DNR Capital Australian Equities High Conviction Fund

Performance Report – August 2017

Market overview and performance

August was dominated by geopolitical risks but these failed to deter global equity markets with most of the markets closing in the black. The S&P 500 Index has posted its fifth straight monthly gain. Hurricane Harvey caused devastation to the Gulf Coast with the market looking to relief efforts and companies involved in the rebuild. Asia was a strong performer off the back of continued positive data. Japan was the main casualty as it suffered the consequences of rising North Korean tensions.

The S&P/ASX 200 Accumulation Index closed up 0.71%. The key focus was on reporting season and resources were the standout with strong cash flow and upside surprise on cash returns. Disappointing results came from the insurance and telecommunications sectors.

The DNR Capital Australian Equities High Conviction Fund underperformed its benchmark by 1.26%.

The top stock contributors were:

- Treasury Wine Estates (ASX:TWE)—FY17 earnings per share (EPS) was up 50%, the company announced a $300m share buyback, and outlook for earnings before interest, tax, depreciation and amortisation (EBITDA) was margin of 25% over time vs the current 19.0%.
- Telstra Corporation (ASX:TLS, no holding)—Telstra announced a large cut to its dividend guidance, which saw shares fall.
- ALS (ASX:ALQ)—Completed the sale of its oil and gas business to allow the company to pursue its strategic plan focused on laboratory testing services.

The top stock detractors were:

- Healthscope (ASX:HSO)—2017 was largely in line but new management guided to a flat FY18 operating EBITDA growth, which disappointed the market expecting 10% growth. We reduced the size of our position but the stock subsequently sold off aggressively and started discounting an overly pessimistic outcome.
- QBE Insurance Group (ASX:QBE)—Underlying margin softness was flagged, prompting the market to reduce estimates towards the lower half of FY17 guidance range. A perfect storm of a soft result, hurricanes and North Korea impacting US$ and bonds sees the stock trading at book value.
- Wesfarmers (ASX:WES, no holding)—FY17 EPS was up 21.6% with Coles earnings before interest and taxes (EBIT) down 13% and Bunnings Australia EBIT up 10%. The resources division reported a big turnaround and the outlook is optimistic.

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

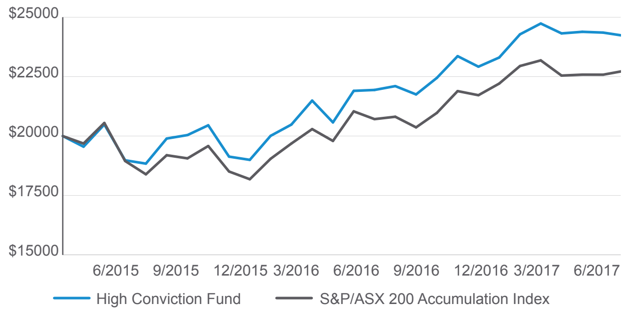
Net active return as at 31 August 2017

	1mth %	3mth %	6mth %	1yr %	2yr %	Incep.* %
High Conviction Fund	-0.55%	-0.41%	3.93%	10.39%	12.96%	8.99%
S&P/ASX 200 Industrials Accumulation Index	0.71%	0.87%	2.40%	9.79%	9.55%	5.94%
Excess return	**-1.26%**	**-1.28%**	**1.53%**	**0.60%**	**3.41%**	**3.05%**

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

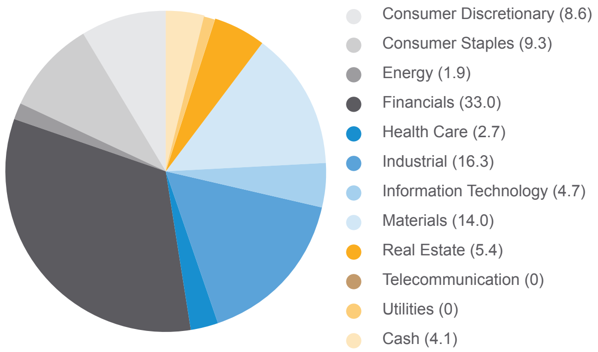
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been 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	4.74	5.37
Cash	4.11	4.11
Woolworths	3.83	6.04
Aurizon Holdings	3.52	4.19
National Australia Bank	3.51	8.90
Janus Henderson Group	3.50	3.70
Tatts Group	3.39	3.74
SEEK	3.18	3.56
Macquarie Group	3.03	4.98
ALS	3.02	3.28

Source: FundBPO and DNR Capital

Market review

The reporting season was subdued, with a notable lack of obvious drivers for the market. It was very much a stock-by-stock proposition, with resources carrying the market. While companies tended to meet expectations for FY17, a consistent trend was the emergence of reinvestment as a range of companies across resources and industrials seek to invest for future growth after a number of years of subdued investment. The most important theme emanating from the current Australian reporting season was the rise in business investment with opex and capex guided higher. This has resulted in a pullback in earnings expectations of 3% over the next year to 4.5% EPS growth for the ASX 200. DNR Capital Australian Equities High Conviction Fund is forecast to grow by 5.5%. If we exclude materials, industrials is due to grow by 5.6% with the DNR Capital Australian Equities High Conviction Fund expected to grow by 7.6%.

Growth stocks vs value stocks

There was no strong thematic across growth or value. Some growth stocks disappointed, like Domino's Pizza Enterprises (ASX:DMP), CSL (ASX:CSL), SEEK (ASX:SEK) and hospitals, while others like Treasury Wine Estates (ASX:TWE), Cochlear (ASX:COH) and Carsales.Com (ASX:CAR) kicked on. The most common thematic across growth stocks was strong top line growth but a higher level of reinvestment. Perhaps this has been influenced by the sales multiples US tech stocks trade on, where there is a focus on reinvesting for the future. Low multiple stocks were a mixed bag as well, with stocks like Telstra Corporation (ASX:TLS), Suncorp Group (ASX:SUN) and QBE Insurance Group (ASX:QBE) disappointing. Those value stocks with a cyclical component like Origin Energy (ASX:ORG) and WorleyParsons (ASX:WOR) tended to do better, as did stock-specific stories like Lendlease (ASX:LLC), Janus Henderson Group (ASX:JHG) and Qantas Airways (ASX:QAN). Perhaps it is not so surprising to see the cyclical stocks performing better, given the rise in capex from a range of companies and governments.

US$ earners

A rising A$ impacted the earnings of US$ earners and impacted outlook statements. However once again the reaction was mixed with poorer results from Computershare (ASX:CPU), Ansell (ASX:ANN) and James Hardie Industries (ASX:JHX) and stronger results from Macquarie Group (ASX:MQG) (1Q), Treasury Wine Estates (ASX:TWE) and Cochlear (ASX:COH).

Defensives

Defensives generally struggled through reporting season (telecommunications, healthcare, infrastructure and some property trusts). Softer bond yields through the month supported this situation to some extent.

Banks

Banks delivered strong results and saw upgrades of 1–2% across the forecast period. This was a result of continued subdued bad debts, lending volumes remaining better than feared and margins responding to the out-of-cycle rate increases. The stronger results have been overshadowed by the Commonwealth Bank's Australian Transaction Reports and Analysis Centre (AUSTRAC) issue and the continued fear of a Royal Commission, as well as concerns regarding the housing market and household debt levels. The outlook for 2018 remains for low, single-digit growth with the bank levy offsetting the margin enhancement. The banks are beginning to focus on enhancing productivity, which is likely to be needed in an era of low-credit growth and bad debts normalising from low levels.

Resources

Resource sector earnings have undergone a strong bounce in FY17 and were a highlight of the reporting season, with strong free-cash-flow generation and increasing returns to shareholders. The market has been grappling with the sustainability of the resource sector earnings revival. Consensus estimates are for earnings to be moderately lower in FY18. However, at spot commodity prices there are substantial upgrades.

Fund positioning

The fund's performance was mixed through the reporting season and we have made a significant number of small changes to reposition the portfolio. We classify the results as follows:

Poor results where we have lowered exposure due to a deterioration in perceived quality:

- QBE Insurance Group (ASX:QBE)—Deterioration in Asia provides a further rebase in earnings
- Healthscope (ASX:HSO)—New CEO setting a modest/conservative earnings base but concerns regarding profitability heading into the opening of North Shore Hospital.

Strong results where we have lowered exposure on valuation grounds:

- Treasury Wine Estates (ASX:TWE)
- ALS (ASX:ALQ).

De-rates but the thesis remains intact, which provides grounds to top-up our positions:

- SEEK (ASX:SEK)—20–25% sales growth forecast
- James Hardie Industries (ASX:JHX)—Strong macro back drop and working through manufacturing constraints
- IRESS (ASX:IRE)—15% sales growth and strong earnings growth expected.

Strong results where the market underreacted or reacted fairly:

- MYOB Group (ASX:MYO)—15% sales growth
- Janus Henderson Group (ASX:JHG)—30% beat
- Woolworths (ASX:WOW)—6% like-for-like sales growth
- Lendlease (ASX:LLC)—Two apartment defaults over the year
- Aurizon Holdings (ASX:AZJ)—Exit of intermodal announced and buyback begun
- Macquarie Group (ASX:MQG)—Strong 1Q
- WorleyParsons (ASX:WOR)—Strong cost out and revenue bottomed.

In terms of overall positioning we remain:

- 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, the leveraged consumer, cyclically low bad debts and a potential Royal Commission).
- Overweight US$ earners given the prospect of a stronger global economy relative to Australia.
- Overweight diversified miners like Rio Tinto (ASX:RIO), BHP Billiton (ASX:BHP) and South32 (ASX:S32).
- We have increased our exposure to better quality cyclical exposure via James Hardie Industries (ASX:JHX), WorleyParsons (ASX:WOR) and Rio Tinto (ASX:RIO), adding around 3% to this area.
- Growth areas we remain exposed to include:
  - SaaS businesses—MYOB Group (ASX:MYO) and IRESS (ASX:IRE)
  - Internet models—SEEK (ASX:SEK) and REA Group (ASX:REA)
  - Infrastructure spending—Lendlease (ASX:LLC)
  - Mining investment—ALS (ASX:ALQ) and WorleyParsons (ASX:WOR)
  - The ageing population—Healthscope (ASX:HSO)
  - Turnarounds—Woolworths (ASX:WOW)
  - Merger synergies—Tatts Group (ASX:TTS), Janus Henderson Group (ASX:JHG)
  - Logistics improvements—Qube Holdings (ASX:QUB).

Stock moves

Purchase of WorleyParsons (ASX:WOR)

WorleyParsons (Worley) delivers projects, provides expertise in engineering, procurement and construction, and offers a range of consulting and advisory services to the hydrocarbons, mineral, metals, chemicals and infrastructure sectors.

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

1. Industry structure—The energy industry has been under significant pressure with the declining oil price. A number of competitors have exited the market, which positions Worley well to win further work.
2. Earnings strength—Worley takes on little construction risk with 85% of its work cost reimbursable and/or fee based. Earnings appear to be bottoming as global energy players are signalling a return to capex growth. Headcount has stabilised and utilisation is on target, which bodes well for future earnings. The backlog has also strengthened to \$5.1b, up 20% from June 2016.
3. Balance sheet—Has been under pressure after the company announced (at the 1H17 results) that \$230m remains outstanding from four state-owned enterprises. Management provided a further update at the May investor day that it is making good progress on collecting the remaining balance.
4. Management—John Grill, founder and largest shareholder, remains chairman. Andrew Wood was appointed as John's successor as CEO in 2012 and has 23 years' experience with the company.
5. Environmental, social and governance (ESG)—Worley has assisted clients in delivering water and wastewater management programs that comply with environmental regulations, are ecologically sustainable, and are cost effective. Worley has capabilities in groundwater exploration, protection and remediation, surface water and watershed management, rainwater harvesting, potable water treatment, recycling and reuse, and desalination.

Key risks

Weaker oil prices force energy companies to delay capex spend. It is worth highlighting that oil fields naturally decline at a rate of 5–7% and there has already been three years of underinvestment.

Valuation

Worley trades on a PE of 18.7x FY18 earnings. We view the valuation as attractive, given bottom-of-the-cycle earnings and the earnings leverage is high as the oil capex cycle improves.

Conclusion

After a number of difficult years we are starting to see a number of positive data points that indicate the cycle is turning for Worley. Management has aggressively cut costs during the downturn and is well positioned to take advantage of improving conditions.

Sale of Macquarie Atlas Roads (ASX:MQA)

Following a strong run over the past few years we have exited our position. The exit was on relative valuation grounds and we have used the funds to purchase Worley.

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