

# DNR Capital Australian Equities Income Fund

## Performance Report – April 2021

### Performance

Australian stocks lagged the US market during the month of April. The S&P/ASX 200 Industrials Accumulation Index was up 2.98% during the period, compared to the S&P 500, which was up +5.3%.

Information Technology (+9.6%) was the best performing sector. Growth stocks in general performed well with bond rates falling, forcing investors to consider a potential return to a duration-friendly, low-rate environment. Industrials (+4.3%) also outperformed. Stronger economic growth and activity has begun feeding through to the industrials' businesses with a number of quarterly updates surprising to the upside. Consumer Staples (-2.6%) was the worst performing sector. The quarterly updates from many retailers disappointed investors, as they cycle earnings from the COVID-19 lockdown activity surge. Utilities (-1.2%) also underperformed led by AGL Energy (AGL -7.5%) who announced a demerger, followed by a surprise resignation of its CEO.

The DNR Capital Australian Equities Income Fund underperformed its benchmark for the period. Key stock contributors were Coles Group (COL), Tabcorp Holdings (TAH) and IPH (IPH). Key stock detractors were Aurizon Holdings (AZJ), Afterpay (APT, no holding) and Lendlease (LLC).

The Fund's dividend yield expectation for 2021 is currently 4.49% (5.93% grossed up for franking credits).

### Top 10 active holdings

Security details	Active weight %	Actual weight %
Tabcorp Holdings	4.87	5.58
Telstra Corporation	4.74	7.32
Skycity Entertainment Group	4.33	4.40
Lendlease	4.01	4.57
ANZ Banking Group	3.84	9.10
National Australia Bank	3.84	9.48
BHP Billiton	3.62	3.62
IPH	3.57	3.66
Suncorp Group	3.39	4.26
Aurizon Holdings	3.36	3.80

Source: Mainstream Fund Services and DNR Capital

### Fund overview

APIR Code	PIM8302AU
Investment bias	Style neutral with a quality focus
Designed for	Investors who are seeking a greater level of income and who can make use of franking credits.
Investment objective	To invest in a concentrated portfolio of Australian equities that aims to outperform the Benchmark (net fees) and deliver higher levels of income relative to the benchmark over a rolling three-year period. The investment objective is not a forecast of the Fund's performance.
Benchmark	S&P/ASX 200 Industrials 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
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	Quarterly
Responsible entity	The Trust Company (RE Services) Limited as part of the Perpetual Limited group of companies
Entry/exit fees	Nil

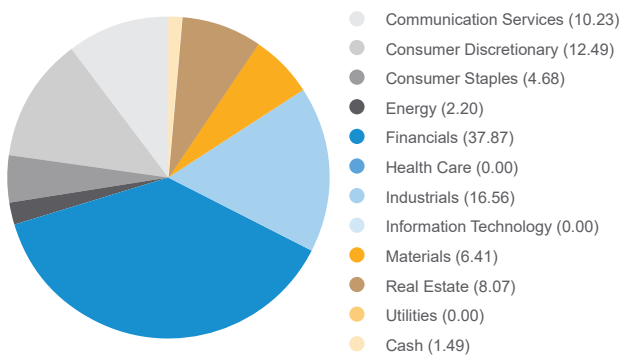
### Net active return as at 30 April 2021

	1mth %	3mth %	6mth %	1year %	Incep.* %
Income Fund	2.48	12.05	28.55	40.57	33.18
S&P/ASX 200 Industrials Accumulation Index	2.98	7.22	18.12	28.56	17.92
<b>Excess return</b>	<b>-0.50</b>	<b>4.83</b>	<b>10.43</b>	<b>12.01</b>	<b>15.26</b>

\* Inception Date—11 March 2020  
 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 Income 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:

- Coles Group (COL):** Outperformed after it released a quarterly sales profile highlighting a positive trend returning in the fourth quarter as shopping trends normalise. It will be difficult to match the earnings growth of 2H20, but we believe COL's is well placed to benefit from cost out and efficiency programs.
- Tabcorp Holdings (TAH):** Announced it had received a revised bid for the wagering business of \$3.5b, which was above market expectations. The lotteries business continued to perform very strongly with further traction evident in the new mobile offering.
- IPH (IPH):** Outperformed during the period. The company has been trading at a distressed valuation largely due to its exposure to the USD. As the currency has stabilised, the stock has appreciated to a more appropriate level, though valuation upside remains.

The top stock detractors for the month were:

- Aurizon Holdings (AZJ):** Sentiment toward the stock took another hit following the Leaders' Summit for Climate, a virtual event hosted by US President Biden. The US announced that it would reduce greenhouse gas emissions by 50% by the end of decade, while other countries also announced more ambitious climate targets.
- Afterpay (APT, no holding):** Outperformed during April, in line with other growth stocks and following a strong online sales update in North America. While we continue to monitor 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.

- Lendlease (LLC):** Fell over the month on no incremental news flow. The company continues to make progress towards its \$8b development target and investors' appetite for build-to-rent and commercial products are showing some signs of improvement.

### Market review

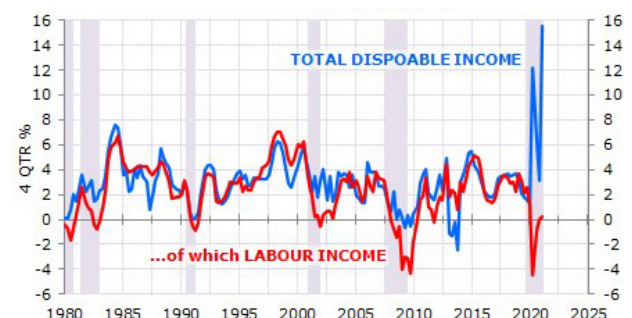
#### Reversal of fortune

The number of COVID-19 cases globally passed 150 million in April, driven by a major spike in cases in India. The global vaccine supply chain is also under pressure, with India approximately 80 million doses short of the total vaccines it had agreed to provide to other countries. Despite this, we see ongoing evidence of increased activity levels, ongoing fiscal stimulus, accommodative monetary policy, very high savings rates, lower unemployment, positive consumer and business surveys, upward earnings revisions and ongoing dividend momentum.

#### Key economic data

With the unprecedented stimulus payments beginning to roll off, economies around the world have been anticipating the 'fiscal cliff'. As household balance sheets have swelled enabling consumption to be funded from savings, this has to date, failed to transpire.

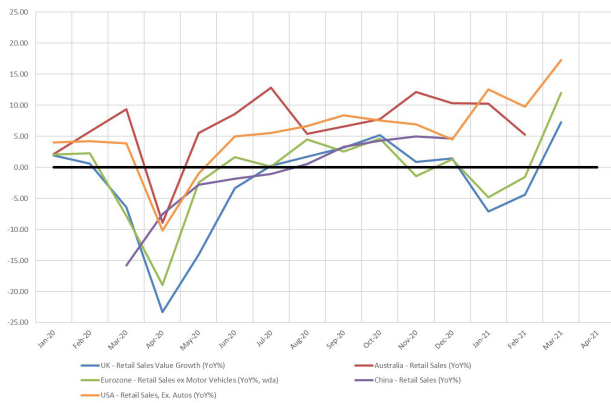
#### US real household income



Source: Minack Advisors

This has manifested most strikingly in ongoing elevated retail sales.

### Select global retail sales growth (YoY)

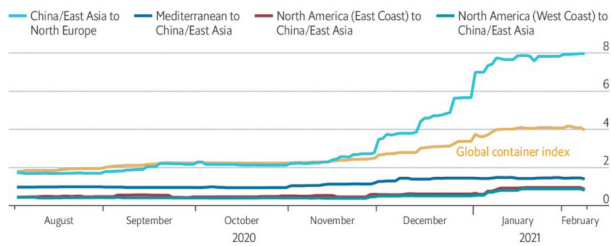


Source: FactSet, DNR Capital

Many companies are reporting difficulties in global supply chains that are straining under increased demand for goods. Container shipping costs, in particular, are spiking in response to increased demand and this was further impacted by the March blockage of the key Suez Canal shipping lane.

### Sea change

Container freight costs, \$'000 per 40-foot container  
By route

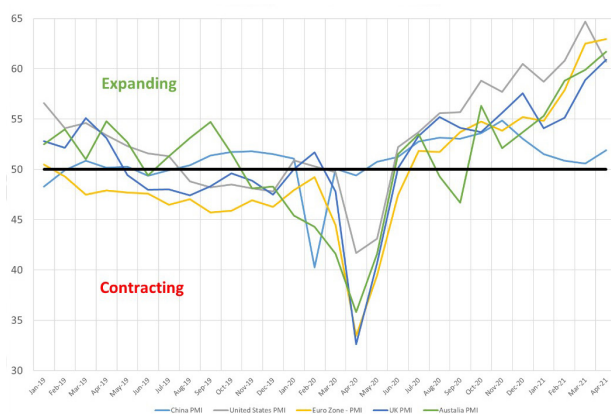


Sources: Freightos Baltic Index; Refinitiv Datastream

Source: The Economist

The closely watched Purchasing Manager Indices (PMI) also points to continued expansion in key global economies, evidencing the pace of global recovery and despite the lingering threats of the virus.

### Select global PMI



Source: FactSet, DNR Capital

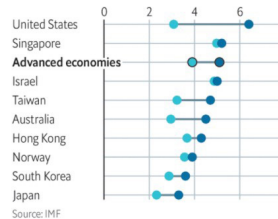
With the economic data pointing to synchronised global GDP growth, the recovery has exceeded the expectations of economists and the International Monetary Fund (IMF), leading many to question whether the global economy is running too hot.

### For richer, for poorer

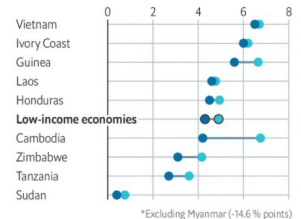
GDP, 2021, % increase on a year earlier  
Countries with biggest change in forecast\*

Forecast made in: ● Oct 2020 ● Apr 2021

#### Advanced economies



#### Low-income economies



Source: IMF

Source: The Economist

As such, the key debate in financial markets is firmly around inflation. While there is general agreement that we will see increased pricing near term, many central banks view it as transitory and are pushing back strongly on the idea that interest rates need to rise to contain excess pricing pressures.

Our favoured barometer of consumer price expectations is breakeven inflation, which measures the difference between inflation-linked, and non-inflation-linked, government bonds. This indicator is at near decade highs, although for now well within ranges tolerable to central banks.

### US 10-year breakeven rate



Source: FactSet, DNR Capital

### Franking matters

#### Australia and franking

Australia has long been a market characterised by high dividend payout ratios, largely driven by franking policy. A franking credit is generated when Australian-resident companies pay income tax and distribute after-tax profits through franked dividends. Depending on their tax situation, shareholders might get a reduction in their income taxes or a tax refund.

#### Who has franking excess balances

The largest stocks in terms of dollar franking balance and percentage of market capitalisation are BHP (BHP), Rio Tinto (RIO) and Woodside Petroleum (WPL). These stocks have generally benefited from record commodity prices, strong free cash flows and big profits. These companies have significant tax bills which accumulate franking balances if not paid out to investors as dividends.

In the short term, we think BHP and RIO are most likely to embark on capital management initiatives to return excess franking balances to investors as free cash flow generation for both companies is significant and balance sheets are strong.

WPL is occupied navigating the appointment of a new CEO and the final investment decision on the Scarborough gas project and funding alternatives, so currently has other priorities.

There are many other stocks that have reasonable franking balances of >5% of market capitalisation and good balance sheets, like Woolworths Group (WOW), Super Retail Group (SUL) and TPG Telecom (TPG). While the opportunities of holding these companies may not be as immediate and are of a lesser scale, we believe capital management will inevitably be on the agenda for them.

#### Timing of capital management

The key factors determining the timing of capital management decisions is certainty, or uncertainty. On one hand, escalating COVID-19 cases and deaths in certain regions (e.g. India) and the emergence of new COVID-19 variants potentially diminishes or delays the global recovery. On the other, successful vaccines and governments' accommodative monetary policy and fiscal stimulus have softened the blow and are propelling the global economy forward. Those companies that have strong balance sheets and better visibility on the earnings outlook will be better placed to embark on capital management practices.

#### BHP Group (BHP) v Commonwealth Bank of Australia (CBA)

With a market cap of ~\$140b, BHP is currently the second largest listed company on the ASX. Over the last 10 years it has paid out about half of its free cash flow in the form of dividends. As such, the company has essentially been building franking balances that are now estimated to be ~\$17b (or ~12% of its market value). Compare this to CBA, which is the largest listed company on the ASX and has a market cap of ~\$160b. It's average payout ratio over the last decade has been closer to ~80%, which means CBA has been paying out most of its franking credits to investors. As such, it has ~\$2b of franking balances available or ~1% of its listed market value.

### Fund categories

At DNR Capital, we categorise income-generating companies as:

**Growers** – High-conviction stocks that may be paying a below-market dividend yield, however we see a clear path towards delivering a sustainable and growing income profile in the medium term (ALX).

**Compounders** – Quality stocks operating within a robust industry structure that have a strong competitive position, underpinning attractive and sustainable income growth (IPH)

**Cows** – Stocks with a solid balance sheet and capital management potential that are being undervalued on traditional earnings-based metrics (AZJ)

**Yielders** – Quality companies at attractive valuations that are delivering sustainable and cash-backed dividends, however with little growth (TLS)

### Fund positioning

We continue increasing our conviction around equity income where opportunities rarely seen since the GFC are presenting themselves.

The DNR Capital Australian Equities Income strategy stands to benefit from four clear performance drivers over the next 3–5 years. These include:

- 1. A favourable factor exposure.** We are positioned in a clear set of quality leaders/defensives, including COVID-19 recovery beneficiaries with notable value.
- 2. Rebased dividends** that are set to rebound for investors as the global economy reopens (forecast dividends to recover by CY23).
- 3. Increasing payout ratios** as boards regain confidence and utilise franking credits, rewarding shareholders in a low yield environment.
- 4. Strong demand,** given the continued search for income in a record low-interest-rate world.

### 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 emergence 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.

## Stock moves

### Purchase of Coles Group (COL)

We recently added COL, which operates Coles Supermarkets, a portfolio of liquor, convenience and petrol retailing. Having underperformed Woolworths Group (WOW) on market share concerns, we believe COL represents good value. The group's supermarket store footprint had lower exposure to suburban centres, which were favoured by anxious consumers during the height of the pandemic and subsequent snap lockdowns. We view this issue as transient rather than representing a long term market share shift and believe these sales will flow back disproportionately to COL in the coming quarters.

#### COL meets DNR Capital's six-point quality web:

1. Industry strength: COL is operating in a well-structured duopoly, sharing in excess of 80% market share with WOW. Aside from Aldi, there is a tail of mostly independently run stores supplied by Metcash (MTS), which have benefited from COVID-19 shop near home trends, but this is likely to revert in the future.
2. Earnings strength: More rational competition, including that of discounter Aldi, has led to modest food inflation, and provides industry tailwinds to profitability. More moderate sales growth will return following an extraordinary period under shelter-in-place order, but is underpinned by population growth. Food inflation and underway cost out programs provide upside to the margin profile.
3. Dividend sustainability and growth: COL is currently trading on a gross dividend yield (including franking credits) of ~5.5% pa. With conditions normalising and capital expenditure programs on track, we view dividend sustainability as high with dividends per share (DPS) growth in line with earnings per share (EPS) at ~5% 3 year compound annual growth rate (CAGR).
4. Balance sheet: Initial concerns harboured at the time of listing around balance sheet strength have been allayed through a number of strategic divestments high cash flow generation. COL has a net debt to earnings before interest, taxes, depreciation, and amortisation (EBITDA) ratio of 0.1x FY21.
5. Management: We view COL management as competent given their performance to date. CEO Steven Cain has broad experience in Australian Food Retail and has been clear with his strategy. With the management team having a more limited tenure than peers, we continue to closely monitor their stewardship of capital and execution against the annunciate goals.
6. Environment, social and governance (ESG): Having divested its interest in gaming, we see COL offering low ESG risk. We note a historic wages underpayment issue but this is minor when compared to peers.

### Key risks

Key risks include a resumption of deflationary price competition witnessed in the latter half of last decade, entrance of an offshore competitor, the execution of large scale capital programs currently underway and changes to grocery shopping habits.

### Valuation

We view the defensive characteristics of COL as warranting a premium to ASX200 and our current discounted cash flow (DCF) valuation of \$20.35 sees upside to its current FY22 PE multiple of 21x, with a fully franked dividend of ~3.9%.

### Conclusion

COL offers defensive earnings growth with upside from an investment program delivering cost savings and margin improvement. Given its cleaner group structure and current discount to WOW, it is our preferred supermarket exposure.

## Investment philosophy

DNR Capital believes a focus on quality companies will enhance returns when it is combined with a thorough valuation overlay. DNR Capital seeks to identify quality companies that are mispriced by overlaying our quality filter, referred to as the 'quality web', with a strong valuation discipline. The investment strategy of the Fund is intended to result in a concentrated portfolio that is high conviction, after-tax focused and invests for the medium-to-long term.

## Investment strategy

The DNR Capital Australian Equities Income Fund has an investment style best described as 'style neutral' with above-average income and associated franking credits. The stock selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices.

The Fund seeks to identify quality medium to long-term investments delivering sustainable, growing income. The Fund seeks to invest in a selection of securities that have high and sustainable dividend capability, strong profit-to-cash conversion, and relatively assured earnings growth.

We define quality companies as being those companies with the following attributes:

- Superior industry position
- Earnings strength
- Dividend sustainability and growth potential
- 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 portfolio. 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 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.

## Disclaimer

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**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](mailto:info@dnrcapital.com.au)

**Website**  
[www.dnrcapital.com.au](http://www.dnrcapital.com.au)