DNR Capital Australian Equities High Conviction Fund

Performance Report – October 2017

Market overview and performance

Equities soared during October, which has historically been a difficult month of the year. Improving economic growth, a strong US reporting season, greater confidence around US tax cuts and positive central bank signalling helped propel markets higher. In Europe, economic conditions surged to their highest level in 17 years, despite rising political concerns in Spain. The Eurozone's industrial sector is now running at its best level since 2000, with cyclical industries like construction showing a strong rebound.

The S&P/ASX 200 Accumulation Index closed up 4.01%. All sectors were up with the exception of Retail as weak consumer conditions prevail. Australia benefited from strong global commodity prices with most industrial commodities recording another strong month as growth becomes more broad-based and less reliant on China.

The DNR Capital Australian Equities High Conviction Fund outperformed its benchmark by 0.40%.

The top stock contributors were:

- Healthscope (ASX:HSO)—Shares have begun the rebound as the market looks through difficult private hospital conditions.
- Treasury Wine Estates (ASX:TWE)—The value of Australian wine exports to China grew by 56% in the 12 months to September and there was particularly strong growth in the high-end segment, where Treasury Wine has brands like Penfolds.
- James Hardie Industries (ASX:JHX)—Shares rebounded as the probability of US tax reform increases along with increased consumer confidence and growing wage inflation that help to underpin demand for US housing.

The top stock detractors were:

- Lendlease (ASX:LLC)—The company provided an update including expectations for a weaker 1H18 construction performance. It indicated FY18 will be impacted by underperformance in Australian construction, which relates to a small number of engineering projects. This will be affected by a stronger performance in development.
- Cash—The portfolio's cash weighting detracted from performance given strong gains in the market.
- ALS (ASX:ALQ)—Shares consolidated during the period. The commodity cycle is improving and ALS is well positioned to capitalise on this growth.

Fund overview

APIR Code	PIM0028AU
Investment bias	Style neutral with a quality focus
Designed for	Investors seeking a medium-term investment focused on achieving growth, with less focus on generating excess income. The investor is prepared to accept higher volatility in pursuit of higher growth.
Investment objective	To invest in a high conviction portfolio of Australian equities that aims to outperform the Benchmark by 4% p.a. (before fees) over a rolling three-year period. The investment objective is not a forecast of the Fund's performance.
Benchmark	S&P/ASX 200 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, typically 25
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	Semi-annual
Responsible entity	The Trust Company (RE Services) Limited as part of the Perpetual Limited group of companies
Entry/exit fees	Nil

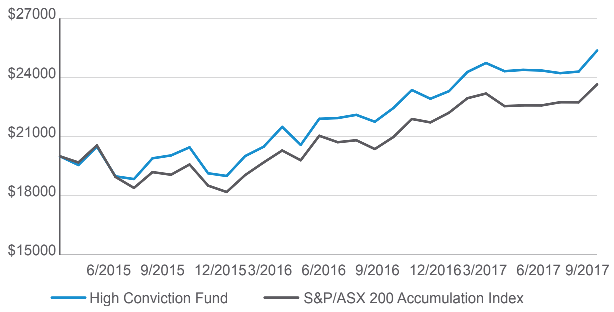
Net active return as at 31 October 2017

	1mth %	3mth %	6mth %	1yr %	2yr %	Incep.* %
High Conviction Fund	4.41%	4.17%	2.56%	16.63%	12.92%	10.45%
S&P/ASX 200 Industrials Accumulation Index	4.01%	4.73%	2.01%	16.13%	11.01%	7.26%
Excess return	**0.40%**	**-0.56%**	**0.55%**	**0.50%**	**1.91%**	**3.19%**

** Inception Date—June 2015*
Source: FundBPO and DNR Capital

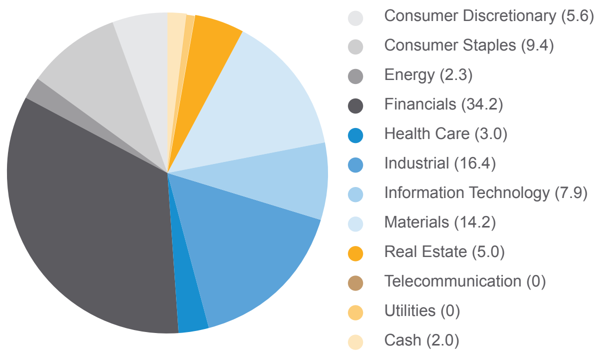
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry fees or taxation.

Growth of $20,000 since inception



Source: FundBPO and DNR Capital

Sector weightings %



Source: FundBPO and DNR Capital

Top 10 active holdings

Security details	Active weight %	Actual weight %
Lendlease	4.43	5.04
Woolworths	4.14	6.27
Macquarie Group	3.94	5.94
National Australia Bank	3.63	9.24
Aurizon Holdings	3.52	4.20
Janus Henderson Group	3.50	3.70
SEEK	3.35	3.75
Tatts Group	3.29	3.64
James Hardie Industries	3.20	3.77
Brambles	2.97	3.93

Source: FundBPO and DNR Capital

Market review

In recent months DNR Capital has focused on the risks to the market, which we will reiterate this month. However, we thought it would be useful to also highlight where we are seeing market opportunities.

Risks

We continue to closely watch the potential for inflation to rise. Low inflation has driven low interest rates, which has supported high asset prices especially for defensive assets. Any change in this regard has important consequences for markets. We are seeing capacity tighten in the US and growth pick up across the globe, which should tighten inflation over time. The political environment is further feeding into this pressure. The electorate is polarising from extreme right to extreme left, which raises the potential for policy miss-steps as populist politicians seek to appease the electorate. Geopolitical risks (North Korea, Middle East) always present potential risks, especially when valuations are steadily rising, complacency appears to be rising, and volatility remains low.

Australia has lagged global indices over the past year by circa 7%. The Australian economic recovery appears to be a little behind global markets and some larger companies are facing structural or company-specific headwinds. Examples include:

- Telstra Corporation (ASX:TLS) facing pressure in mobiles and from the NBN
- Commonwealth Bank of Australia (ASX:CBA) facing conduct issues
- Retail property trusts facing pressure from Amazon
- AMP (ASX:AMP) cancelling buyback and increasing spend to retain funds under advice.

Considering this, we thought it appropriate to focus on the areas of the market where we are finding opportunities (by no means exhaustive).

Opportunities

Global Growth

Global growth has accelerated over the past year with Europe and the US manufacturing indices rising strongly. This is feeding into higher capex and lower unemployment, which starts to feed into a sustainable recovery.

Importantly for Australia, this is feeding into higher commodity prices and offers a pickup in resource-related capex. The mining sector has been raising capital and repaying debt, leaving it well placed to increase capex.

Furthermore, capex has fallen sharply in recent years. The oil and gas sector capex spend has halved. The market is generally forecasting a modest pickup from here that will ultimately limit capacity, drive prices and encourage further spending. We think the risk in the medium term is to the upside. We have identified opportunities like WorleyParsons (ASX:WOR), Qube Holdings (ASX:QUB) and ALS (ASX:ALQ), as well as major resource companies that will benefit from a pickup in resource-related spending.

In addition, the strength of the US economy and moderate signs of a potential pickup in wage inflation should support globally exposed companies like Brambles (ASX:BXB) and James Hardie Industries (ASX:JHX).

US Tax Cuts

Current US government plans are for a cut to the corporate tax rate from 35% to 20%. While there are doubts this level will be achieved because it will be difficult to find sufficient revenue offsets that are politically acceptable, the political consensus (among Republicans) appears stronger for tax cuts than for healthcare changes. We expect some outcome that is positive for tax cuts.

The precise impact on corporates is somewhat difficult to isolate, because there are a range of offsets. For example, corporate net interest deductibility would be limited to 30% of Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA). DNR Capital is invested in a range of companies that earn more than 20% of their earnings in the US and consequently should benefit from these tax changes. Potential beneficiaries include Macquarie Group (ASX:MQG), James Hardie Industries (ASX:JHX), Brambles (ASX:BXB), Treasury Wine Estates (ASX:TWE), Lendlease (ASX:LLC) and Janus Henderson Group (ASX:JHG).

Internet Models

A notable development in recent years has been the use of captured data by companies to expand their addressable market. SEEK (ASX:SEK) and REA Group (ASX:REA) (realestate.com) represent examples of these companies in our fund. A recent SEEK presentation highlights, it is using its candidate database to help it move away from simple job advertising towards the larger, human-capital market. This increases the size of the market it is operating in from $10b to $30b.

Likewise, realestate.com is expanding its market, everaging its database of potential home buyers to sell mortgages. The company appears to be softening the market to sell leads to real estate agents, and we would expect home insurance will be introduced in due course.

Other companies are also seeking to monetise their data. Brambles (ASX:BXB) is exploring the value of its tracking data on the movement of inventory, and retailers are seeking a greater understanding of their customers to increase sales. An example of this is Woolworths (ASX:WOW) introducing targeted promotions to its customers.

Software models

With the increase in use of smart phones and the advances in internet speeds and storage, we have seen acceleration in the use of Software as a Service (SaaS) models. These offer software services delivered over the internet. Typically they involve a monthly payment for the services. The attractions for these businesses include a monthly revenue stream and the ability to embed the offering into a client's business. Furthermore, once you have a market leading platform there is the opportunity to export the offering. These are very attractive attributes. Examples of companies using this model are IRESS (ASX:IRE) and MYOB Group (ASX:MYO).

Fund Manager Models

Like the software models, we are attracted to fund manager businesses like Janus Henderson Group (ASX:JHG) and Macquarie Group (ASX:MQG). The attraction stems from the annuity stream of earnings, the ageing population seeking solutions for their savings, and the leverage their earnings have to this growing pool of savings. Macquarie Group remains a market leader in infrastructure funds management, while Janus Henderson Group can leverage a strong acquisition.

Inflation Hedges

Given our concerns regarding the potential for inflation to rise, we are focused on companies that perform well in an inflationary environment. Quality companies with pricing power are typically well placed. Companies like Woolworths (ASX:WOW) and Link Administration Holdings (ASX:LNK) have either inflation-escalator clauses in their contracts or strong pricing power.

Infrastructure Spending

The populist political environment is likely to drive an increase in infrastructure spending. Australia is already enjoying a pickup and companies like Lendlease (ASX:LLC) should enjoy the benefits (notwithstanding Lendlease's construction division miss-steps).

Fund positioning

Our current positioning is as follows:

- Improving quality
  - Global growth improving—Rio Tinto (ASX:RIO), ALS (ASX:ALQ), WorleyParsons (ASX:WOR)
  - Global reflation and fiscal stimulus—Janus Henderson Group (ASX:JHG), Lendlease (ASX:LLC), Macquarie Group (ASX:MQG).
- De-rated quality
  - Offshore exposed growth—Brambles (ASX:BXB), James Hardie Industries (ASX:JHX)
  - Turnarounds—Woolworths (ASX:WOW), Tatts Group (ASX:TTS)
  - Ageing demographics—Healthscope (ASX:HSO).
- Sustainable growth
  - SaaS businesses—IRESS (ASX:IRE), MYOB Group (ASX:MYO)
  - Internet models—SEEK (ASX:SEK), REA Group (ASX:REA) (realestate.com)
  - Chinese consumer—Treasury Wine Estates (ASX:TWE)
  - Underweight bond proxies where we want to protect against a potential increase in inflation
  - Underweight consumer given the threat from Amazon and the over-leveraged consumer. We remain underweight banks (albeit this is a decision causing some angst given the potential for stronger short-term results offset by the risks of an overheated property market, leveraged consumer, cyclically low bad debts and a potential Royal Commission).
  - Underweight company valuations supported by unsustainably low interest rates.

Stock moves

Purchase of Link Administration Holdings (ASX:LNK)

LNK is a quality company with a dominant market position in superannuation administration in Australia (35% with the next biggest share 8%) and the number two position in share registries. A recent opportunistic acquisition in the UK from a forced seller has seen it acquire a similar business. It will look to apply its expertise and systems to drive improvements in this market and provide another growth lever.

LNK meets DNR Capital's five-point quality web:

1. Industry Structure—LNK holds the number one market and superior cost position and has scale advantage. It is well placed to win market share as companies look to outsource. Furthermore APRA is seeking to encourage the smaller less efficient players to integrate with larger entities which should play to LNK's advantage over time.
2. Earnings Strength—Strong and improving margins and return on equity (albeit below IT peers). Incremental Return on Invested Capital is in mid-30's. Earnings per share growth is expected to be mid-teens for the next few years. Longer term the contracts have inflation escalators on them so it is a nice hedge in a rising inflation environment. Revenue growth long term will trend back to population growth plus inflation but with scale and leverage this should deliver mid-single digit profit growth.
3. Balance Sheet—The gearing is a little higher than market but given the annuity style earnings this appears entirely appropriate. Interest cover is very strong and average net debt to EBITDA comfortable.
4. Management—John McMurtrie joined Link Group in 2002 as Managing Director. John's previous senior appointments include Executive General Manager of ASX's Investors and Companies division and Chief Executive Officer of UBS Australia. He is a strong, experienced CEO with $100m worth of equity driving alignment.
5. Environmental, social and governance (ESG)—LNK scores in the 80th percentile of ASX200 stocks.

The stock has de-rated 20% over the past year, which is presenting an opportunity. The reason for the de-rate is largely that revenue growth has been disappointing with superannuation member consolidation and a couple of superannuation funds being consolidated by competitors. Given LNK has largely finished its major integration of Superpartners, we expect it will be more focused on winning new business and further industry consolidation is likely to favour it (given it predominately looks after larger clients). We see upside from three areas:

1. Winning share in super administration. LNK is the cheapest player in the market due to a scale advantage by some margin. Given a greater focus on efficiency and price we would expect this to translate into market share over time. The market has not factored in much for market share upside.
2. Margin upside. LNK acquired Superpartners, which was initially dilutive to margins. Based on the prospectus it was expecting margins to return to the pre-Superpartner levels of 34%. We expect there was an element of conservatism here given that the greater scale should drive better margins. The market is at 34%.
3. Integration of the UK and further acquisitions. Capita in the UK was the number three player. With LNK's expertise and global capability it will be in a better position to compete for larger clients. We expect further consolidation in funds administration and share registries.

Key risks

The key risk is more aggressive regulation driving faster-than-expected member consolidation. We are forecasting that the number of members compared to the working population will decline from circa 1.35x to 1.1x over a decade. There is some possibility regulation will drive faster consolidation. However, we would expect the larger funds to benefit more in this environment, which will lessen the impact on LNK.

Conclusion

The stock is trading at 14x FY20, which appears cheap given the quality of the business, potential upside to earnings and global comparisons. There is a further 50 cents worth of possible value in PEXA (an unlisted electronic mortgage conveyancing business expected to list next year), which reduces the multiple to 13x. Earnings are defensive with inflation escalators and an annuity stream of income. Consequently, we believe it will trade at a premium to the market. We expect the stock to re-rate as the company wins new customers and delivers synergies, providing the market with greater confidence about the revenue outlook.

Investment philosophy

DNR Capital believes a focus on quality businesses will enhance returns when 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.

Investment strategy

The DNR Capital Australian Equities High Conviction Fund has an investment style best described as 'style neutral'. The security selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices. We define quality businesses as being those with the following five attributes:

- earnings strength (particularly improving return)
- superior industry position
- 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 Fund. 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 is influenced by a macroeconomic appraisal and also considers the risk characteristics of the portfolio, such as stock and sector correlations.

Platform access

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- My North & North
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