

DNR Capital Australian Equities Income Fund

Performance Report – July 2021

Performance

The S&P/ASX 200 Industrials Accumulation Index was down 0.29% during the period.

In a reversal from last month, sentiment swayed back towards the inflationary argument. The top performing sector in this environment was Industrials (+4.3%), however it was largely due to the takeover offer for Sydney Airport Holdings (SYD, +34.9%). Consumer Staples (+1.4%) also outperformed with supermarkets (WOW, +1.7%, COL, 2.3%) performing well. Information Technology (-6.9%) was the worst performing sector following its rally last month. Financials (-1.4%) also underperformed, despite the pro-cyclical mantra of the markets due to the risk of increased bad debts for the banks resulting from further lockdowns in Australian capital cities.

The DNR Capital Australian Equities Income Fund outperformed its benchmark for the period. Key stock contributors were BHP Group (BHP), Sydney Airport Holdings (SYD) and Afterpay (APT, no holding). Key stock detractors were SEEK (SEK), SKYCITY Entertainment Group (SKC) and Qube Holdings (QUB).

The Fund's dividend yield expectation for 2021 is currently 4.80% (6.34% grossed up for franking credits).

Top 10 active holdings

Security details	Active weight %	Actual weight %
Tabcorp Holdings	4.46	5.13
National Australia Bank	4.34	9.55
Lendlease	4.32	4.84
Telstra Corporation Limited	4.03	6.78
Aurizon Holdings	3.60	4.04
SKYCITY Entertainment Group	3.54	3.60
IPH	3.41	3.51
Suncorp Group	3.35	4.26
BHP Billiton	3.28	3.28
Qube Holdings	3.16	3.50

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 31 July 2021

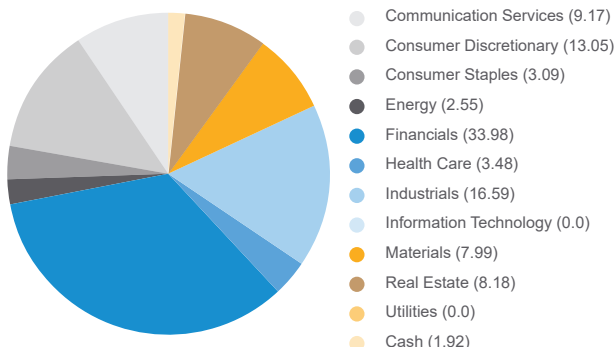
	1mth %	3mth %	6mth %	1year %	Incep.* %
Income Fund	0.68	3.01	15.41	32.58	29.16
S&P/ASX 200 Industrials Accumulation Index	-0.29	5.13	12.73	27.62	18.64
Excess return	0.97	-2.12	2.68	4.96	10.52

* 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:

- **Sydney Airport Holdings (SYD):** SYD received an unsolicited offer from an IFM consortium (IFM, QSuper, GIP) to acquire 100% of SYD at \$8.25. The bid multiple implies a ~23x CY23 and ~20x CY25 EV/EBITDA multiple on consensus estimates. The offer has been rejected by the Board, however there remains potential for a revised offer or a competing bid.
- **BHP Group (BHP):** Performed strongly with the iron ore price holding above \$200 US/t. Production results were largely in line with expectations and current pricing supports a strong dividend outlook.
- **Afterpay (APT, No Holding):** Underperformed during the month as product announcements by Apple and Paypal raised concerns about growing competition amongst BNPL operators. Whilst we have viewed the valuation of APT as stretched, a subsequent takeover offer by Square, Inc has seen the group trade at a premium that is likely to persist until completion.

The top stock detractors for the month were:

- **Qube Holdings (QUB):** QUB announced it had entered into binding commercial terms with LOGOS for the sale of 100% of its interest in the warehousing and property components of Moorebank. Despite this positive announcement, the market is concerned with the outlook for economic activity. Whilst QUB has cyclical exposures, it has been the beneficiary of tailwinds across a number of its businesses including port volumes, mining, agriculture and forestry products and remain exposed into a recovery scenario.
- **SKYCITY Entertainment Group (SKC):** Underperformed after COVID-19 forced a short shutdown of the Adelaide property. The casino sector as a whole was softer on further negative news flow from the Victorian Royal Commission into Crown Resorts.
- **SEEK (SEK):** Underperformed during the month in line with other online classified names impacted by lockdowns. Tailwinds from an economic recovery and a re-architecting of pricing structures position the group well in the medium to long term.

Market review

Global Outlook

Only a few months ago the market was focused on the upside risks to growth and inflation, driven by the combination of loose monetary policy, aggressive fiscal stimulus and accelerating vaccine rollout. This appears to have all changed, with the partial unwind of the reflation trade over the last three months. The main sector-level beneficiaries of reflation (energy, materials, and financials), have all under performed, even as markets continue to rally.

The reflation trade started to reverse from May



Source: MSCI, Minack Advisors

Investors are now focused on the downside risks to growth. There is no question that growth is at an inflection point, the June quarter growth rates (off a very low base) cannot be sustained. However the market is pricing a slowdown, not a downturn. The decline in long-end yields have been driven by a combination of technical factors and growth concerns (as COVID-19 Delta variant contagion accelerates across the world), however inflation expectations remain high, which indicates a pro-cyclical stance.

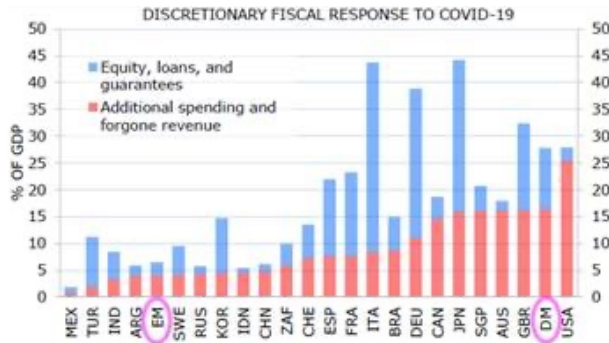
Market's inflation expectations remain high



Source: Bloomberg, ISM, NBER; Minack Advisors

The US has been at the forefront on both stimulus and vaccination, so its recovery has been strong relative to history and also to other major regions. Europe has recently caught up, with vaccinations strengthening its recovery. Two factors have been important to the speed of the country-level rebound. The first was the size of the fiscal response, which was much larger in developed than emerging economies.

Strong fiscal stimulus in DM led by the US

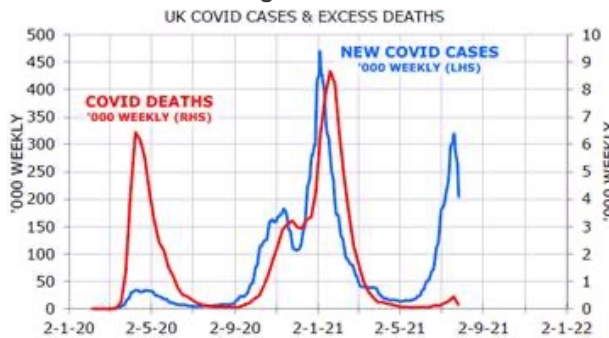


Source: IMF, Minack Advisors

Then there has been the vaccine rollout, with developed markets again leading emerging markets.

The Delta strain is the largest downside risk. However, if the UK experience is any guide, then it seems likely that the underlying growth trajectory remains intact. Demonstrated from UK data in the following chart, the vaccine rollout is muting the health damage of rising infection rates.

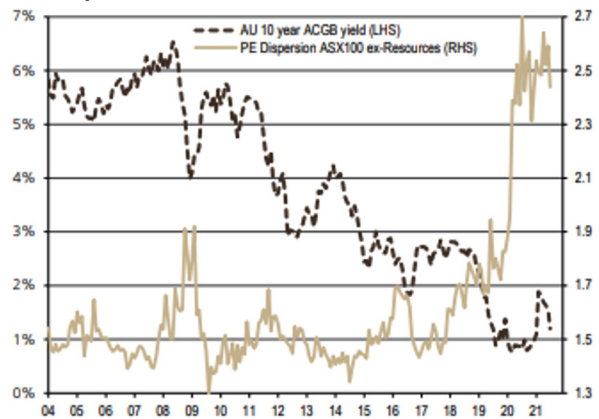
UK infections less dangerous after vaccination



Source: Our World In Data, Minack Advisors

Does the reflation trade have further to run? Price to earnings (PE) dispersion remains extreme, driven by low interest rates, scarcity of growth and/or growth concerns. However, policy makers remain keen to drive growth and policy settings remain loose. So long as pandemic disruptions are short-lived (like the UK experience) then above-trend growth is more likely, which points to a renewed rise in long-end yields and reflation out-performance.

PE dispersion

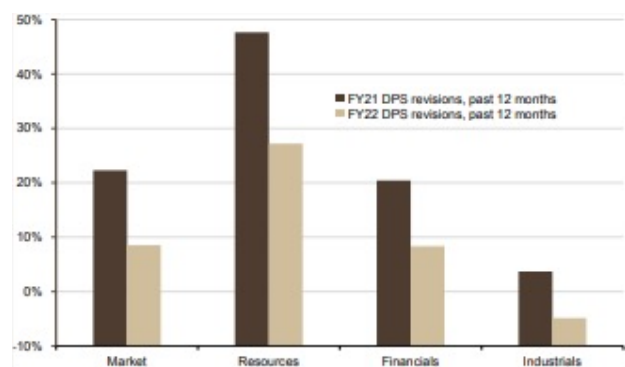


Source: IBES, UBS

Upbeat reporting season expected

After a collapse of >30% in earning per share (EPS) in FY20, market consensus expects ASX100 FY21 EPS to rebound by almost 50% in FY21. This has been driven by record commodity prices, booming house prices and elevated consumption driven by very loose monetary and fiscal stimulus. Dividend expectations have also been raised.

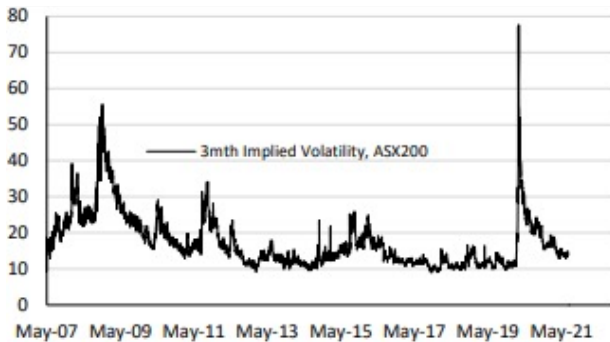
Dividend per share (DPS) revision upgrades



Source: FactSet, UBS

The pre-reporting 'Confession season' delivered more upgrades than downgrades and implied that volatility has fallen sharply over the past six months, suggesting markets are pricing an upbeat outlook for reporting season, but with minimal risk.

ASX200 volatility



EPS growth of almost ~10% is expected into FY22, however the current lockdown in Australia will deliver a hit of >\$20b and increases uncertainty. This may also reduce confidence in board and management to provide meaningful outlook commentary.

Corporate activity

Capital preservation has turned to corporate activity as confidence returns and the economy recovers. M&A has surged with aggregate deal flow already marking a 10-year high. With leverage net debt/ earnings before interest taxes depreciation and amortisation (ND/ EBITDA) falling by 0.5x, the majority of companies are operating with decade-low leverage ratios. As such, there is substantial capacity for more M&A, even before considering private equity and large super funds.

Annual deal value (ASX200)*



ND/EBITDA ratio track (2008-current)



Some recent examples below:

Cash flow appeal: Sydney Airport Holdings (SYD) bid; Qube Holdings (QUB) sale of Moorebank; Spark Infrastructure (SKI) bid.

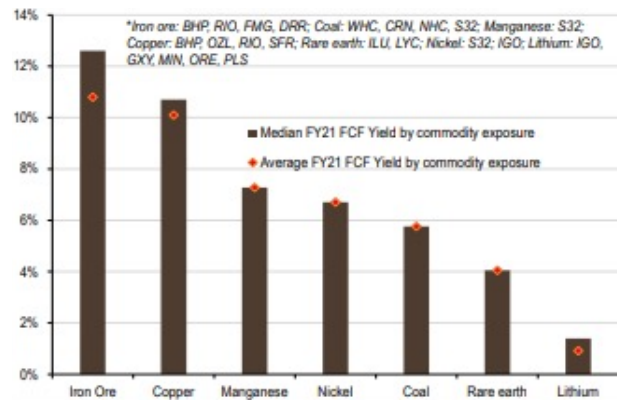
Scale / Enhancing core: Stockland Corporation (SGP) / Halcyon acquisition; Santos (STO) / Oil Search (OSH) proposed merger; Star Entertainment Group (SGR) / Crown Resorts (CWN) proposed merger; Computershare (CPU) / Wells Fargo acquisition.

Demergers: AGL Energy (AGL) demerger; Woolworths Group (WOW) / Endeavour Group (EDV) demerger.

Attractive mining dividend yields

Dividend yields in mining stocks are attractive. This has been driven by record commodity prices. At current prices, iron ore and copper miners are trading at elevated cash flow yields of >10%.

Miner free cash flow yields



Commodity prices are clearly cyclical and are not expected to remain at current levels (in particular iron ore), however consensus expects a material decline in earnings beyond FY21.

With the global recovery underway and the push toward renewable technology investment, it is possible that prices will remain above market expectations for longer. Mining and Materials are outside benchmark for the strategy, however we have preferred positions in BHP Group (BHP), Deterra Royalties (DRR) and Woodside Petroleum (WPL).

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

The Income Fund is expected to generate a gross yield of 6.34% (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 above the market at 10.85% compared to 10.71% for the benchmark.
 - 2-year forward dividend yield is 4.5% compared to the benchmark at 3.5%.
 - 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 15.8x 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 4.5% compared to the benchmark at 3.5%.

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 Atlas Arteria (ALX).

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

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

Yielders – Quality companies at attractive valuations that are delivering sustainable and cash-backed dividends, however with little growth Telstra Corporation (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 Deterra Royalties (DRR)

DRR spun out of Iluka Resources (ILU) in October 2020. Its assets consist of the Mining Area C (MAC) iron ore royalty, including BHP Group's (BHP) new South Flank mine.

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

- 1. Industry structure:** DRR earnings primarily come from MAC - a first quartile iron ore asset which has 62% iron ore grade with a ~35% lump mix. DRR will receive quarterly royalty payments equal to 1.232% of AUD denominated revenue from the MAC plus production capacity payments of A\$1m per 1 million dry metric tonnes (mdmt) increase in annual production above the previous highest annual production level (capacity payments).
- 2. Earnings strength:** BHP plans to add ~80m wet metric tonnes per annum (wmtpa) to the current ~60m wmtpa capacity at MAC as part of its new South Flank project, with first production from the new project announced on 20 May 2021, bringing total MAC production to 140 wmtpa from CY23. Higher grade and premium iron ore products should perform better than low grade products due to stricter emissions controls in China.
- 3. Balance sheet:** DRR has a net debt balance of A\$16.5m (including lease liabilities) as at December 2020, and has been set up with a general corporate and working capital debt facility of A\$40m. The company's low debt position has been chosen to allow the company debt funding capacity to add further royalties to its portfolio.
- 4. Dividend sustainability / growth:** DRR's policy is to declare dividends semi-annually, franked to the maximum extent possible. Target payout ratio is 100% of net profit after tax (NPAT). Underlying dividend of A\$0.22/share = ~5% yield (~7% gross yield), as production ramps and iron ore price reverts to long term. DRR's ability to continue fully franking its dividends is not being considered by the market.
- 5. Management:** Management capability is good, albeit relatively untested at C-Level. Julian Andrews (Managing Director & Chief Executive Officer) has 20+ years' experience and was previously Head of Strategy, Planning & Business Development at ILU, having joined the company in 2017. Brendan Ryan (Chief Financial Officer & Company Secretary) has 30 years of commercial and operational experience in the global mining industry. Prior to DRR, he was Chief Financial Officer and Chief Business Development Officer at Bort Longyear (BLY).
- 6. Environmental, social and governance (ESG):** Due to its exposure to the operations of MAC, the ESG risks of the company closely relate to the operational risk of the mine itself. While it is not the operator, and therefore not generally exposed to reparations or fines for environmental or social infringements, the company is exposed to operational risks, for example if the mine were to be closed or limited in production. In addition, it is exposed to the potential displacement of iron ore in steel making.

Key catalysts

Iron ore prices. Movements in 62% iron ore price benchmark and the lump premium drive royalty payments.

MAC ramp up. Production rates from MAC are a key driver of royalty calculations. Planned ~80m wmtpa expansion by CY23 is a key input to free cash flow expectations and valuations.

Key risks

Iron ore prices. Iron ore prices have been trading at record levels > US\$200 / tonne and are not sustainable. We believe the long term iron price is closer to US\$70 / tonne.

Change in ramp up at South Flank by BHP. As DRR only receives a royalty, its revenue is highly dependent on BHP's ramp up at South Flank. Any delay to project timeliness would in turn affect forecasts.

Change in China government policy impacting iron ore. There could be a shift in the Chinese government's policy away from environmental controls, allowing fresh capacity additions, or reducing the magnitude of winter pollution cuts, in turn lowering profit margins for steel production, and changing the dynamics for preference for grade.

Valuation

DRR is currently trading on an FY24 enterprise value to earnings before interest and taxes (EV/EBIT) of ~10x, which is at the lower end of peer multiples ranging from 7x to 35x (the range for precious metals and iron ore royalties). It is also at the lower end of comparable royalties in the bulk commodities space (that are trading at an average of 7x to 19x) despite having a significantly better quality asset (through owning MAC). Its underlying dividend yield of ~5% (~7% gross yield) is attractive and likely to be exceeded in the short term.

Conclusion

As a royalty company, DRR's yield is less sensitive to changes in iron ore prices than peers. This represents an attractive investment proposition with a combination of record iron ore prices, planned capacity expansion driving free cash flow and fully franked dividends in the low interest rate environment.

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