

DNR Capital Australian Equities High Conviction Fund

Performance Report – May 2021

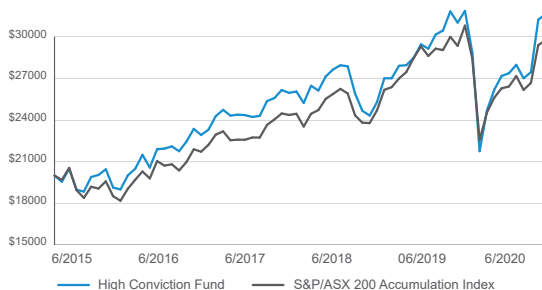
Performance

The S&P/ASX 200 Accumulation Index was up 2.34% during the period.

Financials (+4.4%) was the best performing sector. An increase in inflation expectations in the market saw pro-cyclical sectors outperform, with Financials positively geared to a rising interest rate environment. Despite this, Health Care (+3.5%) also outperformed, with sector heavyweight CSL (CSL +7.0%) recovering from post-COVID-19 lows. Information Technology (-9.9%) was the worst performing sector, with longer-duration stocks expected to suffer in a higher interest rate environment. Utilities (-7.0%) is also exposed to higher rates through its non-cyclical earnings profile, resulting in underperformance during the period.

DNR Capital Australian Equities High Conviction Fund outperformed its benchmark for the period. Key stock contributors were ALS (ALQ), Afterpay (APT, no holding) and Aristocrat Leisure (ALL). Key stock detractors were Commonwealth Bank of Australia (CBA, underweight), Westpac Banking Corporation (WBC, no holding) and CSL (CSL, underweight).

Growth of \$20,000 since inception



Source: Mainstream Fund Services and DNR Capital

Top 10 active holdings

Security details	Active weight %	Actual weight %
Tabcorp Holdings	4.72	5.29
Lendlease	4.01	4.43
ALS	3.60	3.89
Aristocrat Leisure	3.57	4.89
Computershare	3.30	3.75
National Australia Bank	3.28	7.71
Macquarie Group	3.26	5.83
BHP Billiton	3.20	10.24
Cash	3.02	3.02
Telstra Corporation	2.89	4.96

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. (before fees) 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	+0.25% / -0.25%
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 30 May 2021

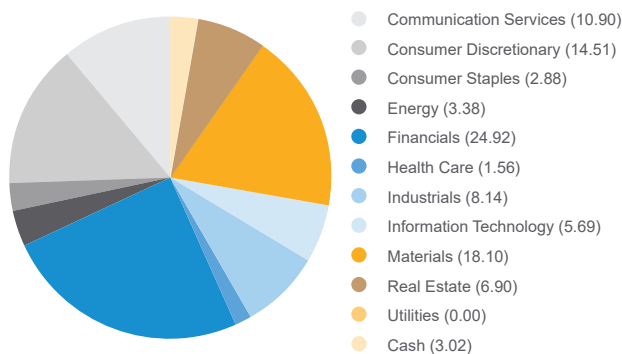
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	Incep.* %
High Conviction Fund	2.73	9.87	15.77	38.05	11.43	10.96	10.41
S&P/ASX 200 Accumulation Index	2.34	8.48	11.74	28.23	9.95	10.11	8.66
Excess return	0.39	1.39	4.03	9.82	1.48	0.90	1.75

* 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:

- **ALS (ALQ):** produced a strong result with a recovery in exploration and continued activity in life sciences. The outlook appears robust given current commodity prices.
- **Afterpay (APT, no holding):** underperformed during the month, in line with broader payments and technology stocks. While we continue to monitor the story and recognise the potential of the platform, we find the valuation unpalatable, given regulatory risks and a model relatively untested under bad-debt scenarios.
- **Aristocrat Leisure (ALL):** produced a strong result given the good performance of its digital games business and continued gains in market share.

The top stock detractors for the month were:

- **Commonwealth Bank of Australia (CBA, underweight):** bounced relative to the other banks as the market anticipates a capital return and strong result in August.
- **Westpac Banking Corporation (WBC, no holding):** surprised the market with a large cost-out program. We remain concerned regarding the outlook for revenue given the franchise is under pressure at present.
- **CSL (CSL, underweight):** outperformed over the month as the accelerated vaccine rollout in the US saw collection centre volumes start to pick up. While FY22 will still be a tough year given the lower volumes collected during COVID-19, a continuation of stronger collection trends will underwrite a strong rebound in FY23.

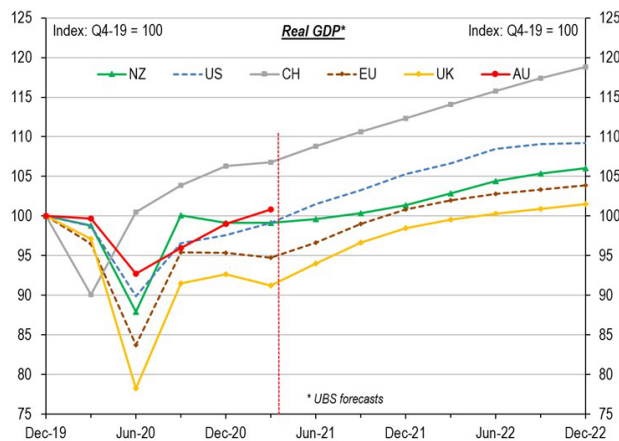
Market review

This month we pivot away from the macro-economic discussions around inflation and growth vs value, and focus on the insights we have gathered over the course of a busy month – the Macquarie Group conference, numerous company results and strategy presentations. Before we do that, we flag the economic performance of Australia against that of the rest of the world.

Australia vs the world

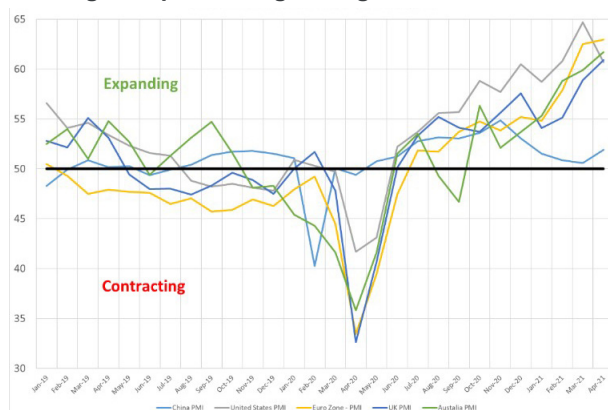
As the world emerges from the coronavirus pandemic, Australia has fared relatively well to date. The recession was not as deep as that of other developed economies, and is emerging from the crisis ahead of most.

Real GDP*



Source: UBS Research

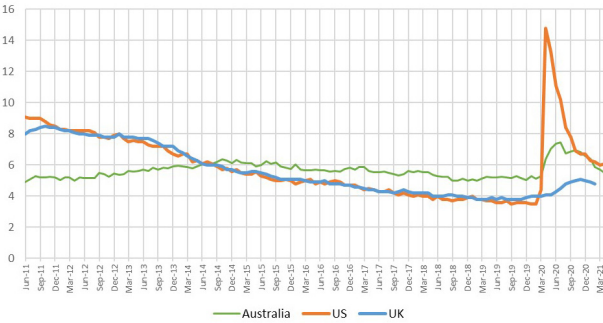
Select global purchasing managers indices



Source: FactSet, DNR Capital

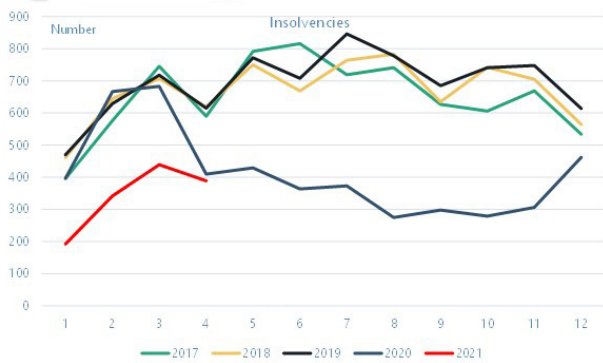
Employment has also returned to pre-pandemic levels, and perhaps most surprisingly, insolvencies are at record low levels.

Select unemployment rates



Source: FactSet, DNR Capital

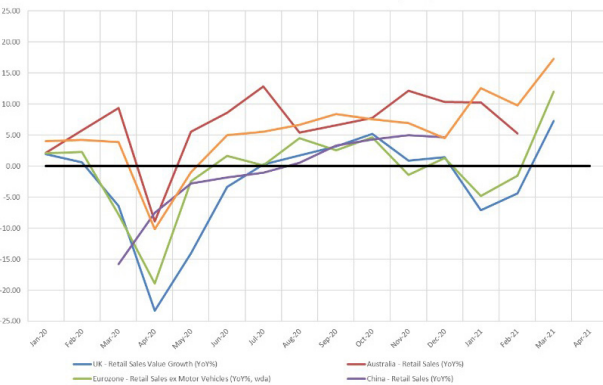
Insolvencies



Source: Jarden, ASIC

Anxiety over the end of JobKeeper and broader government support has so far proven unfounded, as the population continues to spend well in excess of pre-pandemic levels.

Select global retail sales growth (YoY)



Source: FactSet, DNR Capital

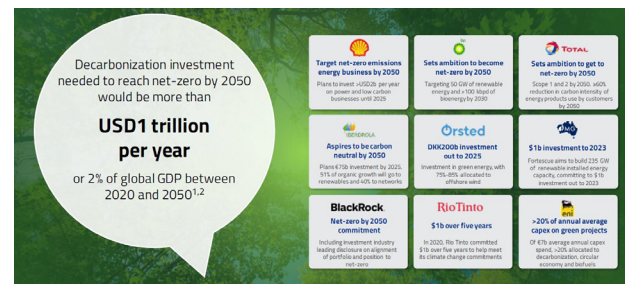
The national accounts indicate this increased consumption is being funded from savings accumulated over 2020 under the unusual scenario where spending fell but incomes increased, mostly as a result of government support.

Insights from management discussions

New energy vs old energy

Almost daily, we hear from companies moving towards a net-zero carbon future. Many companies are now setting long-term targets to become carbon neutral (e.g. TCL, GPT, FMG, STO). Momentum continues to build towards this outcome. Worley (WOR) sponsored an investor day to showcase the amount of money needed to meet these goals and estimated it would cost US\$1 trillion each year to reach net-zero emissions by 2050. Renewables like offshore wind, carbon capture, hydrogen, and adapting energy transmission systems to handle renewables will need to be funded.

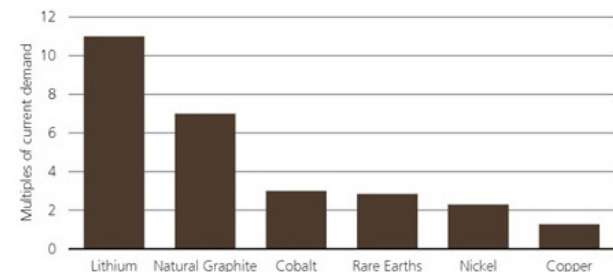
Decarbonisation investment



Source: Worley

This build will require substantial demand for commodities. UBS estimated substantial increases in demand for a range of commodities listed in the graph below.

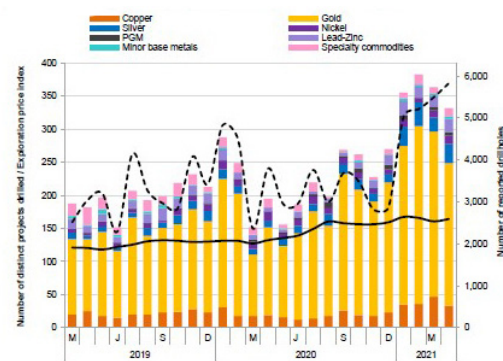
Demand growth through to 2030e



Source: UBS

ALS (ALQ) highlighted the pick-up in drilling activity during its annual presentation. Increased exploration and mining capex will be required to satisfy the demand for commodities. Commodity prices are increasing to incentivise this activity.

Project drilling activity by commodity, February 2019 – April 2021



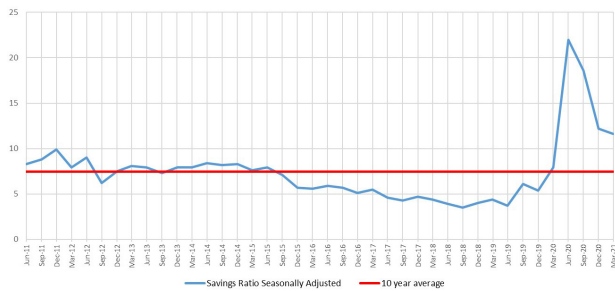
Source: S&P Global Market Intelligence

While we see substantial opportunities as the world rebuilds towards a renewable future, old energy is trading cheaply. A bounce back from COVID-19 is likely to see demand for oil increase from current levels and company boards are reluctant to commit new capital to future projects. This sentiment means pressure on prices is likely to rise. As a consequence, old energy stocks with good projects represent value. We particularly see opportunities for LNG, which will be used as a transition fuel to allow the world to move towards a net-zero carbon future.

COVID-19 winners vs COVID-19 losers

A challenge over the past year has been forecasting a sustainable earnings base from which to calculate valuations. During the coronavirus pandemic, demand collapsed and market forecasts overshot to the downside. Fiscal stimulus boosted demand for certain sectors like online retailers. We have been asking ourselves whether forecasts have overshot to the upside for those companies that did well during the pandemic. JB Hi-Fi (JBH) and Wesfarmers (WES) highlighted the difficulties lapping a strong period. Consumer savings remain elevated however, and perhaps provide longer term support. Nonetheless, it is clear that the appropriate multiple in this situation is difficult to pin down.

Australian household savings ratio



Source: FactSet, DNR Capital

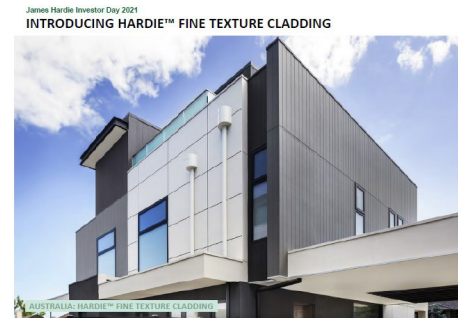
We are also mindful of those business models that have established new markets during the pandemic. For example, Domino's Pizza Enterprises (DMP) has benefited from people staying at home but has also introduced itself to new customers in Germany and Japan, which will allow it to accelerate its growth ambitions in those markets. There are numerous companies across various industries that offer interesting comparisons. CSL (CSL) has been impacted by an inability to collect plasma during shutdowns, while Fisher & Paykel Healthcare (FPH) has benefited from elevated ventilator sales. Casinos were shut down, while online retailers thrived. Opportunities exist where companies have established new markets, new growth opportunities or can recover faster than the market is anticipating.

Pricing power

Input costs are rising. Discussions with numerous companies like Brambles (BXB) highlighted the impact of higher lumber costs and its ability to pass on costs to consumers. We have seen Costa Group Holdings (CGC) downgrade on the back of difficulties accessing labour, but many companies are finding it easier to pass on higher costs to customers (given the strong demand/supply imbalance at present). We are attracted to those companies exhibiting pricing power with strategies to improve their sales mix to drive prices higher.

For example, James Hardie Industries (JHX) outlined a plan to introduce a sophisticated textured product selling at US\$2000 sq.m., compared to US\$750 sq.m. for its existing product. Success in this regard provides the ability to enhance sales and margins.

Introducing Hardie™ Fine Texture Cladding

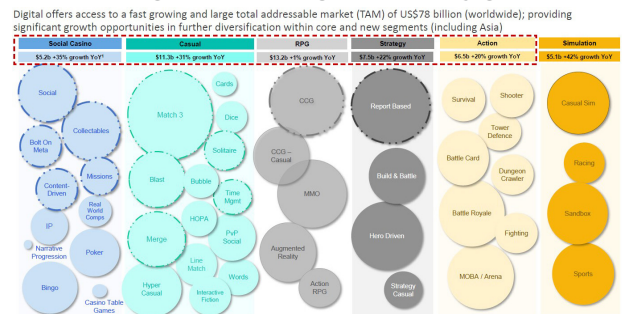


Source: James Hardie Industries

Companies finding new markets

New market opportunities exist for certain businesses. Breville Group (BRG) leads the globe in sales of coffee machines and outlined the strong progress it has enjoyed during the pandemic as consumers stocked up their kitchens. In addition, it has found new markets across Europe as Australia exports its coffee culture to the world. Similarly, Aristocrat Leisure (ALL) outlined in its results the strong progress they have made in staking a share in the digital games market. This is a large growing market estimated at US\$78b and ALL is one of the largest digital studios. They have the opportunity to invest in talent to continue developing content and further expand market share in this growing market.

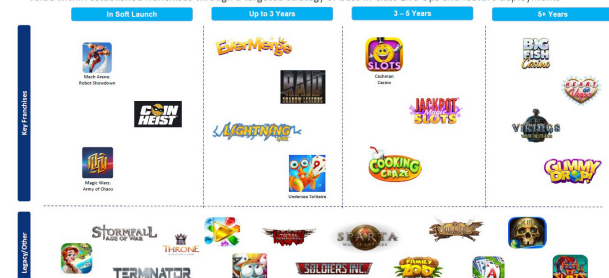
Aristocrat digital market segmentation by genre



Source: Aristocrat Leisure

Aristocrat digital portfolio summary

We continue to expand and diversify our portfolio into new, high value segments while in parallel, we create additional player value within established franchises through a targeted strategy of best-in-class Live Ops and feature deployments



Source: Aristocrat Leisure

Infrastructure spend

The Australian Government released a budget with a substantial fiscal deficit that included plans to spend on a range of areas like roads. The US Government is also seeking to introduce a US\$6 trillion infrastructure spending program. Macquarie Group (MQG) is the largest infrastructure funds manager in the world and also the largest financier of renewable projects. It appears well placed to benefit from this long-term opportunity. In context, they have \$142b in funds under management and if even a small proportion of the large infrastructure spending is financed and owned by MQG itself, then the company is expected to grow substantially over time.

Digitisation

Most companies are discussing plans to digitise and improve the use of data. At its strategy day, Wesfarmers (WES) detailed the establishment of the Advanced Analytics Centre (AAC) that will employ more than 400 data, digital and analytics specialists across the group. Westpac Banking Corporation (WBC) also announced a major \$2b cost-out program, which included the digitisation of its mortgage processes. Opportunities exist for those software companies supporting these companies, but the cost-out opportunity is also potentially significant for many of them (albeit likely to be competed away long term).

Recovering industries

One of the interesting trends we have observed in recent months is the broadening of investment possibilities. Industries facing substantial disruption in the past now appear more investable. For example, telecommunication businesses have faced a tough 20 years – the internet disrupted traditional print communication (like yellow pages), mobile phones disrupted fixed-line income, the NBN disrupted broadband fees and more recently the threat of a fourth player saw intense competition disrupt mobile revenues. The businesses have simplified and consolidated, with pricing tension easing. Furthermore, a recovery from the pandemic will assist roaming revenues.

Initial public offerings (IPOs)

Beware of informed sellers – you do not often receive bargains from highly informed financial sellers of businesses. As the window for FY21 Initial Public Offerings closes, we have observed a volatile period punctuated by a number of high-profile disasters, including Nuix (NXL, down ~50%), Adore Beauty Group (ABY, down ~40%) and several weak outcomes from Latitude Group Holdings (LFS, down ~7%), Dalrymple Bay Infrastructure (DBI, down ~8%) and Pepper Money (PPM, down ~8%).

Despite the performance of these larger floats, on average the IPO market has yielded reasonable returns.

A median return of ~4% suggests several outsized performing floats have skewed the results, but it is difficult to compare these results to the broader market given the different start dates. Unsurprisingly, the Materials sector had the most IPOs, but most were positioned at the microcap end of the market. Telecommunication Services had only a single, high-returning IPO, while capital goods and retail yielded the best outcomes. Diversified Financials proved the worst sector for IPO investment.

Several recently abandoned listings including Australian Venue Co, Best and Less, Gray's Online and Aurora Health, suggest the market has become more sceptical of vendor motivations and timing. We believe in assessing each transaction on its merits, but note the quality of the pipeline has deteriorated significantly. The common factors we have found in most disappointing IPOs include private equity ownership, shorter holding periods and exposure to over-hyped themes. When assessing IPOs, we value high-quality and tenured management (especially founder-led businesses) looking to raise capital to support growth and investment, rather than to provide an exit path for current holders.

Fund positioning

Our current positioning is:

1. **Reopening beneficiaries:** SKYCITY Entertainment Group (SKC).
2. **Beneficiaries of infrastructure/green new deal spending:** ALS (ALQ), QUBE Holdings (QUB).
3. **Improving quality:** Computershare (CPU).
4. **Strong franchise companies:** James Hardie Industries (JHX), SEEK (SEK), Aristocrat Leisure (ALL).
5. **Resilient/defensive companies:** Tabcorp Holdings (TAH).

Key risks

Key risks to the Fund include:

- **COVID-19 disruption.** The longer and deeper the disruption from the COVID-19 pandemic, the greater the negative impact on equity markets. Any disruption to the roll out of the vaccines would be negative, as would the development of vaccine-resistant COVID-19 variants.
- **Interest rates.** Low interest rates are the prime driver of markets at present. Any change to the inflation outlook would have a significant impact on valuations.
- **Political environment.** Further geopolitical uncertainty, like civic destabilisation in the US following the election, could create negative implications for stocks and portfolios.

Portfolio moves

We have made changes to build further resilience by adding a number of high-quality market leaders.

We recently sold ANZ Banking Group (ANZ), and added Commonwealth Bank of Australia (CBA) and CSL (CSL).

Purchase of Commonwealth Bank of Australia (CBA)

CBA is the leading bank in Australia in terms of market share, technology position, and management. It continues to leverage its scale and advantage to take market share from peers. Long term it has the potential to reduce costs. While it trades at a premium to the other banks, it has a stronger balance sheet, generates better returns and is better placed to defend itself against competition.

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

1. Industry structure. It is the market leader with superior scale, superior technology and a strong retail deposit base which provides a competitive advantage.
2. Earnings strength. It has been growing share above peers and earns higher returns and margins reflecting the strength of its retail franchise.
3. Balance sheet. CBA has strong, bad-debt provision coverage and excess capital relative to its peers. We expect a buy back in the second half of this calendar year.
4. Management. Management has performed well and remains focused on investing in the franchise and cementing CBA's competitive advantages.
5. Environmental, social and governance (ESG). CBA rates well relative to the other banks and has a strong board.

Key risks

Key risks include a flare up in bad debts, and increased competition emerging from non-bank players.

Valuation

CBA offers modest but robust earnings growth and a sound dividend yield. We see the position as more defensive relative to ANZ, which tends to have more volatile earnings.

Purchase of CSL (CSL)

We recently added a position in CSL, a biopharmaceutical company engaged in the manufacture, marketing, and distribution of biopharmaceutical and allied products. It operates through the CSL Behring and Seqirus segments. The CSL Behring segment provides plasma therapies and conducts early-stage research on plasma and non-plasma therapies. The Seqirus segment is involved in the production of non-plasma biotherapeutic products and develops influenza-related products.

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

1. Industry structure. It operates the largest network of plasma collection centres and is the largest manufacturer of blood products globally. This provides CSL with a cost advantage to peers in a market where demand continues to grow strongly.
2. Earnings strength. COVID-19 has temporarily impacted on the amount of plasma CSL has been able to collect, meaning that near-term earnings are likely to be flat into next year. Going forward, continued strong industry demand for blood products coupled with tight supply means CSL can generate solid medium-term growth.
3. Balance sheet. CSL maintains a very conservative balance sheet with net debt/earnings before interest, taxes, depreciation, and amortisation (ND/EBITDA) of <0.6. This provides a strong platform to continued research and development programs, as well as fund any potential strategic acquisitions.
4. Management. We view CSL's management as strong given its performance to date. Both CEO Paul Perreault and Chair Brian McNamee are very experienced and have an extensive history in the plasma industry and CSL itself.
5. Environmental, social and governance (ESG). CSL rates strongly from a governance perspective. Some issues have been raised concerning CSL's use of animals in testing.

Key risks

A COVID-19-driven shortage of plasma products could result in a change of prescribing behaviour, which would result in decreased demand. Alternative forms of treatment also pose a risk to the demand for plasma-derived products.

Valuation

We view the defensive growth characteristics of CSL as warranting a premium to the ASX 200. CSL is currently trading on a multiple of 33x FY23, which is reasonable given the medium-term outlook for double-digit earnings growth.

Conclusion

CSL offers defensive earnings growth and the recent underperformance, driven by concerns over near-term collection volumes, provides an opportunity to start building a position.

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

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