

# DNR Capital Australian Equities Income Fund

## Performance Report – June 2021

### Performance

The S&P/ASX 200 Industrials Accumulation Index was up 2.74% during the period.

Information Technology (+13.4%) was the best performing sector. The observed market rotation away from value in part reflects a flattening of the yield curve, pointing to transitory inflation and a slowing in recently strong economic growth. Implied lower-for-longer interest rates benefit longer duration and growth stocks. Communication Services (+5.6%) also outperformed, with the telcos lifting the sector on favourable industry dynamics. Financials (-0.2%) was the worst performing sector, in a direct reversal of the procyclical trade last month. Health Care (+2.1%) would have benefited from the macro view if not for stock-specific factors, with CSL (CSL -1.7%) facing plasma collection concerns.

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

The Fund's dividend yield expectation for 2021 is currently 4.83% (6.39% grossed up for franking credits).

### Top 10 active holdings

Security details	Active weight %	Actual weight %
Telstra Corporation	4.73	7.41
Tabcorp Holdings	4.73	5.43
National Australia Bank	4.50	9.77
SKYCITY Entertainment Group	3.83	3.89
Lendlease	3.72	4.21
IPH	3.53	3.64
Aurizon Holdings	3.52	3.94
Suncorp Group	3.29	4.15
Qube Holdings	3.21	3.57
Cash	3.16	3.16

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 June 2021

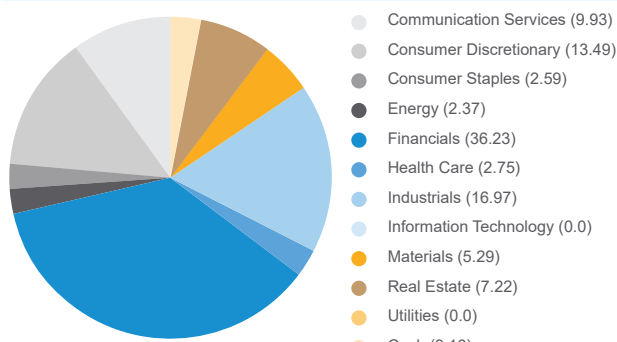
	1mth %	3mth %	6mth %	1year %	Incep.* %
Income Fund	0.97	4.85	14.46	31.22	30.65
S&P/ASX 200 Industrials Accumulation Index	2.74	8.58	13.68	27.38	20.24
<b>Excess return</b>	<b>-1.77</b>	<b>-3.73</b>	<b>0.78</b>	<b>3.84</b>	<b>10.41</b>

\* 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:

- IPH (IPH):** Outperformed during the period. An improving economic environment and strong business capital expenditure intentions should be supportive of patent markets and therefore company revenues. Also boosting revenues has been a strengthening of the US dollar, in which the company prices the majority of its services.
- Commonwealth Bank of Australia (CBA, no holding):** The banks were soft after going ex-dividend and with the broader rotation to growth.
- CSL (CSL, underweight):** Underperformed over the month on concerns of a slower-than-expected ramp up in collection volumes with new restrictions on Mexican donors. 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.

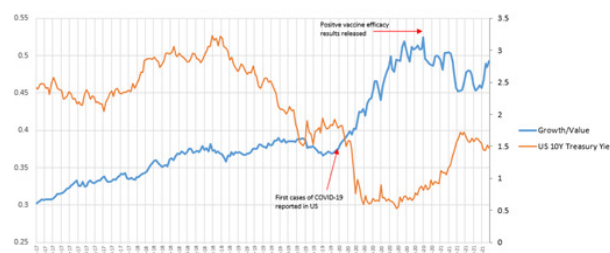
The top stock detractors for the month were:

- 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 new CEO continues to review the operating structure with the potential for future write-downs also weighing on sentiment. LLC continues to make progress towards its \$8b development target and investors' appetite for build-to-rent and commercial products are showing some early signs of improvement.
- Afterpay (APT, no holding):** Outperformed in line with other growth stocks and following initiatives to broaden access to online brands in North America. 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.
- SKYCITY Entertainment Group (SKC):** Underperformed after AUSTRAC announced an investigation into potential historical breaches of anti-money laundering regulations. The company continues to work with AUSTRAC to resolve the historic issues, as well as continuing to improve monitoring systems and processes.

### Market review

The performance of growth peaked in the first quarter of FY21, when initial trials from a clutch of COVID-19 vaccines showed impressive results. The subsequent cyclical rally led a sharp rotation into value, unwinding some of growth's historic outperformance. Having bottomed in August last year, bond yields rose through March as inflation expectations peaked. Much of this rotation unwound in the fourth quarter however, driven by the Federal Reserve's confidence in transitory inflation and ongoing dovish commentary.

### iShares S&P500 Growth (IVE)/iShares S&P500 Value vs S&P500



Source: Iress, DNR Capital

Australian 'go-outside' stocks lagged global peers as our vaccine rollout has disappointed and the return to normality is somewhat delayed. Nonetheless, we believe a return to normality is inevitable and that this presents compelling opportunities with several portfolio stocks expected to benefit including toll roads (e.g. Atlas Arteria, ALX), airports (e.g. Sydney Airport Holdings, SYD), retail malls (e.g. Scentre, SCG), and casinos (e.g. SKYCITY Entertainment Group, SKC). This has been somewhat validated by the recent (5 July 2021) unlisted consortium approach for SYD at \$8.25, which represented a >40% premium to the closing share price of \$5.81.

### GS 'Go-Outside' Basket Performance



Source: Goldman Sachs Global Investment Research, FactSet, Bloomberg

Globally, market valuations are hovering near all-time highs.

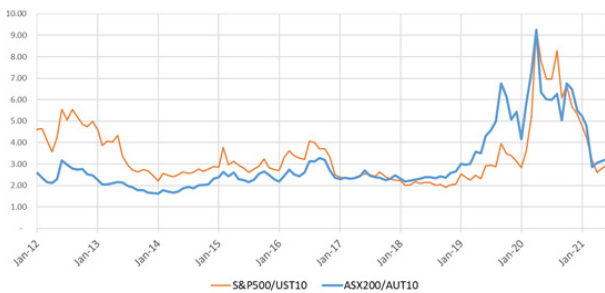
**S&P500, NASDAQ 100 & ASX200 PE (next 12 months)**



Source: DNR Capital

From a relative perspective however, when comparing the earnings yield of the market against bond yields, equities still appear reasonably cheap, and in line with levels observed prior to COVID-19.

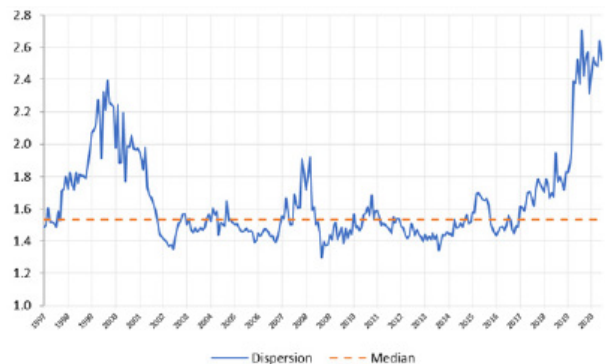
**Bond equity earnings yield ratio (10-year Government Bond Yield)**



Source: FactSet, DNR Capital

Despite narratives of value's return, the gap between high-growth and low-growth stocks remains extreme. Gauging the ASX 200's price/earnings (PE) multiple dispersion, measuring the difference between the two, we note that a modest retracement has reverted to near all-time highs.

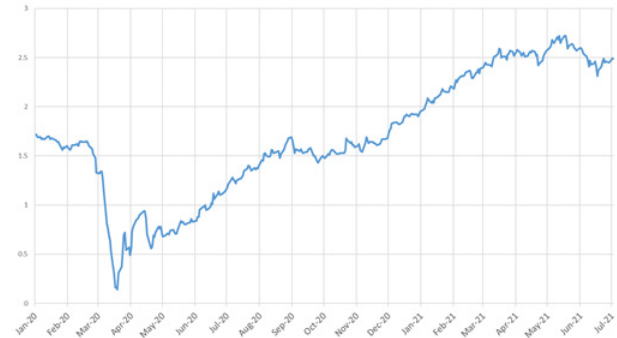
**PE multiple dispersion**



Source: UBS Quant & Strategy

Significant attention has been placed on June's Federal Open Market Committee (FOMC) commentary. Chairman Jerome Powell acknowledged that the committee had begun "talking about talking about" raising interest rates, contrasting last June's insistence that they were not even "thinking about thinking about" raising rates. Notably, the median expectation for rates to increase moved forward from 2024 to 2023. The markets' response saw a sharp rise in the US dollar and a general flattening of the yield curve. The implied level of future inflation, which had been steadily rising since the beginning of the year, also declined.

**US Treasury 5-year breakeven inflation rate**



Source: FactSet, DNR Capital

The reaction surprised many investors, given the implied negative impact on equity valuations from rising interest rates. Support among investors for the Federal Reserve's transitory inflation view has grown however, and the pull forward of rate hikes suggests a willingness to contain any breakout. Subsequent economic data has further galvanised the case for a not too hot or cold 'Goldilocks' economic recovery. While still broadly debated, as the US begins to cycle soft data from last year, questions around pace of growth and permanence of inflation will begin to be answered.

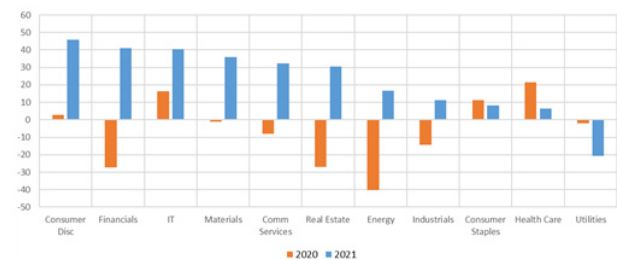
**FY21 – What worked and what didn't**

The S&P/ASX 200 Industrials Index returned +23.97% in FY21 (or +27.38% including dividends). Despite this being the strongest financial year for the market in over 30 years, and despite the Australian economy outperforming on a global basis, the Index lagged most global peers.

**Sectors**

With the exception of Utilities, all sectors of the S&P/ASX 200 Industrials Accumulation Index had positive returns in FY21. Consumer Discretionary and Financials returned in excess of 40%. Several sectors enjoyed a bounce from the previous year's drawdown, but Retail, Health Care and Information Technology delivered sequential positive annual returns.

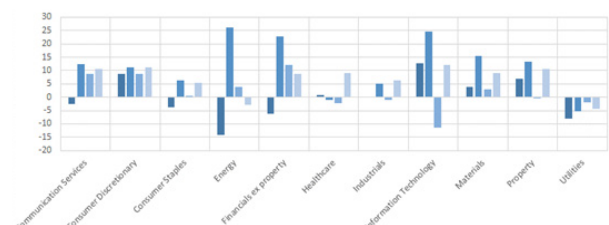
**% Return by GICS Sector**



Source: FactSet, DNR Capital

Returns were broadly consistent over the year, but Information Technology and Financials displayed more volatility.

**FY21 Sector total return by quarter**



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.

Our 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 4.83% (6.39%) 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 10%.
  - 2-year forward dividend yield is 4.6% compared to the benchmark at 3.6%.
  - 2-year forward earnings growth and dividend growth expectations are in line with market growth rates at 9% and 9% respectively.
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 19.9x 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 4.85% compared to the benchmark at 3.74%.

## 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

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 including civic destabilisation in the US and regional tensions with China could create negative implications for stocks and portfolios.

## Stock moves

### Purchase of Amcor (AMC)

AMC is a global packaging manufacturer with two key divisions – flexibles and rigids. The flexibles business has operations in North and South America, Europe and the Asia-Pacific region, and participates in the defensive food, healthcare, home and personal, and tobacco industries. The rigids division is principally exposed to the beverage and personal-care markets in North and Latin America.

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

- 1. Industry structure:** Following the integration of the Bemis transaction, AMC is the global leader in consumer packaging with a footprint, scale and capability to drive significant value. AMC supplies packaging to defensive end markets like food and beverages, which are becoming more attractive as economies enter late-cycle growth.
- 2. Earnings strength:** Near-term earnings are being driven by Bemis synergies, falling raw material costs (which were a material headwind in prior years), lower interest costs and remaining buyback. Long-term underlying earnings will be driven by low, single-digit volume growth in line with population growth and GDP. We forecast a FY21–23 earnings per share (EPS) compound annual growth rate (CAGR) of 7–8%, with modest growth in underlying earnings before interest and taxes (EBIT) (4–5% pa).
- 3. Balance sheet:** AMC's balance sheet is healthy. Net debt/earnings before interest depreciation and amortisation (ND/EBITDA) is expected to finish at ~2.5x by FY22 vs. target of 2.25–2.75x. AMC is likely to return to M&A once the Bemis acquisition is bedded down.
- 4. Dividend sustainability / growth:** AMC has maintained a payout ratio of 70–75%. We forecast dividends to grow 5–7% per annum over FY21–23, broadly in-line with EPS growth. AMC is US\$350m into the US\$500m buyback program.
- 5. Management:** AMC has an experienced management team and board of directors. Managing Director and CEO, Ron Delia, has led the group for two years. Mr Delia's previous role was as AMC's CFO and he also spent time as the divisional of the European flexibles business (AMC's largest business segment by sales). AMC has a strong track record of succession with the company's past three CEOs all being internal appointments.
- 6. Environmental, social and governance (ESG):** AMC has pledged that its packaging products will be 100% recyclable and/or reusable by 2025, currently ~75%. AMC is well positioned to provide its customers with sustainable packaging solutions, leverage changing consumer demands, capture share and margin over the coming years. Tobacco packaging (<10% of total group sales) is a profitable business for the group, however it does bring ESG concerns/risks.

### Key catalysts

**Future of sustainable packaging.** There is upside risk to market expectations from the opportunity that exists for AMC over the next five years to capture market share and margin accretion relating to sustainable packaging needs of fast-moving consumer goods (FMCG) companies.

**Acquisitions.** AMC has an acquisitive history and M&A will likely be back on the agenda following the successful integration of Bemis and completion of the buyback.

### Key risks

**Currency.** With 55% of AMC's earnings coming from outside of the US, a strengthening of the US\$ relative to other currencies could negatively impact the company's earnings.

**Bemis synergies.** AMC currently targets \$180m in synergies from the Bemis merger. While we believe the \$180m target is achievable, failure to capture these synergies within the timeframe would likely disappoint expectations.

**Single-use plastics sustainability concerns.** Criticism of plastic packaging's impact on the environment has been increasing globally over the last 12 months. If this criticism is followed by widespread consumer changes in buying preferences, AMC could be adversely impacted.

### Valuation

AMC is trading at a FY22e P/E of ~14x and offers an EPS CAGR of 5–7% over FY21–23 and a dividend yield of 4–5%.

### Conclusion

We believe AMC offers exposure to a highly defensive earnings stream that should grow independently of industrial or business cycles. This is an attractive investment proposition and represents a reasonable discount to domestic defensive stocks.

## 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