DNR Capital Australian Emerging Companies Fund

APIR code: PIM4357AU

Performance Report October 2023

Performance

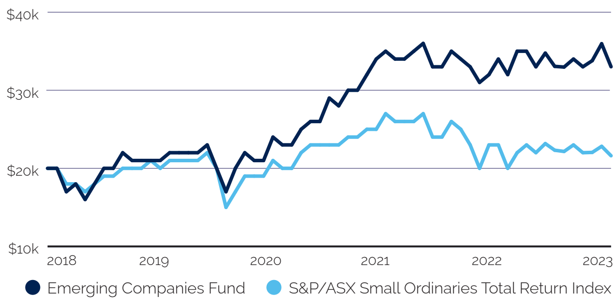
The DNR Capital Australian Emerging Companies Fund decreased -9.56% (net of fees) in October, underperforming the S&P/ASX Small Ordinaries Total Return Index by -4.11%.

Net active return as at 31 October 2023

	1mth	3mth	6mth	1yr	3yr p.a.	4yr p.a.	5yr p.a.	Incep.* p.a.
Emerging Companies Fund	-9.56	-16.99	-12.53	-13.59	9.73	8.34	11.56	8.06
S&P/ASX Small Ordinaries Total Return Index	-5.45	-10.45	-10.28	-5.10	0.52	-0.22	2.55	0.41
Excess return	**-4.11**	**-6.54**	**-2.25**	**-8.49**	**9.21**	**8.56**	**9.01**	**7.65**

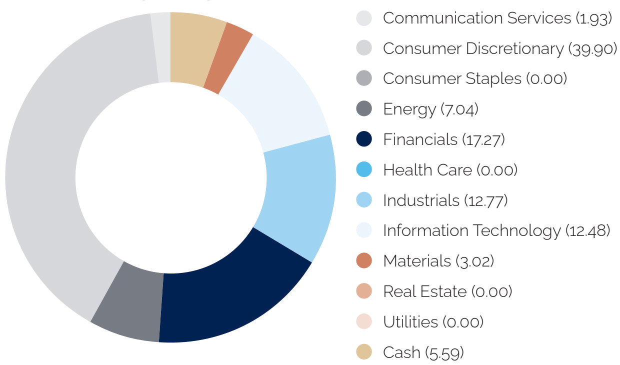
* Inception Date—August 2018
Source: DNR Capital and Apex Fund Services
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Emerging Companies Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry/exit fees or taxation.

Growth of $20,000 since inception



Source: DNR Capital and Apex Fund Services

Sector weightings %



Source: DNR Capital and Apex Fund Services

Top 3 active holdings (alphabetical order)

Security details
Breville Group (BRG)
IPH (IPH)
Lovisa Holdings (LOV)

Source: DNR Capital and Apex Fund Services

Monthly top contributors and detractors

Top 3 contributors
Whitehaven Coal (WHC)
IDP Education (IEL)
Chrysos Corporation (C79)

Top 3 detractors
Credit Corp Group (CCP)
Tabcorp Holdings (TAH)
IRESS (IRE)

Source: DNR Capital and Apex Fund Services

A team with global experience

Sam Twidale
Portfolio Manager
CFA

Mark Sedawie
Portfolio Manager
CFA

Fund and market review

October was a poor month for equity markets due to the impact of higher rates and an increase in geopolitical risks. In the US, GDP grew at a 4.9% annual pace in the third quarter, highlighting the resilience of consumer spending. Faced with a strengthening economy, the US Federal Reserve (the Fed) may need to hold or raise rates for longer which saw bond yields respond higher. Similarly, Australia is facing a robust economy with low unemployment and higher inflation implying the Reserve Bank of Australia (RBA) may also need to hold or raise the cash rate. The dilemma facing financial markets is that while stronger economic growth supports corporate earnings, prolonged higher rates have a negative impact on asset values.

The Fund underperformed with the surge in bond yields impacting long-duration holdings within the Consumer Discretionary, Financial and Industrial sectors. Additionally, the Fund's underweight exposure to Materials was a drag on relative performance. A flight to safety drove a rally in gold stocks, and the optimism surrounding China's stimulus efforts led to an outperformance of base metals. Conversely, metals focusing on decarbonisation faced continued challenges, with lithium particularly affected as the industry moved into a surplus.

The performance was further impacted by Credit Corp (CCP), as challenging conditions in the US led to a slowdown in collections, compounded by an impairment to its ledger book. Despite these setbacks, we recognise the compelling value in CCP. The share price is trading close to book value, a level rarely seen outside the COVID-19 pandemic and the Global Financial Crisis. With rising US consumer credit card delinquencies signalling potential future charge-offs, CCP is well positioned to capitalise on the increase in ledger supply at favourable prices, potentially leading to higher earnings in the years ahead.

Meanwhile, the Energy sector exhibited strong performance as the oil price responded higher to geopolitical tensions. Whitehaven Coal (WHC) shares rallied following the acquisition of BHP Group (BHP)'s coking coal assets in Queensland for US$3.2bn. While this move diversified the business, we have since divested our position. The optionality of the balance sheet has diminished, as the debt incurred from the acquisition will require time to be repaid, leading to reduced dividends and share buybacks. Additionally, the increased exposure to coking coal is heavily reliant on China's steel demand outlook, which has an uncertain outlook.

Significant dislocations between price and value have been observed in the small-cap sector, where companies reporting earnings weakness are encountering disproportionate selling. The current uncertain market environment has shortened investing timeframes, leading to increased volatility in share prices. Instead of viewing lower share prices as a risk, we perceive them as an opportunity for improved investment returns. These market dislocations have created opportunities for long-term fundamental investors, as we anticipate the gap between price and value to converge over time.

Our focus continues to be on what is 'priced' in shares, namely, the extent to which the market has adjusted earnings estimates, and is being discounted by the market via lower valuations. As a result, we have identified several opportunities to invest in undervalued quality businesses within the Consumer and Financial sectors, such as Lovisa Holdings (LOV) and Pinnacle Investment Management Group (PNI). In many cases, both earnings and share prices have seen significant declines ranging from 30-50%. This represents a significantly more favourable starting point for investment compared to previous years when stocks were priced for perfection, trading at high earnings and valuations.

We continue to witness downward pressure on metals associated with the decarbonisation theme. Specifically, the lithium market is experiencing a surge in supply coinciding with a weakening demand landscape. Electric vehicle (EV) demand growth is expected to slow down both in the short term and the long term, leading to reductions in EV penetration rates. Rising costs associated with financing and constructing wind farms pose a potential threat to renewable energy targets. Siemens Energy, a major player in the global wind turbine industry, has incurred substantial losses, with the company now in rescue talks with the German government to secure €15bn in guarantees aimed at stabilising its balance sheet. The Fund has largely realised its gains in this sector and maintains an underweight position. Although we anticipate potential opportunities to surface, we could be too early as commodity down cycles can be long and painful.

The Fund continues to be concentrated in a collection of companies with strong quality attributes and attractive valuations. The Fund is trading on favourable fundamentals with a forward price-to-earnings (PE) ratio of 15x, supported by earnings growth of 27% and a return-on-invested-capital (ROIC) of 19%; metrics well above the benchmark. While the outlook remains uncertain, it is crucial for us to consider the extent to which the markets have already factored in this uncertainty. Market risk appetite is low, earnings are being rebased and valuations have moved lower. By the time there is clarity on the outlook, share prices will already have begun to move ahead in anticipation of this. The current backdrop provides an opportunity for investors with long-term time horizons to accumulate positions in companies that will prosper when economic conditions and interest rates eventually normalise.

Performance attribution

Contributors

- **Whitehaven Coal (WHC):** will acquire 100% of BHP Group (BHP)'s Daunia and Blackwater coking coal mines in Queensland for US$3.2b. The deal diversifies WHC both by product and geography.
- **IDP Education (IEL):** diplomatic tensions between India and Canada have eased with the resumption of visas for Canadian citizens into India.
- **Chrysos Corporation (C79):** announced a global partnership between Barrick Gold and MSALABS to deploy up to 10 Chrysos PhotonAssay units to Barrick projects by the end of 2025.

Detractors

- **Credit Corp Group (CCP):** suffered a $45m after tax impairment of the US purchased debt ledger (PDL) book and reduced net profit after tax (NPAT) by $10m to reflect tougher collection conditions in the US.
- **Tabcorp Holdings (TAH):** provided a trading update for the first quarter of FY2024 with group revenue down 6.1%, reflecting softer macro-economic conditions.
- **IRESS (IRE):** confirmed the sale completion of its managed funds administration business to SS&C for A$52m. IRE continues to be in active discussions with parties regarding the sales process for the platform business.

Fund facts

Inception date: August 2018

Minimum initial investment: $20,000

Risk level: High

Management fee: 1.15% p.a. of the NAV of the Fund

Performance fee: 20% of outperformance of the Fund relative to the Fund's Benchmark (after the management fee)

Entry/exit fees: Nil

Buy/sell spread: +0.25%/-0.25%

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.

About DNR Capital and the Fund

Concentrated: Investing in 20-45 highest conviction, quality small cap Australian listed equities.

Style neutral and quality focussed: A disciplined approach to quality and valuation. Concentrated portfolios of quality companies maximise the opportunity for outperformance.

Global & domestic investment experience: Portfolio managers with global and domestic research experience, helps to identify globally competitive emerging companies.

Aligned team: Portfolio managers are invested in the Fund.

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

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