DNR Capital Australian Equities Income Fund

Performance Report – August 2021

Performance

The S&P/ASX 200 Industrials Accumulation Index was up 5.58% over the month.

Information Technology (+16.8%) was the best performing sector, following Afterpay's (APT +39.2%) takeover offer from Square and Wisetech's (WTC +57.0%) strong profit result. Health Care (+6.8%) also outperformed as the majority of the sector met expectations during reporting season. Utilities (+0.3%) was the worst performing sector, following poor performance in energy markets, evidenced by results released during the recent reporting period. Industrials (+2.5%) also underperformed, as materials and energy-linked industrials in particular underperformed alongside faltering commodity prices.

The DNR Capital Australian Equities Income Fund underperformed the Index for the month. Key stock contributors were IPH (IPH), Commonwealth Bank of Australia (CBA, no holding) and Suncorp Group (SUN). Key stock detractors were BHP Group (BHP), Afterpay (APT, no holding) and Woodside Petroleum (WPL).

The Fund's dividend yield expectation for 2021 is currently 4.84% (6.38% grossed up for franking credits).

Top 10 active holdings

Security details	Active weight %	Actual weight %
National Australia Bank	4.45	9.80
Tabcorp Holdings	4.14	4.76
Lendlease	4.07	4.55
Telstra Corporation	3.93	6.61
IPH	3.81	3.93
Qube Holdings	3.49	3.84
Suncorp Group	3.48	4.42
SKYCITY Entertainment Group	3.43	3.50
Aurizon Holdings	3.38	3.79
Macquarie Group	2.97	6.29

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 August 2021

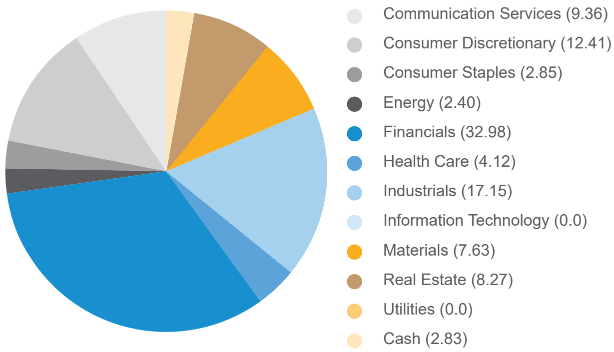
	1mth %	3mth %	6mth %	1year %	Incep.* %
Income Fund	4.46	6.19	15.59	36.24	31.09
S&P/ASX 200 Industrials Accumulation Index	5.58	8.16	19.16	30.37	21.89
Excess return	**-1.12**	**-1.97**	**-3.57**	**5.87**	**9.20**

** 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 month after delivering a solid annual result. Australian filings were consistent, while the Asian business saw strong growth through both organic and network effects. The company also delivered substantial synergies and cost savings from recent acquisitions, building the case for future activity in overseas markets.
- **Commonwealth Bank of Australia (CBA, no holding):** drifted after delivering an in line result with costs higher than expected but bad debts and margins better. CBA has enjoyed a strong run and consolidated post the result.
- **Suncorp Group (SUN):** delivered a better than expected result with cash earnings up 42%. Market confidence in insurance margins increased as repair and price rises take effect and resulted in upgrades to the outlook.

The top stock detractors for the month were:

- **BHP Group (BHP):** underperformed over the month as spot iron ore prices traded lower on concerns that Chinese steel production curbs would lead to lower demand. During the month, the company announced it would merge its petroleum business with Woodside Petroleum (WPL) and proposed to collapse the dual listed structure back into a single Australian listing. The proposal to collapse the dual listing saw significant selling in the Australian market which has traditionally traded at a premium.
- **Afterpay (APT, no holding):** outperformed during the month following a bid by Square, Inc. to acquire the group in an all-stock deal, valuing the business at nearly AU$40b. We view the deal as likely to proceed with little regulatory risk or alternative bidders emerging.
- **Woodside Petroleum (WPL):** underperformed during the period on a weaker oil price and stock overhang concerns. The company announced a proposed merger of equals with BHP's petroleum business, which would create a top 10 global oil and gas company by size. Despite the benefits that would accompany such a transaction, such as improved cash flow metrics and growth profile, the likely overhang from such a large scrip deal has weighed on the stock.

Market review

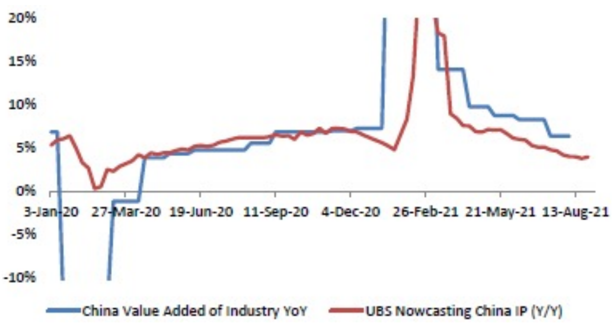
Global growth is slowing following a strong recovery from the depths of COVID-19. The US Federal Reserve (Fed) remains supportive and evidence of sustainable inflation will take time to emerge. Offsetting this is a slowing of growth in China and the COVID-19 Delta spread. Value significantly underperformed during the month, with the valuation dispersion back at extremes. The Fed is walking a fine line between a recovering economy and declining liquidity. Jackson Hole provided comfort to investors that likelihood of rate hikes remain in the distant future. Further stimulus would be supportive of cyclical stocks, particularly in a normalising post COVID-19 world. We retain a balanced portfolio with a range of strong franchise companies offering defensive resilience combined with quality businesses trading cheaply due to the pandemic impacts.

Growth concerns as China tightens and Delta spreads

Over the past few months, a tightening of the Chinese economy, concerns over the spread of the COVID-19 Delta variant and a slowing in US economic growth have overhung the outlook for the global economy.

The lagged impact of Chinese policy tightening combined with catastrophic flooding in Central China and domestic outbreaks of COVID-19 have increased the downside risks to the economy. We have seen some signs of a political response in relation to this softening. The People's Bank of China (PBOC) Governor Yi Gang promised to boost credit support and improve efforts to moderate real lending rates for businesses. The PBOC vowed financial support for the rural sector with the monetary policy tools at its disposal. When in doubt, central banks are conditioned to go deep and to go fast, hence, it is not unthinkable that both the Reserve Requirement Ratio (RRR) and Loan Prime Rate (LPR) are cut.

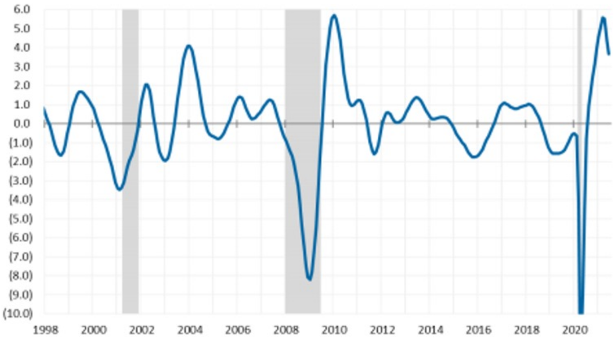
Industrial production



Source: UBS Evidence Lab, Bloomberg, UBS Research

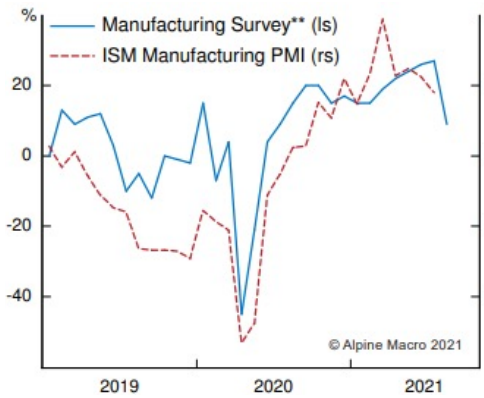
The US economic growth rate has also peaked as evidenced by OECD leading indicator.

US cycle based on change in OECD leading indicator



Source: Jeffries

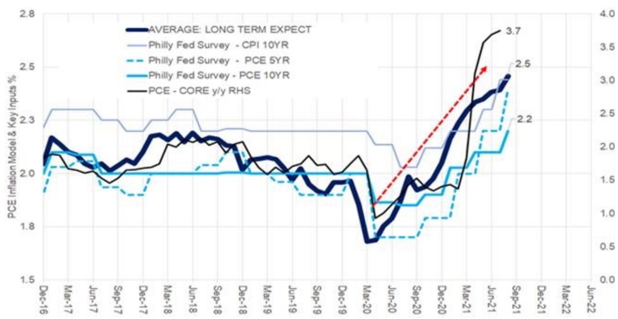
Manufacturing still exhibits solid expansion, albeit off its highs.



**Source: Federal Reserve Bank of St. Louis*
***Source: Federal Reserve Bank of Richmond*

US Federal Reserve gives comfort

The Fed is looking for "substantial progress" on both inflation and job creation fronts. In Powell's Jackson Hole speech, he conceded that "substantial progress" has been made on the inflation front however resisted suggestions that "substantial progress" has been made on the job creation front. In short, the US will continue to leave rates low and run the economy until there is overwhelming evidence of sustainable inflation. In response, real bond yields, equity market volatility (VIX) and the US dollar (USD) dropped. But inflation expectations moved slightly higher, mitigating the decline in nominal yields.



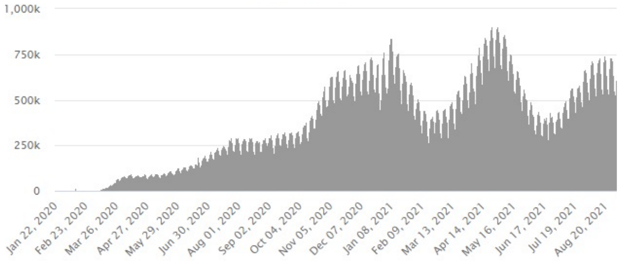
Source: Endeavour Research

The Fed is walking a fine line between a recovering economy and declining liquidity. Tapering also raises the risk of financial volatility impacting the real economy.

COVID-19

Case numbers across the globe are experiencing a third wave as the Delta variant spreads. Global COVID-19 cases passed 216m in August, a material increase from the 196m cases at the end of July.

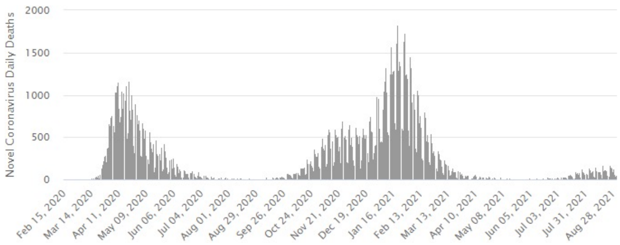
Daily new cases



Source: Worldometers.info

For regions with a high number of prior cases and/or a high number of vaccinations, deaths have fortunately remained modest.

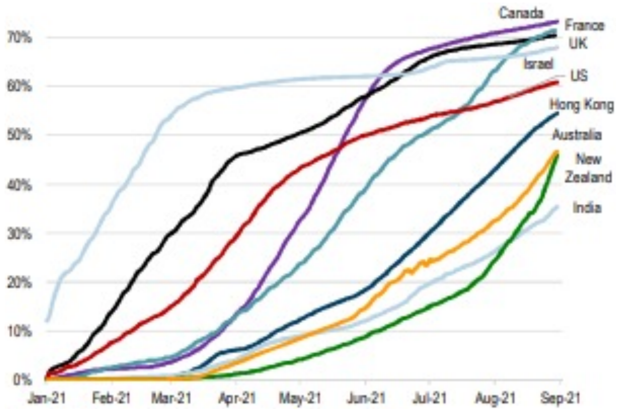
Daily new deaths in the United Kingdom



Source: Worldometers.info

Vaccine rates have also been steadily improving. Globally, more than 5b COVID-19 vaccines have been administered. Now ~40% of the world's population has received at least one dose of a COVID-19 vaccine.

Vaccine rates are encouraging



Source: J.P. Morgan calculations, Bloomberg Finance L.P.

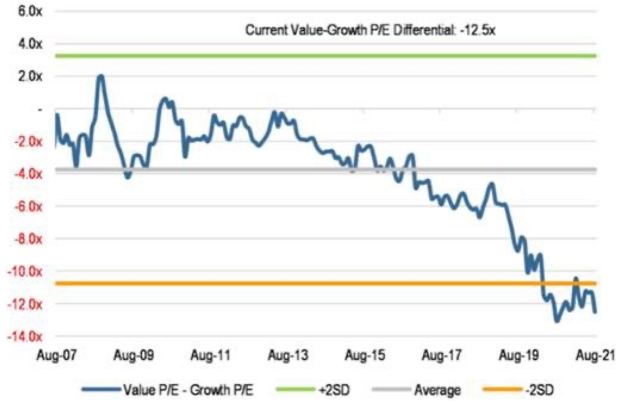
Consequentially, in major economies such as UK and US, populations and governments appear to have little appetite for further lockdowns and economies are returning to a level of normality.

Australia is clearly lagging this trend, but under Delta, zero COVID-19 targets appear increasingly unachievable. We believe accelerating vaccination rates are helping shift the conversation around opening up.

Value vs. Growth

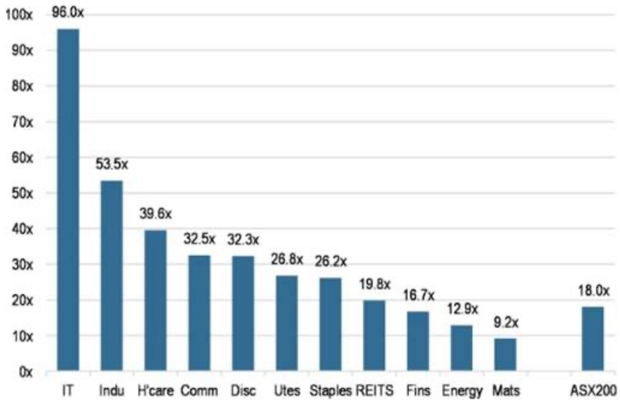
Value underperformed Growth over the last 6 months as growth concerns manifest and as bond yields decline (giving up about half the gains from June 2020 levels). The valuation dispersion is back at extremes.

AU Value vs. Growth 1-year forward P/E



Source: J.P. Morgan calculations, Bloomberg Finance L.P.

GICS 1-year forward P/E



Source: J.P. Morgan calculations, Bloomberg Finance L.P.

Reporting season

Australian stocks rose over reporting season, however underperformed global markets. The ASX has typically underperformed global markets during periods of lockdowns.

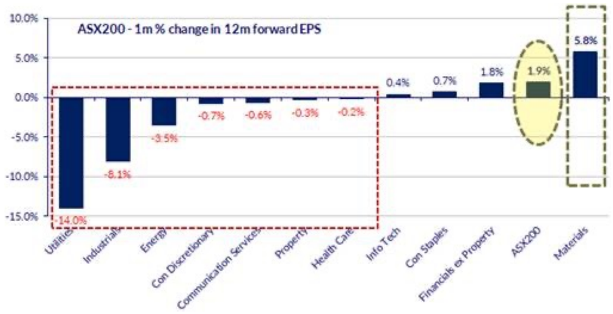
Information Technology (+17%) was the best performing sector, outperforming the next best by more than 10%. The two key drivers of this strong outperformance were Square's takeover offer for APT (+39%); and Wisetech's (WTC +57.0%) strong profit result. The defensive Consumer Staples (+6.9%) and Health Care (+6.8%) sectors were the next two best performers, even though stocks in these sectors reported weak results.

Mining (-9.1%) was the worst performer last month due to a 25% fall in the iron ore price. This led to large falls in iron ore exposures (Fortescue Metals Group (FMG) down 16%, BHP Group (BHP) down 15%, Rio Tinto (RIO) down 10%, Mineral Resources (MIN) down 10%), but less than the fall in the price of iron ore. BHP's plan to remove the dual listing was also a negative catalyst, as the ASX listing of BHP underperformed the UK listing by ~12% over the month.

Key observations from reporting season:

Outlook uncertainty: The FY22 outlook is clouded by current lockdowns, however markets are generally willing to look through this given the vaccine roll out. As such, we saw a pullback to overall expectations for FY22e and FY23e earnings growth, particularly for banks and resources.

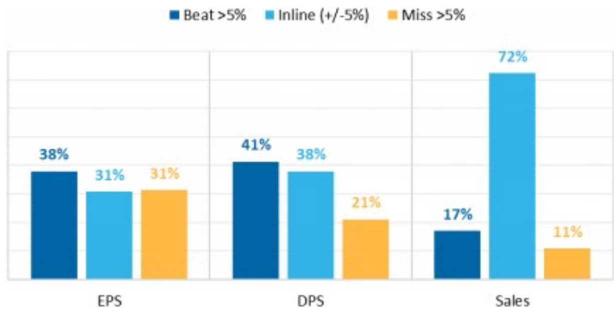
Strong growth delivered: Earnings per share (EPS) growth of 26% was delivered for the year, off a COVID-19 impacted base. Earnings were revised up 2% driven by materials and financials.



Source: CSLA

More beats than misses: 38% of companies beat expectations and 31% disappointed.

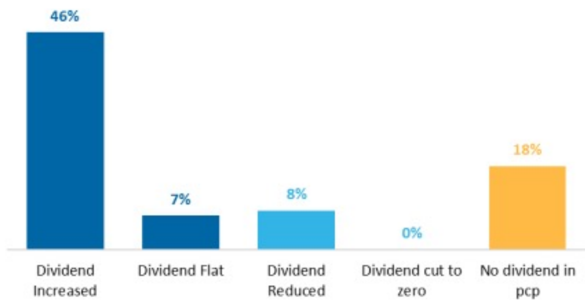
Half year EPS beat or miss vs MRE - percent of companies



Source: FactSet, Macquarie Research

Dividend bonanza: We have foreshadowed the prospect of capital management initiatives, and we have seen at least ~$18b of buybacks and capital returns announced, as well as special dividends.

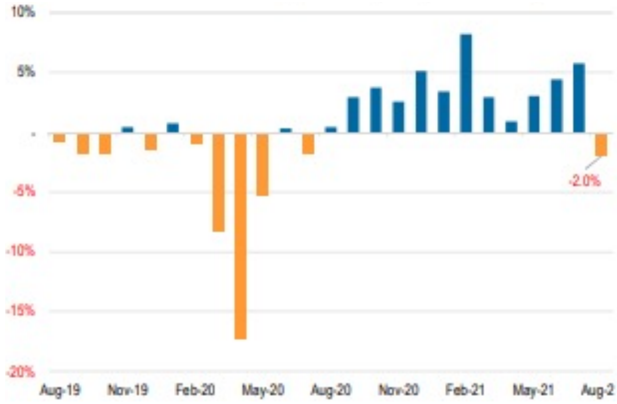
Reported half year dividends (% of companies)



Source: FactSet, Macquarie Research

Dividend outlook revised down slightly: Dividend projections followed the decline in earnings, with post-result revisions down 3%. Despite this slippage, the recovery in dividend per share (DPS) expectations has been significant over the past year, with Australia's ascent outpacing the globe even with this pullback.

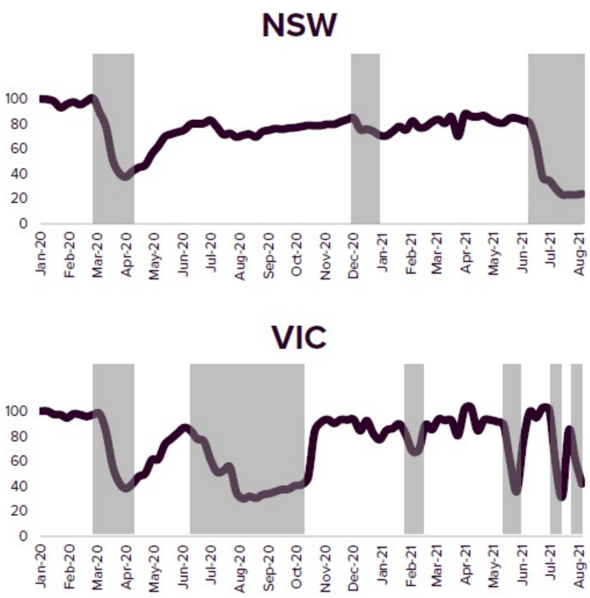
MoMDPS revisions (ASX 200, 1BF, consensus)



Source: J.P. Morgan calculations, Bloomberg Finance L.P.

COVID-19 winners vs losers: We noted a rotation from COVID-19 winners to losers. Winners are trading on high multiples and potentially inflated earnings. As these stocks begin to cycle strong growth, it is increasingly difficult to accurately forecast the earnings outlook. This was well illustrated by Wesfarmers (WES), which delivered a solid result ahead of expectations, but was subsequently sold off. Conversely, a company like Scentre (SCG), whose shopping centres remain closed in some regions, performed well despite only meeting expectations. We believe this reflects the willingness of consumers to return to centres when able, and the strength of the cash flows when that occurs.

Scentre customer visits by region



Source: Scentre Group

Inflation: Inflation remains a key thematic – in particular, wage inflation and reared its head across many sectors – in particular, global cyclicals.

Bank results were soft: Lower bad debts and capital returns provided positive news but softer margins, and higher expenses suggest underlying growth is moderating. Competition is intensifying with the four majors focused on the domestic market. Westpac (WBC) and ANZ Banking Group (ANZ) are struggling operationally, with WBC cutting prices as a result. Fintech companies also continue to raise capital and invest in acquiring new customers taking market share from the four majors.

Improving quality of unloved sectors: A highlight for us was the performance of the general insurance and telecommunication sectors. After many years of poor performance, and an internal focus on repair, we are beginning to see the benefits of price rises and cost cutting across these sectors. QBE Insurance (QBE) saw double digit EPS upgrades and a strong share price reaction. Suncorp Group (SUN) also experienced earnings upgrades and a positive market response. Similarly, Telstra (TLS) saw large upgrades and a good share price bounce.

M&A: Strong balance sheets and excess liquidity is fuelling an M&A cycle. The impact on the portfolio is mixed with benefits from the Sydney Aviation Alliance bid for Sydney Airport Holdings (SYD), offset by Square Inc proposed acquisition of APT.

BHP Group (BHP)/Woodside Petroleum (WPL): The BHP /WPL deal was also a significant announcement during reporting season. The combined group will have a strong portfolio of assets, positioned low on the cost curve, with minimal debt and reasonable growth options. We believe this will look attractive in the medium term. As illustrated in the table below the combined entity has less risk and more growth at a cheaper valuation relative to Santos (STO)/Oil Search (OSH). The downside is that WPL will issue a significant number of shares to BHP shareholders, many of whom will not be long term shareholders of WPL. This is an overhang that needs to be worked through in the near term.

	WPL/BHP	STO / OSH
EV/EBITDA	4.5	4.6
EV/ 2P and 2C	3.2	3.9
Cost / BOE	11-14	11-14.7
Sovereign risk	Low	High
Gearing	12%	30%
Management reputation	Poor	Strong

Source: 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 6.38% (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 10.4% compared to 10.3% 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 15.9x compared to 20.1x 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 (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

Sale of Endeavour Group (EDV)

We have exited our position in Endeavour Group (EDV). This was a small position that resulted from the demerger with Woolworths Group (WOW) during July. Whilst operationally sound and also offering potential M&A activity as an additional growth driver, EDV has quickly traded to a full valuation of ~26x FY22e PE or ~10x FY22e enterprise value to the earnings before interest, taxes, depreciation, and amortisation (EV/EBITDA). In Consumer Staples, we retain a preference for Coles Group (COL) which offers a stronger fully franked yield. EDV remains a high quality business which we will closely monitor.

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.

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

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

Website
www.dnrcapital.com.au

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