Market overview and portfolio performance

Equity markets had a soft start to February before a good reporting season saw some gains. The market closed lower at the end of the month, weighed down by a global sell-off in bank stocks, a weakening economic backdrop particularly from China, deflation fears particularly from Europe, and worries over the upcoming British referendum that could see Britain exit the European Union.

The highlight in commodities during the month was the rally in the iron ore price. The gold price also rallied strongly on safe-haven buying. Russia, Saudi Arabia, Venezuela and Qatar decided to freeze crude oil production at January 2016 levels, which caused an initial spike in the oil price that reversed as some sceptical market sentiment prevailed.

Industry outperformance came from Materials, Industrials and REITs while Financials, Telecommunications and Consumer Staples underperformed. The S&P/ASX 200 Accumulation Index closed down 1.8%.

The Australian Equities Socially Responsible Portfolio underperformed its benchmark by 0.7%.

Portfolio overview

<table>
<thead>
<tr>
<th>Investment bias</th>
<th>Style neutral</th>
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<tbody>
<tr>
<td>Designed for</td>
<td>Investors who want a competitive return but do not want investments judged to have involvement in gaming, pornography, armaments and tobacco</td>
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<tr>
<td>Benchmark</td>
<td>S&amp;P/ASX 200 Accumulation Index</td>
</tr>
<tr>
<td>Investment objective</td>
<td>To outperform the S&amp;P/ASX 200 Accumulation Index by 4% p.a. (before fees) over a rolling three year period</td>
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<tr>
<td>Investable universe</td>
<td>ASX listed securities with a focus on the S&amp;P/ASX 200</td>
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<tr>
<td>Number of stocks</td>
<td>15–30</td>
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<tr>
<td>Asset allocation</td>
<td>Australian equities 80–100% Cash 0–20%</td>
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<tr>
<td>Stock limit</td>
<td>15% maximum weighting</td>
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<td>Investment timeframe</td>
<td>5 years</td>
</tr>
<tr>
<td>Portfolio managers</td>
<td>Jamie Nicol (Chief Investment Officer) Scott Bender (Portfolio Manager)</td>
</tr>
<tr>
<td>Certifications</td>
<td>Certified by RIAA (Responsible Investment Association Australasia)—Responsible Investment Certification Program</td>
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Gross active return

<table>
<thead>
<tr>
<th></th>
<th>1mth</th>
<th>3mth</th>
<th>6mth</th>
<th>1yr</th>
<th>3yr</th>
<th>5yr</th>
<th>7yr</th>
<th>Incep.*</th>
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</thead>
<tbody>
<tr>
<td>Socially Responsible Portfolio</td>
<td>-2.5</td>
<td>-8.0</td>
<td>-1.7</td>
<td>-9.2</td>
<td>7.7</td>
<td>8.8</td>
<td>13.8</td>
<td>8.8</td>
</tr>
<tr>
<td>S&amp;P/ASX 200 Accumulation Index</td>
<td>-1.8</td>
<td>-4.6</td>
<td>-4.0</td>
<td>-13.7</td>
<td>3.0</td>
<td>4.9</td>
<td>10.4</td>
<td>4.3</td>
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Excess Return

* Inception date—June 2006

Annualised excess return

<table>
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<tr>
<th>Portfolio Excess Return</th>
<th>1yr</th>
<th>2yr</th>
<th>3yr</th>
<th>4yr</th>
<th>5yr</th>
<th>6yr</th>
<th>7yr</th>
<th>8yr</th>
<th>Incept.*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4.5%</td>
<td>4.3%</td>
<td>4.7%</td>
<td>4.2%</td>
<td>3.9%</td>
<td>3.7%</td>
<td>3.4%</td>
<td>4.9%</td>
<td>4.5%</td>
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</table>

Excess return (calendar year buckets)

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</thead>
<tbody>
<tr>
<td></td>
<td>9.8%</td>
<td>1.2%</td>
<td>9.7%</td>
<td>2.1%</td>
<td>2.7%</td>
<td>0.1%</td>
<td>5.3%</td>
<td>7.0%</td>
<td>5.9%</td>
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</table>

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.
The top stock contributors were:

- **Brambles (ASX:BXB)**—Delivered a strong first half and upbeat second half outlook that saw management upgrade FY16 guidance to $1015–1035m (prev. $1000–1020m) at June 2015 forex rates. The highlight of the result was improving revenue growth trends across the portfolio.

- **SEEK (ASX:SEK)**—Delivered a strong result for the half, which included a small upgrade to underlying guidance. Growth drivers in the domestic employment business are showing returns on the recent investment program by SEEK. This highlights the upside on offer if the company can transfer its intellectual property in employment and learning to its international assets.

- **Aurizon Holdings (ASX:AZJ)**—The above-rail business delivered soft earnings, with management highlighting new self-help initiatives targeting further cost outs and reducing capex and raising the dividend payout ratio. The below-rail business generates around 50% of earnings and should provide a level of earnings stability over the next few years.

The top stock detractors were:

- **Bank of Queensland (ASX:BOQ)**—Shares fell, given cautious outlook margin statements. Recent volatility in wholesale funding markets, combined with strong competition for new business, will limit Bank of Queensland’s ability to pass on these costs. However the market is underestimating the cost out program.

- **IPH (ASX:IPH)**—Stock sold off as the company delivered results at the lower end of guidance, which disappointed the market. There were also concerns around the acquisition pipeline slowing. We feel the stock was oversold given there was no market downgrade and there is still acquisition potential. We used this weakness to add to our position.

- **iSentia Group (ASX:ISD)**—Underperformed as the company saw margins in Australia, New Zealand and Asia contract. This was due to higher investment in cloud infrastructure and a new Asian management team. We believe the shares were unfairly treated and used this as an opportunity to add to our position.

**Market review**

The market has bounced since mid-February with fears easing and a strong reporting season supporting the Australian market. This month we discuss the key drivers of this bounce, particularly in the context of the major issues we identified last month that were responsible for creating market weakness. We then further analyse the reporting season.

In the context of issues discussed last month we note the following:

- Credit spreads have eased, which has triggered short covering in higher risk stocks. However credit stress will remain elevated until the US energy balance sheets are repaired. The major concern for the market has been whether the credit stress identified in energy names spreads to other sectors of the economy. At this point there is no evidence to suggest that this is occurring.
Recent economic data has improved. US manufacturing has bounced after a number of periods of declining data and US payrolls pointed to an additional 242,000 jobs in February, versus the 195,000 expected. Recent results from US-centric companies pointed to softness in oil states but strength in other regions of the US. Should the oil price remain subdued, we would expect to see improving economic data over the course of the year.

The Chinese authorities announced a lower interest rate and further fiscal stimulus in an attempt to further boost its economy. This is a positive development relative to the market’s subdued expectations for the Chinese economy and signals the Chinese preference to reflation its economy rather than more aggressively devalue its currency to boost its competitiveness.

The Australian economy displayed surprising resilience during the fourth quarter with GDP growth up 3%. This has surprised many market commentators with the strength of the non-mining economy particularly notable. The result of the above collection of modestly positive outcomes compares to the market’s very negative expectations during the start of this year. The result is that the market has become a little less negative, which has triggered short covering by hedge funds that were positioned for a continuation of deteriorating news flow.

**Australian reporting season**

We were pleased with the reporting season overall, particularly in light of the pessimistic expectations that preceded it.

Key highlights

1. The earnings revisions ratio of 0.88 was the highest in two years.
2. Sales growth remains modest but we saw a pickup in domestic-exposed companies and some offshore earners benefiting from the A$. Cost out remains a focus and margin expansion was noted in Industrials.
3. Resources remained soft and saw a drop in dividends, however the sector is becoming a smaller part of the index and thus deteriorating resource earnings will become less of a headwind going forward.
4. Guidance and outlook statements were more positive than expected, especially considering the market sentiment was suggesting a more negative outcome. Solid operating data and the smattering of guidance upgrades by domestic industrials like Scentre Group (ASX:SCG), JB Hi-Fi (ASX:JBH), Vicinity Centres (ASX:VCX), Goodman Group (ASX:GMG) and Domino’s Pizza Enterprises (ASX:DMPI) confirmed that the Australian economy is holding up well, particularly for the consumer and housing-related sectors. A number of offshore earners like Brambles (ASX:BXB), Cochlear (ASX:COH) and James Hardie Industries (ASX:JHX) also upgraded guidance and thus dispelled concerns that slowing global growth would impact their earnings.
5. There was a rotation underway during the month with last year’s winners generally struggling. There was also a rotation from growth to value stocks.

The Socially Responsible Portfolio did not perform as well. Two of the Socially Responsible Portfolio’s best performing stocks last year, iSentia Group, ASX:ISD and IPH Limited, ASX:IPH, failed to exceed market expectations and suffered from a de-rating. The actual results were strong with iSentia enjoying 22% revenue and profit growth and IPH enjoying a 75% profit increase. We considered these results as solid but the share price reaction highlighted that they failed to meet lofty expectations. The re-rating has taken out the excess valuation from the stocks and the outlook remains sound.

**Best results**

**Brambles Limited (ASX:BXB)**

Brambles has had a history of delivering slightly disappointing results. However it delivered this time and as a consequence enjoyed a strong share price reaction. The company upgraded its underlying profit guidance to US$1015–1035m (was US$1000–1020m), and lowered its net interest guidance as FY16 growth capex to be <US$400–450m (was US$500m). This represents a step up in growth forecasts of 8–10%pa (was 6–8%) and reflects Brambles’ success in net new business wins, customer volume growth and repricing. It reaffirmed its FY19 ROCi target of >20%. Brambles remains one of the few large cap companies delivering strong sales growth (8%) and whereas in past halves it has struggled to convert this sales growth into profit growth (with costs rising), this half it delivered with EBIT growth of 10%.

**IRESS Limited (ASX:IRE)**

The opportunity for IRESS has been the roll out of XPLAN (browser-based software) into the UK market, which faces similar regulatory pressure as Australia yet is less technologically advanced. However the major competitor in the UK has been noisy and seeking to win IRESS customers when it seeks to convert them onto XPLAN. The result highlighted strong customer wins in the half with revenues up 11%. The following chart highlights the progress over recent years and the acceleration into the end of the year. The Australian XPLAN business continues to grow strongly and with Commonwealth Bank coming on board this year the outlook remains robust. The financial markets’ business is more mature, but retains a very strong market position. Overall profits were up 9% in what was a transition year and the company is flagging strong revenue growth and solid profit growth over the next year.

**SEEK Limited (ASX:SEK)**

SEEK delivered a better than expected result with 22% revenue and an underlying profit growth (excluding learning) of 19%. The company reaffirmed profit guidance. The highlights were the domestic employment business that grew by a better than expected 18%. This reduced fears that the business was maturing. SEEK is trying to expand from being a jobs-board business into other areas of human resource management and its recent roll out of SEEK Profile (which competes with LinkedIn) is performing well and adding to income. The international business was up 36% with China benefiting from the transition of its economy to the service industry. The soft spots include the learning business, but we were encouraged by management pointing to a bottom in the 2H16 and a return to growth next year.
Poor results
Aurizon Holdings (ASX:AZJ)

Much of the bad news occurred during December and after initial weakness, the stock subsequently rallied. There is no doubt this was a poor result with EBIT down 32%. This was partially due to some one-off factors but also due to BHP Billiton Limited (ASX:BHP) moving some volume to its own wagons. There remains a possibility that this volume will come back once BHP moves onto new contracts where it will have to pay a higher fixed fee (even if it does not use Aurizon’s wagons). The opportunity for Aurizon is to realise the value of its network (which trades substantially below other regulated assets). Furthermore, the implied value of its above rail business trades at circa 5x EBITDA, which compares to the 10.5x sales price that the Pacific National assets are attracting. We think the market is assigning a large management discount due to the recent poor decisions to spend capital on iron ore and the loss of a key leader. We would like to see renewed focus on the cost out and further capital management to realise this value gap.

Super Retail Group (ASX:SUL)

The Supercheap result disappointed with the leisure business (BCF, Ray’s) disappointing once again. Management pointed to a poor Christmas due to pricing and marketing decisions. Profit was down 2%. We exited the stock as we are concerned that even if the management effort across the various divisions can turn around leisure, problems could emerge elsewhere. Furthermore, the impact of the lower A$ will have a greater impact on the cost of goods in the next half and we saw the first signs of a retailer struggling to pass on the higher cost associated with the A$.

Portfolio moves

Purchase of Vocus Communications Limited (ASX:VOC)

The recent merger of Vocus with M2 Communications has created a full-service, vertically-integrated, infrastructure-backed, trans-Tasman telecommunications company. While there is little complementary customer or product overlap between Vocus and M2, there is proven investment merit in vertically integrating retail and infrastructure assets (i.e. TPG). M2 operate an efficient low-cost reseller model (Dodo, iPrimus and Commander brands in Australia; ~8% mkt share). Access to Vocus Communications national network/backhaul for NBN POIs is a key enabler to:

1. Lowering its network service delivery costs.
2. Competing for market share gains in an NBN (Australia)/UFB (New Zealand) marketplace. Vocus Communications is expected to benefit by mobilising MTU’s expansive distribution network to further penetrate its approximately 3400 on-net building connections, including the SME marketplace.

Vocus Communications meets DNR Capital’s five-point quality web:

1. Industry structure—It is now the fourth largest integrated telecommunications company in Australia (behind Telstra, Optus and TPG) and third largest in New Zealand (behind Spark and Vodafone).
2. Earnings strength—We expect the switch to the NBN to create opportunities for the company to win market share from the incumbents. In addition, we believe there is upside risk (not captured in current market forecasts) from higher cost synergies than $40m target (representing only ~3% of M2 cost base) and revenue synergies by combining the businesses.
3. Balance sheet—The balance sheet is robust with net debt/EBITDA of ~1.5x.
4. Management—Its management team is strong with extensive telecommunications and sales experience. Both founders of Vocus and M2 are on the board of Vocus Communications.
5. Environmental, social and governance (ESG)—Vocus has low-risk from an ESG perspective.

Key risks

Both Vocus and M2 have been very acquisitive although have a reasonable track record on integration. Ownership of international backhaul is now the obvious outstanding network component—NextGen (EV estimate of $700–800m). Exposure to power retailing is identified as an area of growth although may come under pressure from Tier I retailers and unhedged wholesale pricing exposures.

Valuation

Vocus is currently trading at a ~40% discount to TPG and in line with Telstra despite superior growth expectations. The stock is trading on a FY17 expected PE of ~16x and a FY18 expected PE of ~15x, which is attractive given our double-digit expectations for earnings growth over the period.

Conclusion

We expect the stock to continue to outperform.
Performance Report  February 2016

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.

Investment strategy

The Australian Equities Socially Responsible Portfolio has an investment style best described as ‘style neutral’, focusing on environmental, social and governance (ESG) issues.

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 ESG risk.

The Australian Equities Socially Responsible Portfolio incorporates a negative portfolio screen across:

- pornography
- gaming
- armaments
- tobacco.

A positive ESG screen is also used to identify those securities with enhanced ESG policies.

DNR Capital sources ESG-related information from Bloomberg.

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.

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