

DNR Capital Australian Equities Income Fund

Performance Report – May 2021

Performance

The S&P/ASX 200 Industrials Accumulation Index was up 2.62% during the period.

Financials (+4.4%) were 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%) are also exposed to higher rates through their non-cyclical earnings profile, resulting in underperformance during the period.

The DNR Capital Australian Equities Income Fund underperformed its benchmark for the period. Key stock contributors were Afterpay (APT, no holding), QBE Insurance Group (QBE) and Super Retail Group (SUL). Key stock detractors were Commonwealth Bank of Australia (CBA, no holding), CSL (CSL, underweight) and Lendlease (LLC).

The Portfolio's dividend yield expectation for 2021 is currently 4.87% (6.45% grossed up for franking credits).

Top 10 active holdings

Security details	Active weight %	Actual weight %
Telstra Corporation	4.88	7.50
Tabcorp Holdings	4.70	5.42
National Australia Bank	4.55	10.15
Lendlease	4.03	4.56
Skycity Entertainment	4.02	4.09
Suncorp Group	3.55	4.45
Aurizon Holdings	3.45	3.87
IPH	3.44	3.53
BHP Billiton	3.15	3.15
Qube Holdings	3.06	3.43

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 May 2021

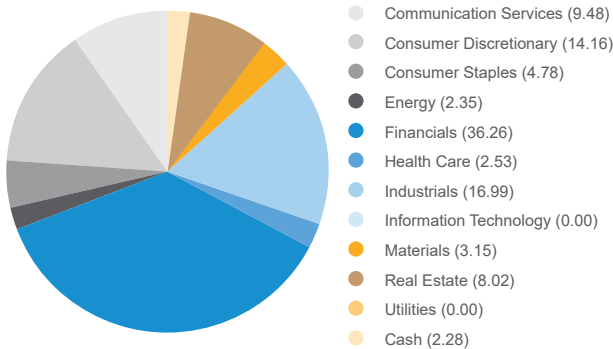
	1mth %	3mth %	6mth %	1year %	Incep.* %
Income Fund	1.33	8.85	12.51	33.59	31.97
S&P/ASX 200 Industrials Accumulation Index	2.62	10.17	10.03	27.51	19.07
Excess return	-1.29	-1.32	2.48	6.08	12.90

* 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:

- **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.
- **QBE Insurance Group (QBE):** bounced as global peers continue to highlight improving pricing which augers well for future profitability.
- **Super Retail Group (SUL):** continues to benefit from a sustained and increased demand for automotive, home exercise and camping and outdoor equipment. We believe the group's verticals are well positioned to capitalise on changing consumer habits, offering dominant market positions and capturing online sales.

The top stock detractors for the month were:

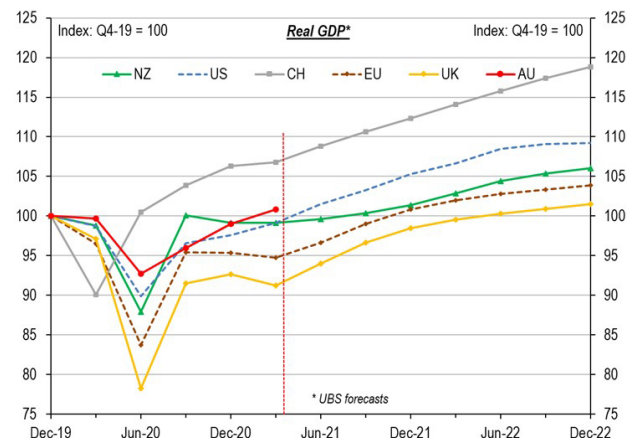
- **Commonwealth Bank of Australia (CBA, no holding):** bounced relative to the other banks as the market anticipates a capital return and strong result in August.
- **CSL (CSL, underweight):** outperformed over the month as the accelerated vaccine rollout in the US saw collection centre volumes start 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.
- **Lendlease (LLC):** fell over the month on concerns that project delays might result in softer-than-expected earnings in 2H21 with the earnings contribution possibly pushed into the December half. 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

Australia vs the world

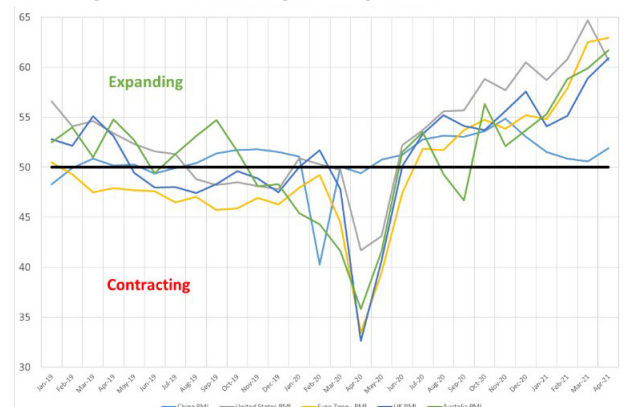
As the world emerges from the coronavirus pandemic, Australia has fared relatively well to date. The recession was not as deep as that of other developed economies, and is emerging from the crisis ahead of most.

Real GDP*



Source: UBS Research

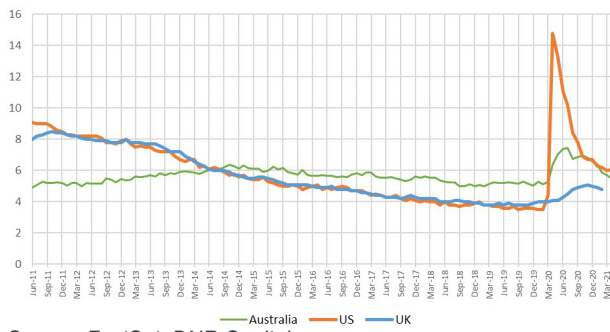
Select global purchasing managers indices



Source: FactSet, DNR Capital

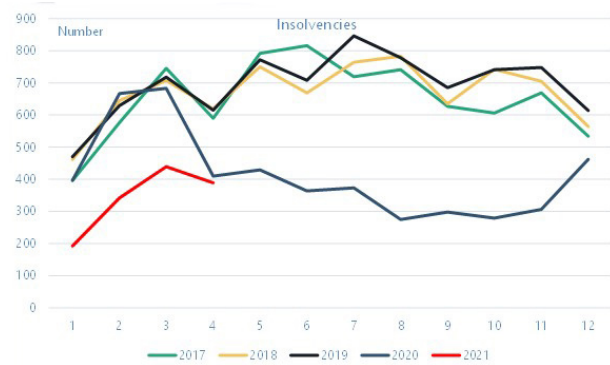
Employment has also returned to pre-pandemic levels, and perhaps most surprisingly, insolvencies are at record low levels.

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.

Fund commentary

The Fund underperformed during May for two key reasons: 1) No weighting to the Information Technology sector; and 2) No Commonwealth Bank of Australia (CBA) holding. We discuss each below.

1. Information Technology sector

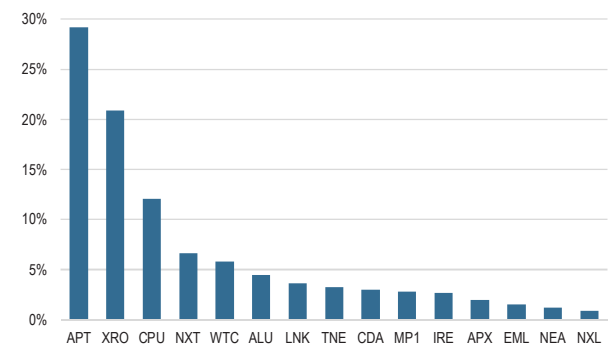
In the past Australia has not had a particularly meaningful Information Technology sector. A decade ago it had just a ~0.5% weight in the market. Today, the sector weighting is ~4%, principally due to the meteoric rise of Afterpay (APT) and the longer-term growth of Xero (XRO).

Change in tech index weight



Source: Bloomberg Finance L.P.

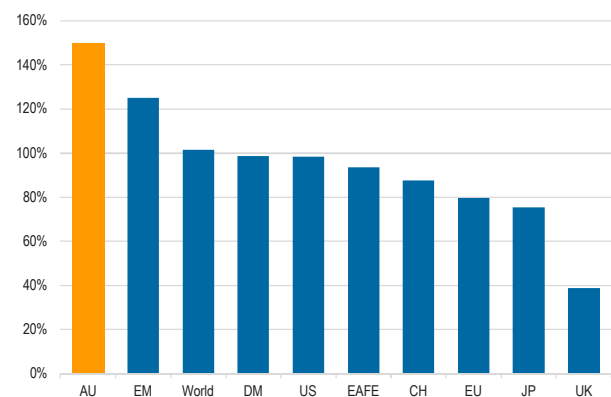
ASX 200 IT – Stock weighting in IT index



Source: Bloomberg Finance L.P.

Interestingly, Australia's Information Technology sector has outperformed peers since the depths of March 2020.

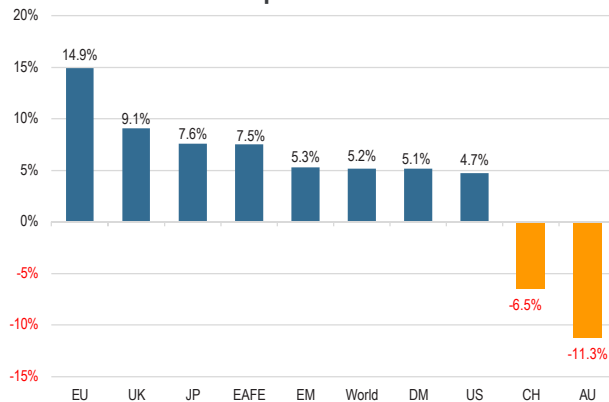
Global markets – tech performance (23/03/20 to current)



Source: Bloomberg Finance L.P.

However, the calendar year to date tells a much different story with performance down double digits, compared to up globally.

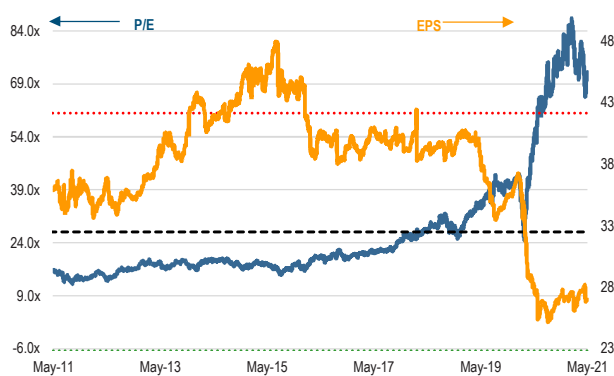
Global markets – tech performance YTD



Source: Bloomberg Finance L.P. as at 27 May 2021

Downward earnings per share (EPS) revisions have seen material multiple contraction from a very high base (reaching >85x in February). Albeit, the sector still remains on a very lofty PE multiple.

ASX 200 IT EPS vs 112M forward P/E



Source: JP Morgan Research

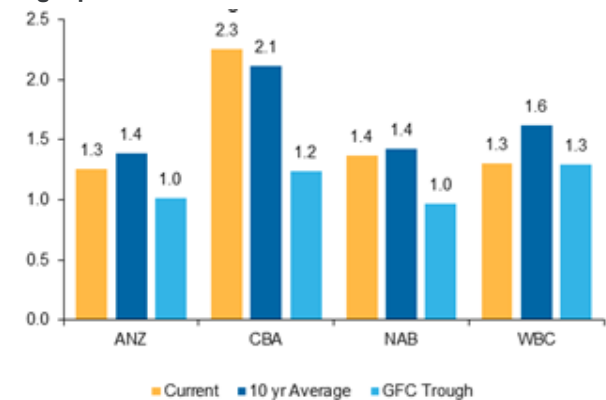
2. Commonwealth Bank of Australia (CBA)

CBA passed \$100 for the first time during May. It has also outperformed the other three major banks by ~10% over the last quarter, the bulk of that occurring during May.

CBA's 3Q21 underlying earnings trends were broadly consistent with peers. However, better revenue growth, the ability to sustain balance sheet momentum and improving margins continue to set CBA apart.

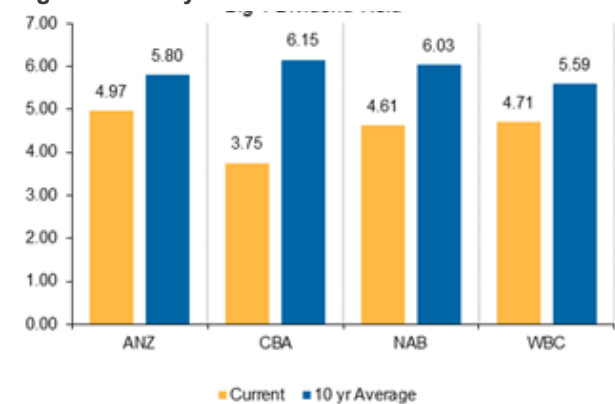
CBA's capital position also remains sector leading. This should provide the board with confidence despite economic and regulatory uncertainty. With over ~\$2.3b of franking credits on the balance sheet, we expect CBA to do an off-market buyback of ~\$5.5b. While likely to be well received, this leaves the stock trading at a hefty premium to peers, and with a less attractive dividend yield.

Big 4 price/book ratio



Source: Macquarie Research

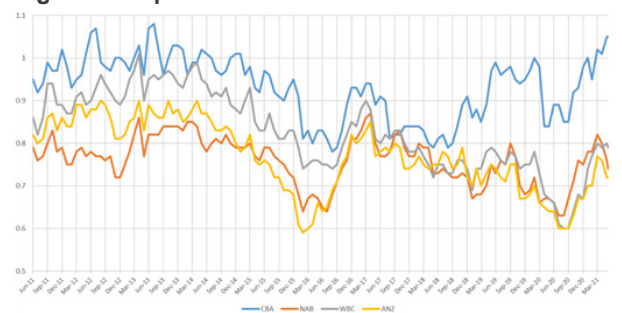
Big 4 dividend yield



Source: Macquarie Research

In our view, CBA's consistent performance and superior balance sheet position justifies a premium valuation to peers. However, headwinds from low interest rates, heightened competition in retail banking and an elevated PE multiple of ~19x (~30% premium to peers) leaves little scope for further upside.

Big 4 banks pe rel



Source: FactSet, DNR Capital

Fund characteristics

We continue to position the Fund in high-quality businesses that offer a combination of attractive dividend yields, growth, franking benefits and importantly, valuation support.

The Fund of quality names with attractive risk-return characteristics should deliver a growing dollar income outcome through the cycle.

The Income Fund is expected to generate a gross yield of 6.46% (including franking) for calendar year 2021, very attractive relative to alternatives.

1. The quality characteristics of the Fund are attractive relative to the Fund's benchmark:
 - 2-year forward return on equity is in line with the market at 13%.
 - 22-year forward dividend yield is 4.6% compared to the benchmark at 3.5%.
 - 2-year forward earnings growth and dividend growth expectations are in line and above market growth rates at ~6% and ~3.2% respectively compared to ~6% and ~0.8% for the benchmark.
2. Despite having stronger growth and quality characteristics relative to the market, the valuation is more attractive:
 - 2-year forward PE is at 15.9x compared to 19.5x for the benchmark.
3. In addition, despite the superior growth outlook, the defensive attributes of the Fund have been maintained:
 - 2-year forward free cash flow yield is ~5.4% compared to the benchmark at ~4.1%..

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

While the “growth vs. value” debate takes centre stage, 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 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.

Stock moves

We have made changes aimed at building further resilience, adding a number of high quality market leaders including Wesfarmers (WES) and CSL (CSL). To fund these purchases we exited James Hardie Industries (JHX) and REA Group (REA). Both stocks have performed well and remain quality leaders, however valuations have become full.

Purchase of Wesfarmers (WES)

WES operates Bunnings Warehouse, discount department stores Kmart and Target, Catch-Group Officeworks, and several industrial businesses including chemicals, safety, energy and lithium processing. Having spun off Coles and disposed of several underperforming assets, the group operates a more focused conglomerate model with strong focus on return on capital and shareholder value.

WES meets DNR Capital's six-point quality web:

1. Industry structure: WES primary businesses possess dominant market shares in well-structured industries, with defensive earnings and opportunities for growth. Bunnings is the clear leader in hardware and whilst underperforming Target is wound down, Kmart and Officeworks are well positioned in consolidating segments.
2. Earnings strength: WES core retail businesses continue to benefit domestic consumer trends but are also well positioned for growth with store and category expansion runways. Ongoing investment in brand, store network and digital capabilities underpins a defensive earnings growth profile.
3. Balance sheet: With a near net cash position, WES offers a strong balance sheet with optionality for acquisitions and capital management.
4. Dividend sustainability / growth: WES is currently trading on a gross dividend yield (including franking credits) of ~5% p.a. With conditions normalising and capital expenditure programs on track, we view dividend sustainability as high with dividends per share (DPS) growth at ~5% 3 year compound annual growth rate (CAGR).
5. Management: We view WES management as focused and competent given their performance to date. CEO Rob Scott has broad experience across their divisions and has been clear with his strategy. Most divisional heads have long tenure with group, and we believe incentives are aligned with shareholders.
6. Environmental, social and governance (ESG): We see WES offering low ESG risk. We note exposure to lithium and chemical processing but conclude these risks to be negligible in context of the group.

Key risks

Key risks include a sharp reversal of consumer household expenditure, the entrance of offshore competitors, and execution of capital projects including the Mount Holland lithium project.

Valuation

We view the defensive characteristics of WES as warranting a premium to ASX200 and our current discounted cash flow (DCF) valuation of \$61.54 sees upside to its current FY22 PE multiple of 28x, with a fully franked dividend of ~5%.

Conclusion

WES offers defensive earnings growth with upside from a strong balance sheet optionality, and ongoing investment opportunities. Market leading brands and focused, returns oriented management makes WES a preferred consumer exposure.

Purchase of CSL (CSL)

We also recently added a position in CSL (CSL). CSL is a biopharmaceutical company, which engages 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 involves in the production of non-plasma biotherapeutic products and develops influenza related products.

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

1. Industry structure: CSL 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 mean 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. Dividend sustainability / growth: We classify CSL as a 'Grower'. One-year forward dividend yield is ~1% p.a., however double-digit growth over the next 5 years will deliver a better dollar income outcome compared to the market.
5. Management: We view CSL's management as strong given their performance to date. Both CEO Paul Perreault and Chair Brian McNamee are very experienced and have extensive history of involvement with the plasma industry and CSL itself.
6. 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 resulting in a change of prescribing behaviour which results in demand destruction. 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 ASX200. CSL is currently trading on a multiple of 33 times 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 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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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.

Platform access

- Asgard
- BT Panorama
- HUB24
- Mason Stevens
- Netwealth
- Wealth O2