Australian Equities Income Portfolio

Performance Report – December 2021

Market overview and portfolio performance

Scott Kelly
Portfolio Manager

Jamie Nicol
Chief Investment Officer

The S&P/ASX 200 Industrials Accumulation Index was up 1.84% during the period.

Utilities (+6.9%) was the best performing sector, as higher energy prices and the persistence of investor interest in utility and infrastructure assets saw the sector well supported. Financials (+4.3%) also outperformed with the major banks trading higher in a broad-based value rally. Information Technology (-5.4%) was the worst performing sector, largely on the back of poor returns from Afterpay (APT -23.7%) which reacted to a major sell down of potential parent company Block (NYSE:SQ). Consumer Staples (-2.4%) also underperformed with sector heavyweight Woolworths Group (WOW -6.9%) disappointing investors at its first half trading update.

The DNR Capital Australian Equities Income Portfolio underperformed the Index for the month. Key stock contributors were Afterpay (APT, No Holding), Woolworths Group (WOW, No Holding) and CSL (CSL, Underweight). Key stock detractors Commonwealth Bank of Australia (CBA, No Holding), Goodman (GMG, No Holding) and IPH (IPH).

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

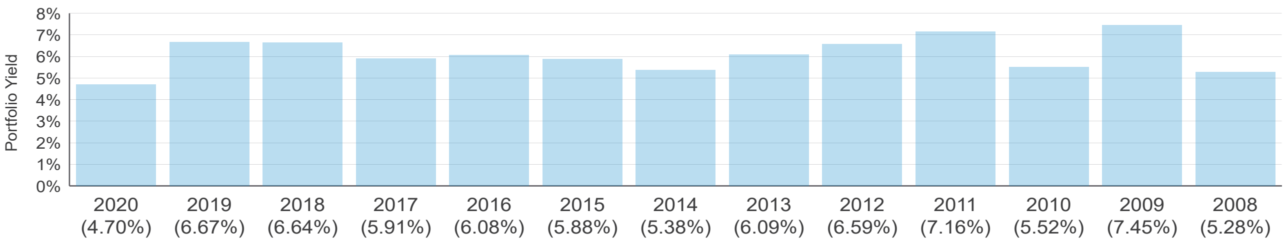
The Portfolio's dividend yield expectation for 2022 is currently 4.0% (5.1% grossed up for franking credits).

Gross active return

	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Income Portfolio	1.57	1.53	7.19	23.15	16.44	10.19	10.58	14.39	8.50
S&P/ASX 200 Industrials Accumulation Index	1.84	0.45	4.94	19.30	13.42	8.78	8.50	12.33	6.35
Excess Return	**-0.27**	**1.08**	**2.25**	**3.85**	**3.02**	**1.41**	**2.08**	**2.06**	**2.15**

** 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

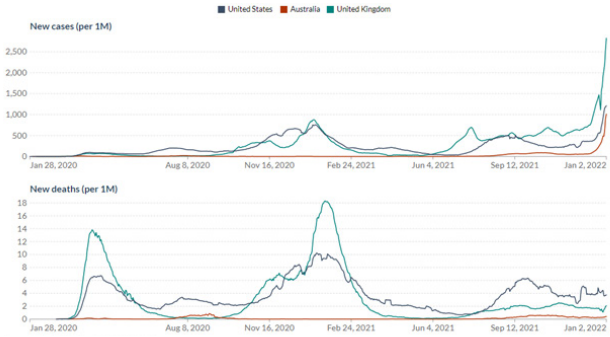
Summary

2021 saw the beginning of the end of COVID-19's grip on global markets but its legacy will echo for the foreseeable future. The Omicron variant has sparked further anxiety but appears to be ushering an acceptance of the virus's transition from pandemic to inevitable part of everyday life.

COVID-19 update

The Omicron variant, combined with a sustained reopening, has seen asymptomatic growth in cases around the world. Global vaccination efforts may not be preventing breakthrough cases as the virus evolves, but the death and hospitalisation rates have to date remained subdued.

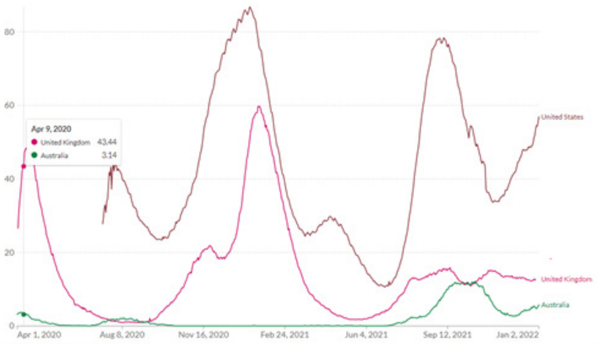
Daily new confirmed COVID-19 cases and deaths per million people



Source: John Hopkins University CSSE COVID-19 Data

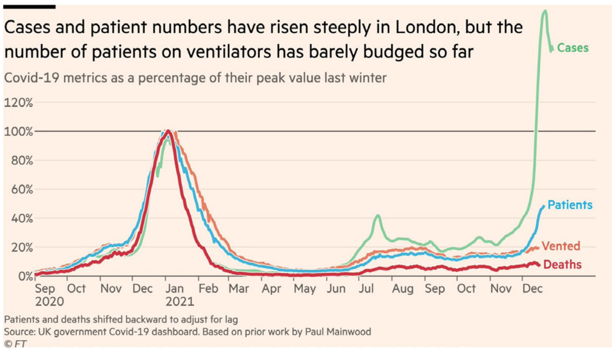
Whilst too early for experts to fully attribute this welcome development, it appears to be a combination of high vaccination rates, improved treatment, and a potentially milder variant.

Number of COVID-19 patients in intensive care (ICU) per million people



Source: Official data collated by Our World in Data

As noted in the Financial Times, in January 2022, despite record cases, key severity indicators are encouragingly resistant.



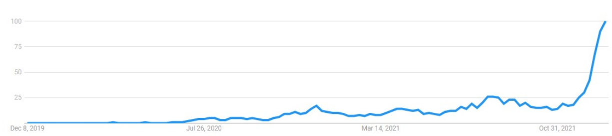
Source: UK government COVID-19 dashboard

Despite the encouraging data, health systems have limited resources and exposed workforces. As the total number of infections grows, a deterioration in the absolute number of critical care admissions will influence government responses.

Testing has become a bottleneck in the world's march towards normality, revealing another pressure point in a global supply chain already under duress. Testing resources have become critical to managing the reopening of economies. Issues with availability are well demonstrated in Australia, where backlogs are impacting movement and activity. Pent-up intentions to travel, unleashed over the holiday period, have been hampered as interstate and international requirements overwhelmed the available testing resources.

The familiar polymerase chain reaction (PCR) nasal swabs provide greater accuracy, with genetic detection able to identify very small amounts of viral DNA, but require a laboratory and several hours to produce results. Lateral flow or Rapid Antigen Tests (RAT), detect associated proteins with SARS-COVID-2, can produce result in 15-30 minutes, but carry a greater risk of incorrect results. Nonetheless, necessity has dictated a relaxing of testing pre-conditions. With the PCR testing beyond its capacity, RAT's are becoming the *de facto* solution, unfortunately coinciding with a global shortage.

Google search trends for rapid COVID-19 antigen test



Like vaccines before them, production and distribution may take some time to ramp up but will ultimately end in an affordable glut.

Key 2022 opportunities and threats

Threats

The benchmark US 10-year bond yield resumed its upward trajectory, reflecting anxiety around inflation and the withdrawal of quantitative easing. With the market now fully pricing three rate rises in CY2022, risks are emerging over equity valuations, as the relative attractiveness of bonds increases. Whilst many unknowable variables influence this trend, pressure on growth and longer duration equities is likely to grow alongside a steepening yield curve. Despite a healthy consumer and robust earnings growth being observed in many sectors, the impact of rapidly rising interest rates could hamstring the global recovery and foreshadow a recession.

Supply chains continue to be impacted following waves of COVID-19 related restrictions and supply constraints, concurrent with record demand. The inability to secure inputs and inventory has the potential to derail many industries, further stoking inflation and impact margins.

The Chinese property market continues to be volatile with the People's Bank of China (PBOC) attempting to balance a crackdown on excessive speculation and leverage while not damaging this important component of the Chinese economy. Australia in particular remains heavily exposed to Chinese domestic production to support the housing market.

Opportunities

Volatility in equities has at times spiked during the year, but generally remained subdued. Whilst an obvious risk to equity markets, as active managers we are primed to take advantage of opportunities to buy durable, high quality franchises during periods of market dislocation.

Decarbonisation - following the COP26 UN Climate Change Conference (Glasgow), momentum continues to build for reducing carbon across the economy. Long-term opportunities exist for a range of companies exposed to this trend, requiring substantial levels of commodities, labour and capital to facilitate the goal.

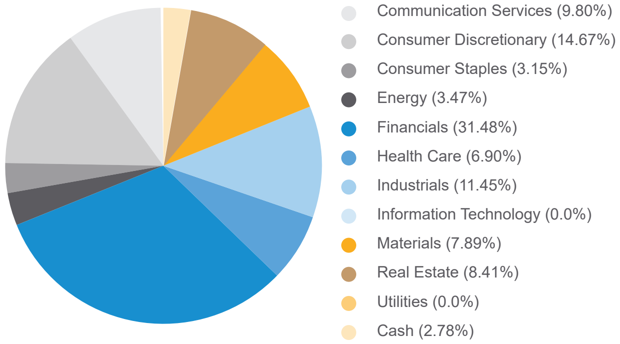
Digitisation is a well-established thematic that is still evolving. Alongside the explosion in new technology businesses, traditional companies are seeking to reduce costs by investing in digitisation and automating. Successfully deploying technology solutions to replace manual operations both supports margins and provides competitive advantages. Investments in flexible and automated platforms can lead to market share gains while saving on staffing costs. Many companies are succeeding in porting their products and services online, leveraging existing IP from traditional use cases into new opportunities.

Dividend outlook

The outlook for dividends remains robust as the recovery from pandemic-impacted 2020 continues. Dollar dividends in 2021 were 65% higher than 2020, driven by an earnings recovery, higher payout ratios and capital management initiatives. These drivers are expected to continue in 2022, with a forecast dividend yield of 4.0%, higher than 2021 on a dollar basis. This compares favourably to both real estate yields (2.6%) and to bond yields (Australian 10-year: 1.91%), in continuation of the 'there is no alternative' (TINA) thematic that has seen equity markets outperform in a lower interest rate environment. COVID-19 remains the key risk to earnings and dividends, though the increasingly mild nature of new variants sees this risk reduced. From a macroeconomic perspective, the direction of monetary policy will be a key factor again in 2022 as central banks attempt to withdraw pandemic stimulus measures and contain an increasingly non-transitory inflation surge.

Portfolio attribution

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors		Alpha*
Afterpay	No Holding	0.42%
Woolworths Group	No Holding	0.25%
CSL	Underweight	0.17%
Top 3 detractors		
Commonwealth Bank of Australia	No Holding	-0.62%
Goodman	No Holding	-0.15%
IPH	Overweight	-0.14%

12 month - top contributors and detractors

Top 3 contributors		Alpha*
CSL	Underweight	1.13%
Telstra Corporation	Overweight	0.93%
Macquarie Group	Overweight	0.84%
Top 3 detractors		
Lendlease	Overweight	-1.49%
Commonwealth Bank of Australia	No Holding	-0.84%
Aurizon Holdings	Overweight	-0.78%

** 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:

- **Afterpay (APT, No Holding):** underperformed in line with Nasdaq listed acquirer Block (formerly Square), as broader underperformance of technology stocks weighed on the stock.
- **Woolworths Group (WOW, No Holding):** underperformed following a trading update and earnings guidance below market expectations. COVID-19 direct and indirect costs had accelerated while sales moderated during the period.
- **CSL (CSL, Underweight):**underperformed following announcement of the acquisition of Vifor Pharma for $11.7b USD. The rationale for the acquisition was not immediately apparent and the accompanying $4.5b USD equity raising received only lukewarm support given the size and the timing being so close to year end.

The top stock detractors for the month were:

- **Commonwealth Bank of Australia (CBA, No Holding):** the banks bounced back after a poor month in November on limited news.
- **Goodman (GMG, No Holding):** outperformed during the period after a strong Q1 operational update in November buoyed sentiment in the sector. The increased demand for industrial and logistics assets has caused significant tightness in the market, leading to both improved rental revision outlooks and increased development backlogs. The cap rate on industrial assets has now reached all-time lows, as has the margin to the 10-year bond rate. GMG continues to benefit from the macro environment, but remains highly susceptible to an upward shift in the benchmark bond rates.
- **IPH (IPH):** underperformed in December on no significant news flow. IPH's revenue exposure to the USD likely played a part in the weaker performance, with the AUD strengthening during the period against the USD.

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 generated a gross yield of 5.8% (including franking) for calendar year 2021, compared to 5.5% for the benchmark.

The Income Portfolio is expected to generate a gross yield of 5.1% (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 11.1% compared to 10.8% for the benchmark
    - 2-year forward dividend yield is 4.4% 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
- Despite having stronger growth and quality characteristics relative to the market, the valuation is more attractive:
    - 2-year forward PE is at at 15.8x compared to 19.7x 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 5.1% compared to the benchmark at 3.9%.

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).

Portfolio 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. **Recovery in dividends** as the global economy reopens.
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 Portfolio 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.
- **Global growth.** Higher energy costs and supply chain disruptions could drag on global growth rates.

DNRCapital

Portfolio moves

Purchase of TPG Telecom (TPG)

TPG Telecom, formerly Vodafone Hutchison Australia Pty and renamed following the merger with TPG, is Australia's newest fully integrated telecommunications operator.

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

1. **Industry structure** — The telecommunications industry has largely consolidated into an attractive 3-player market structure. TPG / Vodafone remains the challenger brand with ~20% market share in mobile, relative to Telstra Corporation (TLS) (~50%) and Optus (~30%).
2. **Earnings strength** — We believe TPG's underlying earnings will recover strongly through to FY25 led by an acceleration in 5G/LTE-led fixed wireless access (FWA), a rebound in roaming charges and customers when international borders reopen, merger synergies and a more rational competitive environment emerges in mobile.
3. **Balance sheet** — TPG's balance sheet is solid with net debt / earnings before interest, taxes, depreciation, and amortisation (ND/EBITDA) currently at ~2.3x and expected to fall to ~1.5x by FY25.
4. **Dividend sustainability and growth** — Current dividend yield is ~2% (plus franking) however we expect dividends to triple through to FY25 (from FY20 levels).
5. **Management** — The management team is strong led by CEO, Iñaki Berroeta (previously Vodafone Australia CEO). He is a 20-year veteran of the telecommunications industry and long-serving Vodafone executive.
6. **Environmental, social and governance (ESG)** — The company has a low ESG exposure.

Key risks

There are a number of key risks including:

1. Execution risk and synergy realisation
2. Escalation of competition in mobile
3. David Teoh (TPG founder and previous Chairman) overhang of ~15% of shares on issue (expected in 2H22).

Valuation

We estimate that TPG is trading on a synergy adjusted EBITDA multiple of <8x, a free cash flow yield of >8% and a Cash PE of <15x. This represents an attractive valuation given the potential revenue synergies above our underlying assumptions.

Conclusion

The investment opportunity represents underlying defensive characteristics as well as growth potential, both characteristics are expected to be highly sought after in the current environment.

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 PPS
- BT Panorama (Direct, Compact and Full)
- Coloinal First State FirstWrap
- Federation Alliance
- HUB24
- Linear
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium
- Wealthtrac

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