

# Australian Equities Income Portfolio

## Performance Report – August 2022

### Market overview and portfolio performance



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The S&P/ASX 200 Industrials Accumulation Index was down -0.42% during the period.

Communications (+1.2%) was the best performing sector, with key constituents Telstra Corporation (TLS +2.1%) and REA Group (REA +2.0%) beating expectations of a weaker outlook. Industrials (+1.0%) also outperformed, with economic activity holding up better than feared. A strong recovery from Qantas Airways (QAN +16.7%) also helped the sector higher. Property (AREITs) (-3.6%) was the worst performing sector, as bond rates moved higher and property values came under pressure. Consumer Staples (-2.7%) also underperformed, with defensive names trading at higher multiples failing to deliver convincing results (Woolworths Group (WOW) -3.8%, Coles Group (COL) -6.4%).

The DNR Capital Australian Equities Income Portfolio outperformed the Index for the month. Key stock contributors were IPH (IPH), Woodside Energy Group (WDS), BHP Group (BHP). Key stock detractors were TPG Telecom (TPG), SEEK (SEK) and Wesfarmers (WES, no holding). The Portfolio's dividend yield expectation for 2022 is currently 4.1% (5.5% grossed up for franking credits).

### Portfolio overview

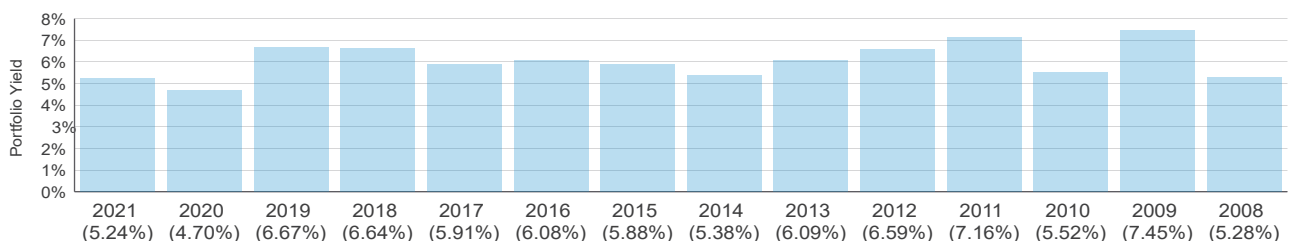
Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before 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

### Gross active return

	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Income Portfolio	0.82	1.02	4.36	3.50	9.56	10.14	10.21	12.50	8.23
S&P/ASX 200 Industrials Accumulation Index	-0.42	-0.97	1.25	-7.08	3.93	6.71	7.23	9.71	5.55
<b>Excess Return</b>	<b>1.24</b>	<b>1.99</b>	<b>3.11</b>	<b>10.58</b>	<b>5.63</b>	<b>3.43</b>	<b>2.98</b>	<b>2.79</b>	<b>2.68</b>

\* 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

The ASX200 Industrials Accumulation Index (the strategy's benchmark) fell -0.4% in August, however outperformed other developed markets over the month. Fed Chair Powell's much anticipated Jackson Hole speech was hawkish and led to a global risk-off move in equities. The DNR Australian Equities Income Portfolio outperformed its benchmark assisted by positions in Resource and Energy stocks, which were the best performing sectors. Ongoing tightness in European gas markets and persistent concerns that Russian supply could be reduced further has driven European gas prices higher.

### Reporting season key takeaways

Reporting season was generally positive with earnings slightly ahead of expectations. The ASX 200 Industrials delivered +7% EPS growth during FY22. Companies continue to manage challenges from labour shortages, inflation and COVID-19 disruptions. In addition, the consumer remains resilient despite concerns about rate hikes, falling home prices and the rising cost of essentials. However, we are cautious not to extrapolate given we are in the middle of an earnings downgrade cycle and central banks continue to tighten to slow inflation.

Given macro headwinds, we expected guidance to be conservative and when it was provided, it was. The revisions to dividends are relatively consistent with the downgrades to earnings since the beginning of July, down 2-3%. We also saw a rise in the number of buyback announcements highlighting limited mergers and acquisitions (M&A) opportunities and strong balance sheets.

### Other key thematics include:

- labour shortages and increasing labour costs continue to be a headwind;
- supply chain bottlenecks and logistics costs are starting to normalise;
- elevated inventory levels remain a focus with risk of destocking and discounting if demand should fall away; and
- higher interest costs are also having an impact.

### Interesting results included:

IPH (IPH): reached an agreement to acquire Smart & Biggar, the largest IP agency firm in Canada, for A\$387m and is expected to be at least ~10% accretive. In addition, this provides a solid platform for further accretive M&A in the region. The deal will be predominantly cash and debt funded, bringing IPH's pro-forma net debt/EBITDA to ~1.8x. The underlying FY22 result was a slight beat, driven by margin improvement with patent volumes in-line with expectations. ANZ benefited as integration and realisation of cost synergies progress.

Qube Holdings (QUB): despite COVID-19 disruptions to staff, extreme weather events and other supply chain disruptions, QUB was able to post underlying EPS growth of ~32%. Management demonstrated that they were able to offset inflationary pressures through higher prices, which has been a key debate for the stock. FY23e guidance was for further growth across all operating

divisions. Full year contributions from NAT, Bluescope and Harvest Co should benefit QUB, while pricing at the end of the period in Patricks appears to be improving at a high single-digit run rate. Additionally, volume outlooks for commodities and grain look solid and the potential reversal of one-off impacts should help bulk margins. After the remaining \$300m of Moorebank proceeds are received, QUB's balance sheet will be geared below 20% versus its target gearing of 30-40%, providing the company significant flexibility.

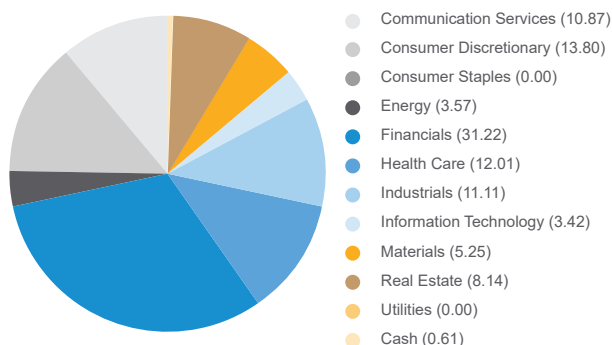
SEEK (SEK): provided a strong update with the core Australia and New Zealand business delivering extremely strong revenue growth in FY22 of +53%. Volume growth was strong in Australia and New Zealand +40% year on year in 2H with job ads at all-time highs, and total yields contributing a further 14%. Margins were impacted, however, by higher costs to unify software platforms, and Latin American losses. Guidance was well ahead of market expectations but was based on existing volumes remaining at current levels and so was perceived as having downside risk. Australia and New Zealand volumes and revenues continue to exceed expectations, but so does the cost base, reflecting the groups ongoing commitment to investing. Questions exist around the size of the investment required to capitalise on SEK Asia's opportunity, which is a focus of management but hinges on execution. The main question for the market is the extent of a slowdown in job numbers. We believe SEK's core domestic monopoly can continue growing earnings over the longer-term and is priced for slower job listings. We view its current valuation as the most attractive it has been in several years.

Telstra Corporation (TLS): FY22 results were slightly ahead of consensus and FY23 guidance was in-line with expectations. However, the 2H22 dividend of 8.0cps was higher than expectations and provides confidence that management believe it can grow from here. Longer-term ambitions were also maintained with the T25 target upheld for mid-single digit EBITDA CAGR (excluding acquisitions) to FY25.

TPG Telecom (TPG): the 1H22 result was ~6% lower than consensus. One-off restructure costs accounted for about half the miss, however operating costs were only down A\$5m on pcp despite the company targeting A\$125-\$150m of synergies. Other key drivers (including mobile subscriber growth, fixed wireless subscriber growth, mobile ARPU's and roaming revenue recovery) showed positive momentum, albeit at a slower pace than we and the market had hoped and expected. In addition, the ACCC decision on the MOCN deal is now expected 2 December 2022 (previously October 2022) with further slippage probable assuming Optus appeal. At the end of the day, there was limited change to the medium-term outlook of the business and whilst the original investment thesis remains intact, it is now clear this will likely play out over a longer horizon.

## Portfolio attribution

### Sector weightings %



Source: DNR Capital

### Monthly - top contributors and detractors

Top 3 contributors		Alpha*
IPH	Overweight	0.39%
Woodside Energy Group	Overweight	0.30%
BHP Group	Overweight	0.21%

Top 3 detractors		Alpha*
TPG Telecom	Overweight	-0.43%
SEEK	Overweight	-0.19%
Wesfarmers	No Holding	-0.12%

### 12 month - top contributors and detractors

Top 3 contributors		Alpha*
Woodside Energy Group	Overweight	2.73%
Tabcorp Holdings	Overweight	1.16%
Afterpay	No Holding	0.90%

Top 3 detractors		Alpha*
Commonwealth Bank of Australia	No Holding	-0.88%
SEEK	Overweight	-0.64%
SKYCITY Entertainment Group	Overweight	-0.29%

\* 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.

### Attribution

The top stock contributors for the month were:

- **IPH (IPH):** outperformed during the period, following a solid result and an international acquisition. The addition of Smart & Biggar, a Canadian IP specialist law firm, represents IPH's first foray outside Asia and is expected to increase the network effect of its business, providing revenue synergies and cost-out opportunities.
- **Woodside Energy Group (WDS):** outperformed during the period, as energy prices recovered from their setback last month. The outlook for energy markets remains tight, with Russian supply impacted by sanctions and an elongated period of underinvestment reducing the ability of the rest of the producing world to respond.
- **BHP Group (BHP):** outperformed over the month as concerns over weakness in the Chinese real estate market were offset by continued signs that Chinese policy makers are committed to policy easing to stimulate demand.

The top stock detractors for the month were:

- **TPG Telecom (TPG):** 1H22 result was ~6% lower than consensus. One off restructure costs accounted for half the miss. Other key drivers (e.g. mobile subscriber growth, fixed wireless subscriber growth, mobile ARPU's and roaming revenues) showed positive momentum, albeit at a slower pace than market expectations.
- **SEEK (SEK):** FY22 earnings were slightly lower than consensus but within the guided range. Whilst FY23e guidance was strong (EBITDA growth >15%), management provided a caveat that it is contingent on current job ad levels being maintained into FY23. Whilst likely to be conservative, such commentary appeared to be a glass half full view on the economic outlook.
- **Wesfarmers (WES, no holding):** released a strong FY22 earnings results, beating expectations driven by its Kmart division and strong outcomes for its industrials businesses. Bunnings and Officeworks are beginning to moderate some benefits experienced during the pandemic, and despite a more reasonable valuation we remain cautious on a normalisation of consumer spending.

## 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 Strategy 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 5.5% (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 11.8% compared to 11.5% for the benchmark.
  - 2-year forward dividend yield is 4.5% compared to the benchmark at 4.0%.
  - 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 14.9x compared to 16.6x 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 5.9% compared to the benchmark at 5.1%.

## 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.

## Stock moves

### Purchase of Auckland International Airport (AIA)

AIA is the premium gateway asset to New Zealand with a significant freehold land bank of 1,500 hectares. In FY2019, AIA serviced >21m domestic and international passengers. The airport is well positioned to continue to service international passengers, given its geographical proximity to key markets, population size and lack of operational constraints.

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

1. **Industry structure:** Monopoly asset positioned at centre of New Zealand's economy for domestic and international tourism and business travel. In CY2019, AIA serviced ~77% of all international passengers to New Zealand. Air NZ accounts for majority of passenger traffic at airport. AIA's business is divided into two streams – aeronautical, which is subject to economic oversight by the NZ Commerce Commission – and non-aeronautical, which is not subject to oversight.

- 2. Earnings strength:** AIA is forecast to return to profitability in FY23 and passenger volumes (PAX) to return to 100% of pre-pandemic over FY24- 25. Earnings will also be underpinned by a strong recovery in aeronautical revenue and retail income, development completions in logistics, hotel and retail and a normalisation of earnings before interest, taxes, depreciation and amortisation (EBITDA) margin at 75-77%.
- 3. Balance sheet:** AIA has an A- Stable credit rating, based on FFO/net debt strength (AIA has minimal capex commitments at present). AIA's FFO/net debt is forecast to return to well above its 11% FFO minimum threshold during FY24 (i.e. 20%+). AIA has renegotiated its interest coverage ratio covenant three times in two years with its bank syndicate. The most recent change has resulted in an extension of its dividend locker until 31 Dec 2022 (previously 31 Dec 2021).
- 4. Dividend sustainability and growth:** We expect AIA to reinstate dividends during FY23. AIA has a conservative dividend policy with 100% earnings per share (EPS) payout. FY25e (normalised) dividend yield is 2-3% and growth will typically average 8-10% pa, post stabilisation of international PAX. Normalised free cash flow (FCF) yield is higher at 4-5% pa.
- 5. Management:** Carrie Hurihanganui has been Chief Executive of AIA since February 2022. Carrie has over 22 years of operational and strategic experience in the aviation industry, having held several senior roles at Air New Zealand (including Chief Operating Officer), leading customer experience transformation, maximising business growth and building high performing and engaged teams.
- 6. Environmental, social and governance (ESG):** AIA are a responsible entity in balancing ESG interests and emphasise diversity, governance and environmental factors in its decisions. The 'Social' and 'Governance' parts of ESG are generally not an issue. It also works with carriers on emissions intensity of their operations and seeks to reduce the carbon footprint of its business activities.

### Risks

The largest risk to earnings is the potential for ongoing disruption to travel recovery. Related to this is the potential for a deterioration of the political relationship with China, as well as regulatory changes, movements in bond yields and foreign exchange risk.

### Valuation

We estimate AIA is trading on a normalised ~16x EBITDA multiple (post COVID-19 recovery / post new pricing regime), compared to a historical average of ~20x. We expect AIA to generate a free cash flow yield of 4-5% growing at 8-10% pa. AIA's total property portfolio is held at a book valuation of NZ\$2.1bn under investment properties however is conservatively valued at >\$3bn.

### Conclusion

AIA is a quality asset that is the early stages of recovery following significant COVID-19 disruption. We expect increasingly positive news flow as borders reopen, travel restrictions are reduced and airlines increase capacity. Inflation protection is embedded through its regulated asset base and the regulatory process. There is upside

risk to passenger forecasts and regulatory parameters which could see much higher revenue and earnings than currently assumed by the market.

### Purchase of Domino's Pizza Enterprises (DMP)

Domino's Pizza Enterprises operates retail and food outlets, primarily through franchised operations across ANZ, Europe and South East Asia. The group owns the Master Franchise for twelve countries and maintains a network of 3,400 stores.

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

- 1. Industry structure:** DMP operate in the Quick Service Restaurant market in Australia, Europe and Asia. Whilst this market is highly fragmented DMP maintains a competitive advantage by virtue of scale and brand. Globally the group have a large advantage in home delivery, with the business has been tailor specific for delivery for several decades.
- 2. Earnings strength:** DMP has a return on equity of 42% and is forecast to grow earnings per share of 17% compound annual growth rate (CAGR) over three years, through a combination of store rollout, comparable sales growth and acquired regions.
- 3. Balance sheet:** DMP's balance sheet is sound with forecast FY23 3.7x net debt/EBITDA and interest cover ratio of 12x. Australian Equities Income Portfolio Changes.
- 4. Dividend sustainability and growth:** DMP is forecast to grow its dividend at 15% CAGR over three years with an 80% payout ratio.
- 5. Management:** We view management are strong, long tenured and brought up through the business. Founder Dom Meij remaining as CEO, with regional heads having decades of experiences with in the dominos system.
- 6. Environmental, social and governance (ESG):** DMP have higher ESG risk evidenced by wage underpayment issues in 2017, alongside social concerns around obesity and waste. Engagement with the group gives us confidence risks are being better managed through dedicated ESG capabilities and evolving sustainability reporting.

### Risks

The largest risk to earnings are from global food inflation which impact franchisee profitability, potentially slowing store rollout plans.

### Valuation

DMP currently trade at ~26x FY24 PE, lower than its longer-term average and attractive for 17% CAGR EPS growth. Our discounted cash flow (DCF) values the group at \$93.5 per share.

### Conclusion

DMP offers compelling valuation for a long runway of earnings growth through store rollouts, comparable sales growth and new region acquisitions. With an entrepreneurial and tenured management team, we believe the company can leverage a proven business model to reliably compound earnings and dividends for the foreseeable future.

## 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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