business sufficient to fund major projects and shareholder returns on a go-forward basis.
4. **Management:** STO management has developed a robust reputation, with Kevin Gallagher (CEO) taking the reins in 2016 and engineering a stark turnaround in company performance and culture. Most recently, the management team guided STO through a successful acquisition of listed peer Oil Search.
5. **Environmental, social and governance (ESG):** The environmental risks to STO are substantial, with hydrocarbons expected to be replaced by green fuel sources as the world transitions towards a Net Zero future. However, STO has modelled oil and LNG prices to 2060 utilising the IEA STEPS, SDS and NZE scenarios. The outcomes support the case for continued operation of STO assets, with scope for investment in future supply. STO's climate strategy centres largely on the implementation of several Carbon Capture and Storage (CCS) projects. STO's onshore assets make CCS technically and financially viable, compared with its offshore counterparts. When complete, STO's Moomba CCS will be one of the world's largest and lowest cost CCS projects, storing up to 1.7 million tonnes of CO_2 per annum, at a lifecycle cost of less than $US24 per tonne CO_2.

Risks

The largest risk remains global energy prices, which are at elevated levels due to a large underinvestment in supply and the impact of economic sanctions on Russian energy supply. A significant economic shock could weaken the demand outlook, resulting in some softness in prices.

Valuation

STO currently trades at a 12-month forward PE ratio of 6.7x, ~60% below its 10-year average of 17.6x.

Conclusion

STO provides exposure to global energy markets, with a significant structural shortage in supply expected to underpin higher prices. The company has high-quality, low-cost assets and a tenured, successful management team who are capable of executing on growth via promising development projects. The decision to sell some of the Fund's Woodside Energy Group (WDS) shareholding in order to fund the STO purchase allows the Fund to retain its exposure to the promising energy thematic, while reducing company-specific risk by investing in a global peer which has underperformed on a relative basis.

Sale of TPG Telecom (TPG)

We have exited our position in TPG. The 1H22 result was slightly disappointing relative to expectations albeit underlying trends were largely positive (including ARPU, subscriber and Fixed Wireless growth). Whilst the original investment thesis remains intact, it is likely to play out over a longer horizon. TPG was a small position in the fund and we deployed to better risk / return opportunities.

Sale of Tabcorp Holdings Limited (TAH)

TAH was sold to fund increases in other positions in the Fund. The business has incrementally improved its competitive position since the demerger, however still faces headwinds when competing against the offshore based corporate bookmakers. This combined with recent market volatility, drove the decision to exit TAH and redeploy the proceeds into other opportunities.

Investment philosophy

DNR Capital believes a focus on quality businesses will enhance returns when it is combined with a thorough valuation overlay. We seek to identify quality businesses that are mispriced by overlaying a quality filter, referred to as the 'quality web', with a strong valuation discipline. The portfolio is high conviction and invests for the medium term.

Investment strategy

The DNR Capital Australian Equities High Conviction Fund has an investment style best described as 'style neutral'. The security selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices. We define quality businesses as being those with the following five attributes:

- earnings strength (particularly improving return)
- superior industry position
- a sound balance sheet
- strong management
- low environmental, social and governance (ESG) risk.

Where we are satisfied that a company possesses quality characteristics, then it is eligible for inclusion in the Fund. However, it must also represent value and sit comfortably within our portfolio construction requirements.

A range of valuation methodologies are used depending on the nature of the company being assessed to identify mispriced opportunities.

The portfolio construction process is influenced by a macroeconomic appraisal and also considers the risk characteristics of the portfolio, such as stock and sector correlations.

Platform access

- Asgard
- BT Panorama
- Colonial First State FirstWrap
- HUB24
- Macquarie Wrap
- My North & North
- Netwealth
- Wealth O2

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