

DNR Capital Australian Equities Income Portfolio

Performance Report February 2023

Performance

The DNR Capital Australian Equities Income Portfolio outperformed the S&P/ASX 200 Industrials Total Return Index by 0.44% in February. The Portfolio's dividend yield expectation for 2023 is currently 3.5% (4.5% grossed up for franking credits).

Gross active return as at 28 February 2023

	1mth %	3mth %	1yr %	3yr p.a. %	5yr p.a. %	7yr p.a. %	10yr p.a. %	Incep.* p.a. %
Income Portfolio	-0.53	1.53	9.66	11.78	10.13	10.92	10.75	8.30
S&P/ASX 200 Industrials Total Return Index	-0.97	0.51	5.15	5.04	6.26	8.04	7.89	5.63
Excess return	0.44	1.02	4.51	6.74	3.87	2.88	2.86	2.67
Income Portfolio dividend yield incl. franking credits¹	0.70	0.71	5.85	5.88	6.46	7.33	8.06	7.14
Franking %	59.5	59.5	80.0	75.0	74.9	73.6	73.0	71.5

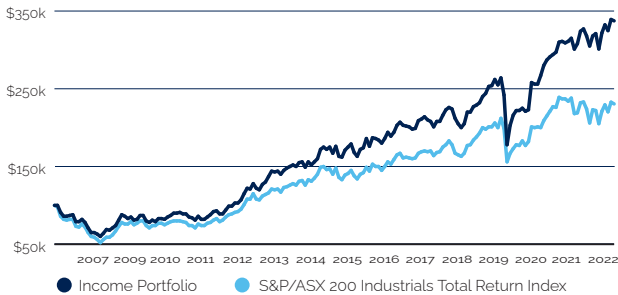
*Inception date—December 2007.

Source: DNR Capital

¹ Portfolio income yield calculated as the sum of all income received over the period divided by the capital base at the start of the period and uses income sources ex-date (including franking credits).

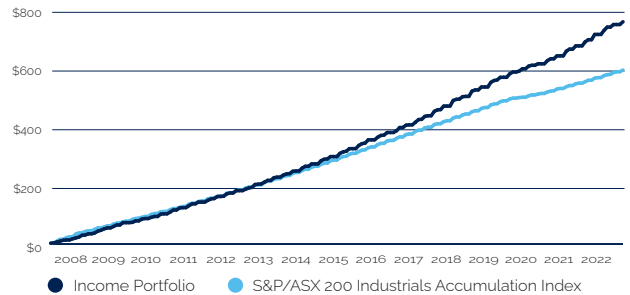
Performance data relates to the DNR Capital model Portfolio. Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators.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

Growth of \$100,000 since inception



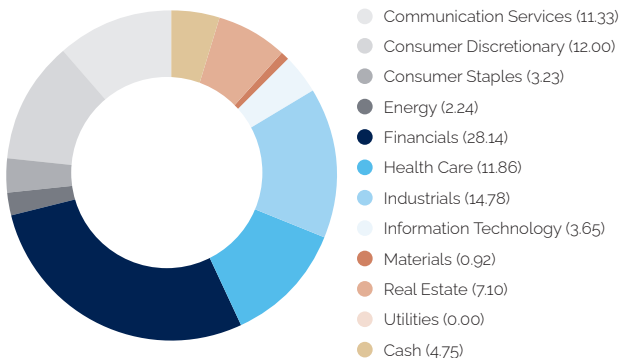
Source: DNR Capital

Accumulated income from \$1,000 since inception



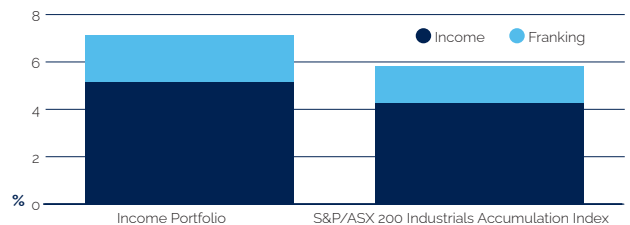
Source: DNR Capital

Sector weightings %



Source: DNR Capital

Income yield incl. franking credits since inception



Source: DNR Capital

Experienced portfolio managers



Jamie Nicol
Chief Investment Officer



Scott Kelly
Portfolio Manager

Top 5 active holdings

Security details

The Lottery Corporation (TLC)

QBE Insurance Group (QB=E)

IPH (IPH)

TPG Telecom (TPG)

Suncorp Group (SUN)

Monthly top contributors and detractors

Top 3 contributors		Alpha*
Commonwealth Bank of Australia	No Holding	0.67%
The Lottery Corporation	Overweight	0.44%
QBE Insurance Group	Overweight	0.38%
Top 3 detractors		
Domino's Pizza Enterprises	Overweight	-0.89%
Aurizon Holdings	Overweight	-0.23%
Lendlease	Overweight	-0.22%

* 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.

Contributors

- **Commonwealth Bank of Australia (CBA, no holding):** delivered a strong result but was in line with expectations and highlighted that interest margins have peaked with competition for mortgages and deposits increasing.
- **The Lottery Corporation (TLC):** outperformed over the month after reporting continued strong trading in the lotteries business. Volumes will fluctuate with jackpot sequences however, underlying trends should support continued solid growth.
- **QBE Insurance (QBE):** delivered a result 20% above expectations with strong price growth and improving claims performance. With the stock cheap going into the result, it has performed well.

Detractors

- **Domino's Pizza Enterprises (DMP):** content underperformed following a surprisingly weak earnings result, with efforts to offset inflation failing to gain traction across the network, despite earlier suggestions these efforts were working. Following raised prices and delivery surcharges, volumes rapidly declined, impacting store profitability and rollout progress. Whilst we have reduced our exposure, the result raises questions on the business model, requiring further research.
- **Aurizon Holdings (AZJ):** management downgraded earnings guidance for FY23 by -4% primarily due to poor weather, a derailment and new investment. Management advised it expects to pay dividends at the bottom end of the payout range over the near term as it invests for growth within the Bulk division. These are mainly one-off and the Network division will recover lost earnings over the next couple of years.

- **Lendlease (LLC):** underperformed during the month as the outlook for higher rates weighed on the property sector in general. Management continues to make incremental progress towards the stated 2024 return targets with a sharpened focus on executing the existing development backlog of over \$100bn.

Portfolio and market review

The S&P/ASX 200 Industrials Total Return Index was down 0.97% during the period. As central banks continue their attempt to curb inflation, stronger than expected economic data led to expectations of higher interest rates. This led to an increase in real bond yields, which in turn, led to a decline in valuations.

Utilities (+2.3%) was the best performing sector, following an improved takeover offer presented to Origin Energy (ORG +9.4%), allaying fears that the deal would fall through. Information Technology also outperformed (+2.2%), with key constituents Computershare (CPU +5.7%) and WiseTech Global (WTC +4.1%) benefitting from higher cash rates and reporting a key customer contract, respectively. Financials (-3.8%) was the worst performing sector, with the banks reporting a weaker outlook for loan growth as well as increasing signs of stress in their loan books. Consumer Discretionary also underperformed, following some disappointing results from retailers (Harvey Norman Holdings, HVN -13.9% and JB Hi-Fi, JBH -9.5%) which highlighted a faltering consumer in housing-related categories.

Reporting season observations

The February 2023 reporting season showed few signs of any significant slowdown in demand. Operating costs were elevated and trading updates were mixed. Overall, there was little clarity provided on the outlook for the economy, although there were more misses than beats, which perhaps does not bode well for the outlook.

1. Caution on the outlook. Most companies acknowledged that the economy was shifting toward a more challenging environment.
2. Labour constraints remain topical. Many companies are struggling to find labour and are seeing labour cost increases.
3. Easing supply chains. As shipping costs and energy input costs fall.
4. Housing activity is slowing. Not surprisingly, higher interest rates have caused housing activity to slow for a range of builders and developers.
5. Bank margins are peaking. Banks have enjoyed a very good year for profitability with bad debts very low, customer savings high and rapidly rising interest rates yielding more on customer deposits than normal. We saw evidence of customers switching transactional deposits to higher interest paying accounts and greater competition in mortgages, suggesting a tighter margin environment later in the year.
6. Insurance companies enjoying strong results as prices lifted to offset higher catastrophes.
7. Consumer stocks displayed mixed trends. Consumer staples were generally solid, and discretionary companies such as Super Retail Group (SUL) and

Wesfarmers (WES) performed well. Others, like Breville Group (BRG) noted a cautious consumer.

8. Higher interest costs for companies with large debt balances presented new challenges.
9. Payout ratios. Companies remain cautious on lifting payout ratios to pre-COVID-19 levels, preferring to use buybacks to return cash. With commodity prices down, resource dividends are expected to be 15-20% lower compared to last year's record levels.
10. Quality business models stood out in terms of the ability to pass on inflation and lift prices – CSL (CSL), SEEK (SEK), and Carsales.Com (CAR).

Best results

QBE Insurance (QBE) – recorded a solid result as management's efforts to improve consistency paid off. Higher premium growth combined with higher investment returns (from higher interest rates) delivered strong outcomes for the period.

Qube Holdings (QUB) – also delivered a strong result with above market expectations and an improved outlook. Operationally, it was successful in passing on prices, continuing to benefit from elevated demand and tight supply conditions in logistics.

Worst results

Aurizon Holdings (AZJ) – management downgraded earnings guidance for FY23 by -4% primarily due to poor weather, a derailment and new investment. Management also advised it expects to pay dividends at the bottom end of the payout range over the near term as it invests for growth within the Bulk division. These are largely one-off in nature and the Network division will actually recover lost earnings over the next couple of years.

Domino's Pizza Enterprises (DMP) – earnings result disappointed with efforts to pass on inflation failing across the network. Delivery surcharges and poor execution resulted in customers trading down and volumes declining. The company is now revisiting its pricing strategy to reinvigorate customer demand. The market now questions its ability to execute successfully in a tighter inflationary environment.

Banks positioning

The big 4 banks all reported strong financial updates and are well placed to deliver their strongest revenue growth in over a decade. They have been enjoying the benefit of Net Interest Margin expansion as interest rates have been rising, whilst deposit rates have remained low. Customer savings rates are also high, with bad debts still very low. However, this is already captured in market expectations for FY23.

Beyond this, we expect trends to moderate for several reasons:

1. The tailwind from higher interest rates appears to be coming to an end. The Commonwealth Bank of Australia (CBA) result showed that monthly net interest margins may have actually peaked last October.
2. Mortgage growth is slowing (due to uncertainty in the property market), and in response, banks' pricing competition appears to be stepping up.
3. We are expecting increased competition in deposits, and are already seeing evidence of customers switching out of savings accounts and transactional deposits to higher interest paying accounts.
4. Low cost funding from the federal government's Term Funding Facility (or TFF) becomes due over the June, September and December quarters of 2023 and will need to be replaced with more expensive wholesale funding.
5. Inflation pressures continue to put pressure on the cost base and people still account for 2/3rds of the cost base.
6. Asset quality will be under pressure as consumers struggle with higher interest rates and in our view the risk of higher bad debts is rising.
7. The likelihood of increased political scrutiny as consumers face increased challenges.

Our preference is for the business banks over the retail banks. Small and Medium-Sized Enterprise (SME) competition surprisingly appears to be contained, relative to retail. NAB remains our preferred exposure. We believe it is better placed than peers and executing well. ANZ Group Holdings (ANZ) and Westpac Banking Corp (WBC) are both the value alternatives amongst the big 4, however, are executing poorly. Both trade at ~1x Price / Book and offer gross dividend yields of almost ~7%. CBA is generating better returns on equity and deserves a premium, however at >2.2x Price / Book, is just too expensive.

About DNR Capital and the Portfolio

Concentrated: Investing in 15-30 highest conviction, Australian listed equities. Concentrated portfolios of quality companies maximise the opportunity for outperformance.

Style neutral and quality focussed: A disciplined approach to quality and valuation.

Dual investment objective: Acknowledging the value of both income and capital, this strategy focuses on delivering a high level of tax effective income, that grows over time, in addition to growing the investors capital.

A diversified set of opportunities: At DNR Capital, we categorise income generating companies as:

- **Growers:** A company that is delivering below market income in the short term, however is expected to deliver above market income growth over the long term.
- **Compounders:** A company that is delivering a market level of income, with the potential to deliver above market income growth on a sustainable basis.
- **Cows:** A company with a solid balance sheet and capital management potential that is being undervalued on traditional earnings-based metrics.
- **Yielders:** A company that is delivering sustainable and cash-backed dividends, however with minimal (or no) income growth.

Experienced and aligned team: The portfolio managers have more than 45 years of combined investment experience and are invested alongside our clients.

Proven process: DNR Capital was established in 2001 and a consistent firm-wide investment process has delivered more than 19 years of investment outperformance.

Disclaimer

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