

Australian Equities Income Portfolio

Performance Report – June 2022

Market overview and portfolio performance



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The S&P/ASX 200 Industrials Accumulation Index was down 8.05% during the period.

Consumer Staples (+0.2%) was the best performing sector, with retailers Woolworths Group (WOW +2.7%), Coles Group (COL +1.6%) and Endeavour Group (EDV +4.3%) favoured for their defensive characteristics in a potential recessionary scenario. Healthcare (-3.1%) also outperformed, with their defensive nature weathering the worst of the sell-off CSL (CSL -1.0%). Financials (-11.9%) was the worst performing sector, with their sensitivity to lower economic growth causing them to trade down. Information Technology also underperformed, with the more cyclical and expensive names Wisetech Global (WTC -10.1%), Xero (XRO -13.8%), Block Inc. (SQ2 -28.2%) leading the sector down.

The DNR Capital Australian Equities Income Portfolio outperformed the Index for the month. Key stock contributors were Woodside Energy Group (WDS), Commonwealth Bank of Australia (CBA, No Holding) and Skycity Entertainment Group (SKC). Key stock detractors were Woolworths Group (WOW, No Holding), Transurban Group (TCL, No Holding) and Lendlease (LLC).

Portfolio overview

Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before fees) over a rolling three year period
Investable universe	ASX listed securities with a focus on S&P/ASX 200 and ASX listed convertible securities
Number of stocks	15–30
Asset allocation	Australian equities 80–100% Cash 0–20%
Stock limit	15% maximum weighting
Minimum suggested investment timeframe	5 years

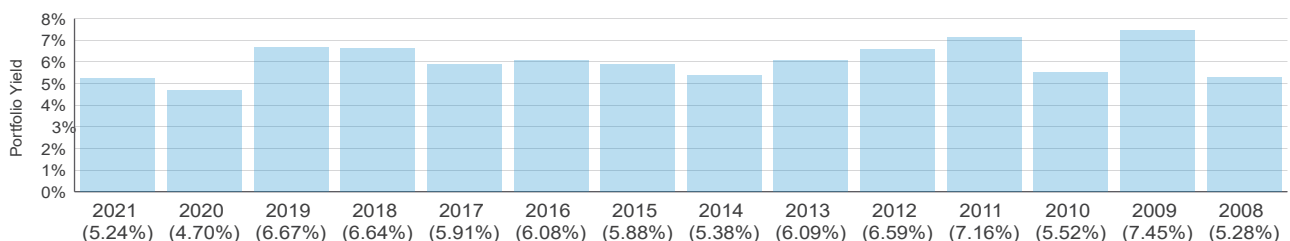
The Portfolio's dividend yield expectation for 2022 is currently 4.3% (5.8% grossed up for franking credits).

Gross active return

	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Income Portfolio	-4.15	-5.87	-3.41	3.54	9.56	8.57	8.96	13.06	7.94
S&P/ASX 200 Industrials Accumulation Index	-8.05	-11.16	-13.45	-9.18	2.18	4.89	5.68	9.83	5.08
Excess Return	3.90	5.29	10.04	12.72	7.38	3.68	3.28	3.23	2.86

* Inception date—December 2007

Grossed-up yield (calendar year)*



*Gross yield calculation uses income (including franking credits) ex-date and applies a monthly capital rebasing over the 12 month period (January to December).

Source: DNR Capital

Performance data relates to the DNR Capital model portfolio. Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators. Past performance is not an indication of future performance. No allowance has been made for taxation and fees are not taken into account.

Market review

Market overview

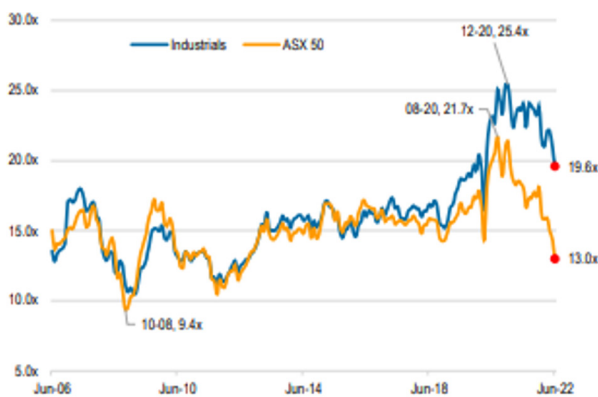
Australian equities ended the financial year weaker, with the ASX 200 Industrials Index (the strategy's benchmark) falling -8.05% in June. The decline was driven by central bank rate hikes pushing up real yields (to offset inflation) as well as rising concerns that a recession is forthcoming in late 2022 or 2023 (as interest rate expectations rise). Stagflation has become a more likely probability. However, a reprieve off lows was experienced late in the month with lower oil and commodity prices and a retreat in bond yields providing some relief for markets.

The strategy outperformed its benchmark for the month of June and for the 12 months ended FY22.

Multiple de-rate first / earnings downgrade next

The decline in stock prices has been entirely due to lower market multiples as real yields have risen. The ASX Industrials Index P/E is now at ~17x – ~4.5x turns lower this year, whilst aggregate earnings have risen >25% in FY22 and dividends added a further ~4%.

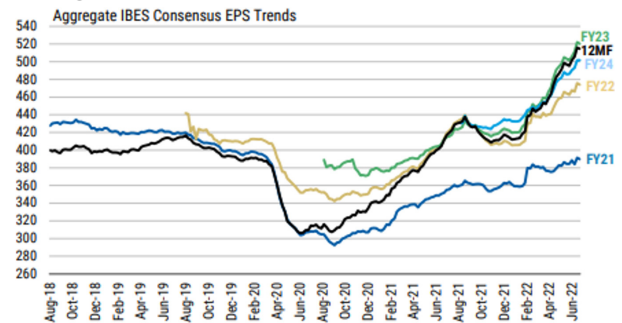
P/E 1Y Forward ASX 200 vs. ASX Industrials



Source: Bloomberg Finance L.P.

However relying on these multiples as a buy signal is fraught with danger. Earnings estimates are holding up for now and in some instances rising (e.g. energy, materials, and industrials), however we expect earnings expectations to be revised lower with reporting season in August the most likely catalyst. Whether we ultimately have a recession or not, growth is slowing and the market is worried about a recession and this concern will soon be reflected in earnings expectations.

Annual aggregate consensus EPS trends FY21 through to FY24



Source: RIMES, IBES. Morgan Stanley Research. Date as at June 23 2022.

We expect the inflation rate to decline over the course of this year as softer economic growth stymie inflationary pressures at the same time as supply-side disruptions ease. With this backdrop, it is possible that policymakers may back off on raising rates, albeit underlying inflationary pressures may still exist. There is plenty of space for policy mistakes.

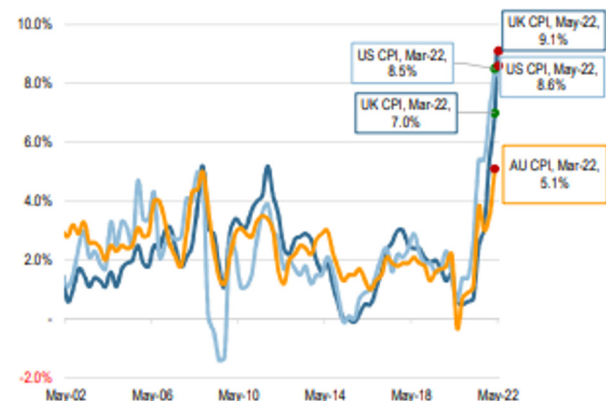
Australia still looks well positioned

The RBA has commenced its rate rising cycle. Somewhat surprisingly, markets are anticipating Australia will lift rates more aggressively than the US.

We find this very unlikely for a number of reasons:

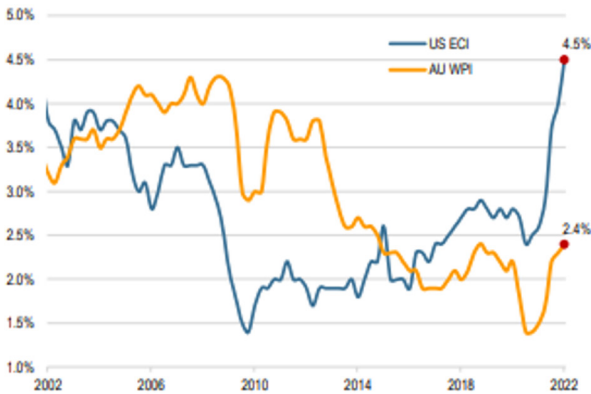
1. In comparison to the likes of the US and UK, the Australian macro backdrop looks relatively benign... Inflation is running at 5.1% (1Q22) and wage growth (1Q22) at 2.4%, both of which are below the rates being experienced in other markets;
2. We have higher levels of consumer debt (relative to the US) and housing / credit growth is highly sensitive to RBA policy changes;
3. Consumer Confidence has dipped, but is well above the likes of the US and UK; and
4. Australia is well positioned on numerous fronts, including commodity exposure and not least of all the Terms of Trade (below), which stands at a record high.

AU inflation vs. US & UK



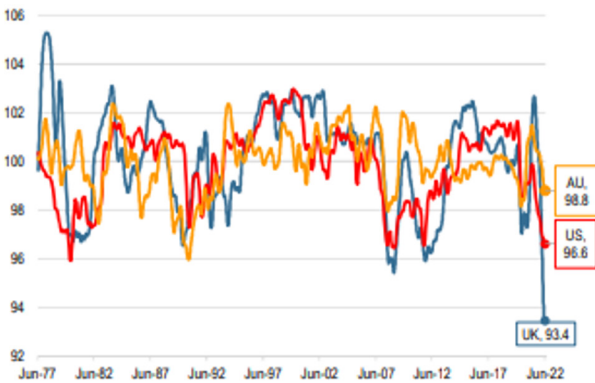
Source: J.P. Morgan, Bloomberg Finance L.P.

AU WPI vs. US ECI



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

Consumer confidence



Source: Bloomberg Finance L.P.

Consumer confidence



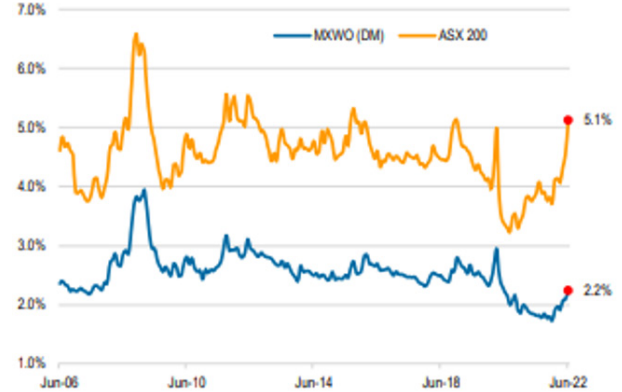
Source: Bloomberg Finance L.P.

Should the market adjust its interest rate expectations down, this would bode well for Australian equities relative to global peers.

Dividend outlook favours Resources & Energy over Banks

In terms of dividend yield, Australia continues to offer significantly higher dividend yields, with the ASX 200 at 5.1% vs Developed Markets at just 2.2%. The yield differential between the two indices is currently at a record high.

Dividend Yield – AU vs. DM



Source: Bloomberg Finance L.P.

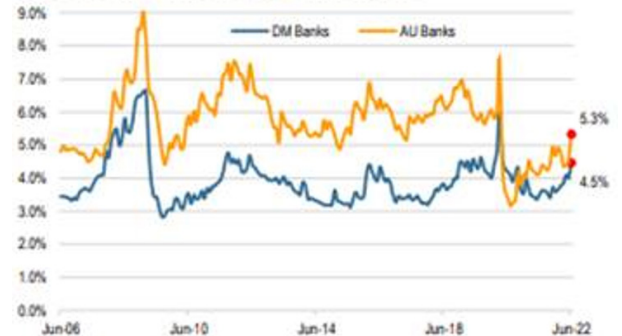
Dividend Yield – Differential between AU and DM



Source: Bloomberg Finance L.P.

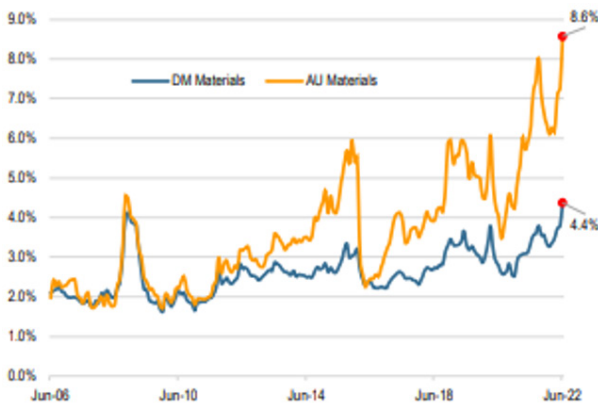
The dividend opportunity still appears to be in Resources and Energy over Banks in a historical and relative context. Our preferred exposures remain BHP Group (BHP) and Woodside Energy Group (WDS) with attractive double-digit Free Cash Flow (FCF) and dividend yields on offer.

Dividend Yield – AU banks vs. DM



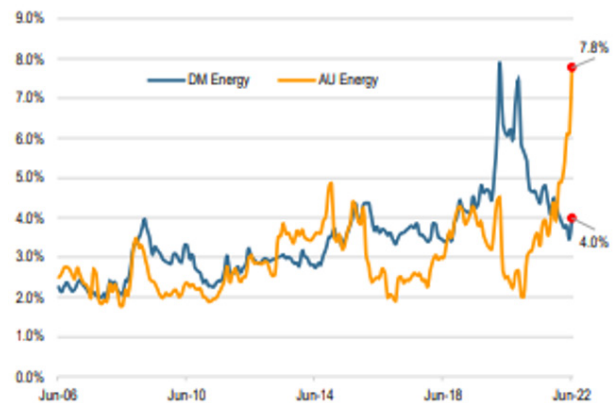
Source: Bloomberg Finance L.P.

Dividend Yield – AU Materials vs. DM



Source: Bloomberg Finance L.P.

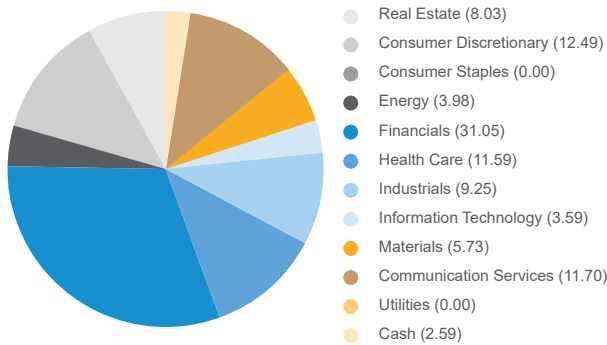
Dividend Yield – AU Energy vs. DM



Source: Bloomberg Finance L.P.

Portfolio attribution

Sector weightings %



Source: DNR Capital

Attribution

The top stock contributors for the month were:

- **Woodside Energy Group (WDS):** outperformed during the month, following continued turmoil in global energy markets. Underinvestment in the supply of fossil fuels combined with the severe disruptions caused by Russian sanctions has seen significant appreciation in energy prices. Despite the higher prices, fossil fuels capital expenditure intentions among energy companies remains low, underpinning an elongated period of undersupply going forward.
- **Commonwealth Bank of Australia (CBA, No Holding):** pullback as the market begins to fear a slowdown in housing.
- **SKYCITY Entertainment Group (SKC):** after a period of weakness, SKC rebounded over the month. While there was no material news flow for SKC, the broader casino industry continues to work through the issues identified following the review into Crown and Star.

The top stock detractors for the month were:

- **Woolworths Group (WOW, No Holding):** outperformed in-line with broader food retail stocks during the period, with food inflation trends underpinning sales growth. Metcash's full year earnings highlighted ongoing strong sales and price increases underpinning margins. WOW's valuation remains unsupportive however, with earnings risk from rising costs potentially underappreciated.
- **Transurban Group (TCL, No Holding):** outperformed with the market focused on protecting against higher inflation. TCL's portfolio has substantial inflation protection through contracted tolling agreements linked to inflation escalators. However, the stock continues to trade on EV/EBITDA multiples >20x despite interest rate expectations surging. Gearing is also substantial at ~40% and Net debt / EBITDA >8x.
- **Lendlease (LLC):** underperformed during the month as the outlook for higher rates weighed on the property sector generally. Management continues to make incremental progress towards their stated 2024 return targets with a sharpened focus on executing the existing development backlog of over \$100b.

Monthly - top contributors and detractors

Top 3 contributors		Alpha*
Woodside Energy Group	Overweight	0.70%
Commonwealth Bank of Australia	No Holding	0.64%
SKYCITY Entertainment Group	Overweight	0.54%

Top 3 detractors		Alpha*
Woolworths Group	No Holding	-0.30%
Transurban Group	No Holding	-0.29%
Lendlease	Overweight	-0.28%

12 month - top contributors and detractors

Top 3 contributors		Alpha*
Woodside Energy Group	Overweight	2.29%
Tabcorp Holdings	Overweight	0.97%
QBE Insurance Group	Overweight	0.80%

Top 3 detractors		Alpha*
SEEK	Overweight	-0.56%
Super Retail Group	Overweight	-0.45%
Transurban Group	No Holding	-0.45%

* Alpha is the portfolio return less benchmark return. These tables represent the stocks contribution of alpha to overall portfolio alpha and is determined by the stocks active weight relative to the benchmark and share price return relative to the benchmark.

Portfolio positioning

Despite the outperformance of growth (relative to value) over the last decade, the DNR Australian Equity Income Strategy has achieved its objectives and exceeded its benchmark and the broader market.

We are a quality investment manager with a neutral investment style (neither growth nor value), albeit with a robust valuation discipline.

We continue to position the Portfolio in high-quality businesses that offer a combination of growing \$ income, franking benefits and attractive valuations.

Given the uncertainty, we are maintaining a balanced portfolio across three broad thematics.

Quality defensives: Industry leading stocks that should be able to win market share regardless of the economic cycle and pass inflation onto customers (e.g. IPH, TLS).

COVID-19 recovery plays: Quality stocks that have been oversold following the negative impact of lockdowns and are early in the recovery phase (e.g. CSL, SCG)

Inflation beneficiaries: Stocks that should benefit from higher inflation and higher interest rates and where valuations are attractive (e.g. SUN, WDS).

Portfolio characteristics

We continue to position the Portfolio 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 should deliver a growing dollar income outcome through the cycle.

The Income Portfolio is expected to generate a gross yield of 5.8% (including franking) for calendar year 2022, very attractive relative to alternatives.

- The quality characteristics of the Portfolio are attractive relative to the Portfolio's benchmark:
 - 2-year forward return on equity is above the market at 11.5% compared to 11% for the benchmark.
 - 2-year forward dividend yield is 4.7% compared to the benchmark at 4.3%.
 - 2-year forward earnings growth and dividend growth expectations are in line with market growth rates at ~8% and ~7% respectively
- Despite having stronger growth and quality characteristics relative to the market, the valuation is more attractive:
 - 2-year forward PE is at 14.1x compared to 15.6x for the benchmark.
- In addition, despite the superior growth outlook, the defensive attributes of the Portfolio have been maintained:
 - 2-year forward free cash flow yield is 6.5% compared to the benchmark at 5.0%

Portfolio 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 (MQG)

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

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

Key risks

Key risks to the Portfolio include:

- **Political environment.** The crisis in Ukraine and sanctions against Russia are severely impacting commodities markets, with the potential to destabilise the region and cause global inflationary shocks. Regional tensions with China also continue to pose risks to trade.
- **COVID-19 disruption.** The development of vaccine-resistant COVID-19 variants or sustained supply chain impacts still poses risks, especially with government support mostly withdrawn.
- **Interest rates.** Low interest rates have been a primary driver of markets over the past few years. With markets now pricing monetary tightening, changes to this trajectory or further inflationary shocks would have a significant impact on valuations.
- **Global growth.** Sanctions against Russia are driving up energy prices and creating global energy security concerns. Historically, sustained price shocks in oil have impacted global growth and catalysed recessions.

Portfolio moves

Purchase of Computershare (CPU)

CPU is a global leader in registry maintenance, transfer agency services, employee share plans, corporate communications, corporate trust services and mortgage services. After listing on the Australian Stock Exchange in 1994, the company has increased its global reach by acquisition and now operates in 21 countries, servicing more than 40,000 clients and employs around 14,000 people.

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

- 1. Industry structure:** It is a global market leader in share registries and employee plan administration. It has competitive strengths as a result of its scale and IT leadership. The mortgage business (20%) is of lower quality but represents a potential growth opportunity.
- 2. Earnings strength:** Despite recent weakness, CPU continues to earn an attractive return on equity (ROE) of 20-30%.
- 3. Balance sheet:** Is solid with FY23e ~1x net debt to earnings before interest, tax, depreciation and amortisation (ND/EBITDA) and a ~4x covenant.
- 4. Dividend sustainability and growth:** CPU has low capital intensity and thereby is strongly cash generative with a free cashflow yield in the high-single-digits. Current dividend yield is 2-3%, however we expect a double-digit compound annual growth rate (CAGR) through to FY25.
- 5. Management:** Is highly regarded driving efficiency and allocating capital effectively.
- 6. Environmental, social and governance (ESG):** Risk is largely regarding privacy and handling data and in this regard, CPU has a long history and is a market leader.

Risks:

- 1. FX volatility:** With CPU operating in 21 countries, reporting in USD while maintaining an Australian listing, the company is exposed to multiple FX movements.
- 2. Changes in interest rate expectations:** Margin income represents a significant component of earnings and is the product of benchmark interest rates and the level of client held balances. Change in interest assumptions, or indeed the structure and quantum of balances present a risk to our investment thesis.
- 3. Global investment sentiment:** While CPU has limited equity market linked revenue, negative investment market sentiment can impact activity levels with particular reference to mergers and acquisitions (M&A), corporate actions and project work.
- 4. Loss of material contract or mandate:** CPU's revenue base includes integrated contracts across a number of business units. Contract losses in one business stream could impact a number of different business units as a result.

- 5. Wage inflation:** A significant component of CPU's cost base relates to staff costs. Wage inflation has been noted by the company as impacting the FY21 results. In addition, remote working environments have the potential to create staff retention issues

Valuation

Near term PE's of 25-30x are misleading given the expected recovery in earnings over the next 2-3 years (>100% EPS growth). The FY24e PE of ~15x, is attractive relative to history and given upside skew to consensus earnings.

Conclusion

CPU is much more than a play on interest rates, with a reliable revenue base backed by multi-year contracts and significant market presence in chosen markets. Our positive view is driven by a number of factors, including: 1) the reliability of CPU's revenue base given 76% recurring revenue, 2) expected growth in margin income from higher interest rates, 3) the acquisition of the Corporate Trust business, 4) a potential rebound in mortgage services, and 5) operational synergies.

Purchase of Rio Tinto (RIO)

We have increased our exposure to the Resource and Energy sectors by adding RIO to the portfolio.

Whilst iron ore represents ~60% EBITDA contribution in FY23e, RIO also has an attractive exposure to Aluminium. This is complementary with the portfolio's position in BHP Group (BHP) which is also exposed to Copper.

Both diversified miners are trading well below historical EBITDA multiples and are expected to deliver double-digit free cash flow yields over FY22 and FY23 that are largely being paid out as dividends. Some capital management potential also exists with significantly de-leveraged and strong balance sheets. Management has been applying prudent capital allocation frameworks and increasing yields to shareholders in the absence of high returning projects.

The key downside risks to our projected earnings, cash flows and target price relate to weaker-than-expected commodity prices/economic growth and currency fluctuations. We are remaining prudent by investing in high quality miners with top quartile assets. Operating risk in BHP and RIO is lower than for smaller metals and mining companies with fewer operations. They also have a diversified commodity exposure and are in a strong financial position which reduces the equity risk. Current share prices are supported by discounted cash flow (DCF) valuations applying long-term commodity assumptions (well below current spot prices).

Sale of Amcor PLC (AMC)

Following a period of strong outperformance, we have exited our position in AMC. The packaging sector has fared well given its defensive attributes, however this now sees AMC trading at ~16x FY23e PE, a 10-15% premium to its US peers at ~14x and a fair valuation. We have deployed proceeds to top-up our existing position in Tabcorp Holdings (TAH) following the demerger. The improving industry structure for wagering sees the stock attractively positioned on a risk / return basis.

Purchase of Steadfast Group (SDF)

SDF is Australasia's largest general insurance broker network and underwriting agency group with 473 general insurance brokerages across Australia, New Zealand and Singapore, with a portfolio of 26 underwriting agencies. The group also provides complementary services such as Steadfast Technologies. Through the SDF Network, insurer partners have access to ~\$10bn of gross written premium (GWP), predominantly from the SME market. SDF also has a 60% interest in global general insurance broker unisonSteadfast which is separate from the Steadfast Network and offers multijurisdictional coverage across 135 countries.

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

- 1. Industry structure:** SDF's scale means it has buying power with insurers. One third of intermediated GWP is on its network. It passes on higher prices to customers and during periods of falling prices offsets via increasing insurance levels or charging fees for getting client's better outcomes. Its offering for advisers depends on their buying power plus their offering. SDF's systems are a differentiator relative to competitors and offers data insights which allows brokers to segment client base and potential needs.
- 2. Earnings strength:** SDF has historically delivered double-digit earnings growth driven by both organic growth and acquisitions. As the Australian commercial premium rate cycle continues to mature and SDF executes its trapped capital strategy, near-term tailwinds appear robust. Over time the rate cycle will ultimately turn and the pool of domestic acquisitions will decline. However, offshore opportunities can provide new avenues for organic and inorganic growth. Opportunities include monetisation of its global network (unisonSteadfast), and introducing the client trading platform (SCTP) in large offshore markets such as the US. These growth drivers are primarily organic, requiring limited capital outlay, and uniquely differentiate SDF's growth options vs peers.
- 3. Balance sheet:** Net debt to earnings before interest, taxes, depreciation and amortisation (ND/EBITDA) of ~0.5x leaves it well placed to pursue growth through acquisitions.
- 4. Dividend sustainability and growth:** Defensive and strong free cash flow generation delivering high single digit free cash flow yields, a dividend yield of ~3% (plus 100% franking) and growth of >10% pa. The stock sits neatly in between the 'Compounder' and 'Grower' dividend categories we define.

5. Management: Outstanding management who have done a great job for the past two decades, albeit there is meaningful key man risk, with CEO Robert Kelly critical in the formation and transformation of SDF.

6. Environmental, social and governance (ESG): Not a high risk proposition unless SDF is overselling policies which seems like a modest risk.

Risks:

- 1. Insurance cycle:** A sharp downturn in the insurance cycle could affect revenues, although we note that, to some extent, the company can insulate itself by increasing fees.
- 2. Personnel changes:** Key man risk, with CEO Robert Kelly critical in the formation and transformation of SDF. More broadly, if there is meaningful loss of key staff within the brokers/underwriting agencies SDF operates, this could affect earnings.
- 3. Expansion/acquisitions:** Offshore expansion and acquisitions may prove not to be as accretive as expected.

Valuation

The 2-year forward PE of ~21x is attractive relative to history and given upside skew to consensus earnings due to further mergers and acquisitions (M&A) activity. We think little to no value is ascribed to offshore network monetisation and the potential for SCTP international expansion. After lifting its equity stake in unisonSteadfast (unison) to 60%, SDF has positioned key executives to replicate its Network economics offshore. The size of unison is >AUD\$50bn by GWP, more than 5x current Network. SDF is exploring the feasibility of expanding the SCTP offshore in the US. Collectively, this signals much stronger long-term growth prospects which we believe are not factored into the stock.

Conclusion

SDF's earnings stream is highly defensive, with strong free cash flow generation. EPS growth of >10% p.a. is likely in the medium term, driven by: 1) organic GWP growth; 2) efficiency improvements through back-office automation and broker practice consolidation; 3) future acquisitions of small brokers, likely on accretive terms; and 4) a relatively defensive business profile.

Investment strategy

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

The Australian Equities Income Portfolio also has a preference for securities that have high and sustainable dividend capability, strong profit-to-cash conversion, and relatively assured earnings growth. Securities that generate franking credits predominate.

We define quality businesses as being those with the following six attributes:

- earnings strength (particularly improving return)
- superior industry position
- a sound balance sheet
- strong management
- low environmental, social and governance (ESG) risk
- Income sustainability / growth

The focus of the Portfolio is on yield. We are focused on a growing, sustainable dividend yield above the market.

Where we are satisfied that a security 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 business being assessed to identify mispriced opportunities.

The Portfolio construction process is influenced by a top-down economic appraisal and also considers the risk characteristics of the Portfolio, such as security and sector correlations.

Investment philosophy

DNR Capital believes a focus on quality businesses will enhance returns when it is combined with a thorough valuation overlay. We seek to identify quality businesses that are mispriced by overlaying a quality filter, referred to as the 'quality web', with a strong valuation discipline. The Portfolio is high conviction and invests for the medium term.

Platform access

- AMP My North
- BT Panorama (Direct, Compact and Full)
- Colonial First State FirstWrap
- Federation Alliance
- HUB24
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium
- Wealthtrac

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