YARRA
CAPITAL MANAGEMENT

Investment Commentary
Quarter to 30 June 2018

Yarra Australian Real Assets Securities Fund

Total returns as at 30 June 2018

	From 17 December 2015	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception^ % p.a.
Yarra Australian Real Assets Securities Fund	9.36	1.78	7.75	5.82	7.24	9.85	7.88	7.58
S&P/ASX Custom Infrastructure, Utilities and A-REITs Index*	10.47	2.69	9.26	7.99	NA	NA	NA	NA
Excess Return†	-1.11	-0.92	-1.52	-2.17	NA	NA	NA	NA
Growth Return‡	NA	NA	NA	-20.60	-8.88	-1.71	-0.04	0.15
Distribution Return‡	NA	NA	NA	26.42	16.12	11.56	7.93	7.44

Past performance is not a reliable indicator of future performance. Taxes payable by investors have not been taken into account. The figures shown have been provided for illustrative purposes – they are unaudited and subject to change. The total returns shown are prepared on an exit to exit basis – they include all ongoing fees and expenses and assume reinvestment of all distributions.
^ Inception date of Yarra Australian Real Assets Securities Fund: December 2005.
* The Fund's benchmark is a market cap weighted index of infrastructure, utilities and REIT securities included in the S&P/ASX300
† Excess return: The excess return figures shown represent the difference between the portfolio's return and the benchmark return.
‡The Growth Return is measured by the movement in the Fund's units price, ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders by way of income distribution in a 12-month period. It does not include distributions amounts deemed as capital distributions.

Market review

Australian Real Assets outperformed the wider market in the June quarter as a number of corporate actions supported the benchmark.

The S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Accumulation Index rose 9.3% in the three months to June 30 compared to 8.4% from the S&P/ASX 300. The benchmark also outperformed international indices, with the MSCI World Index returning 3.8%.

REITs (+9.8%) contributed the most to the index's return in the quarter. Investa Office Fund (IOF, +23.7%) was the top performer after receiving a non-binding, all-cash proposal from Blackstone to acquire the REIT for $5.25 per share – a 13% premium to IOF's last traded share price. Elsewhere, Retail REITs also contributed to the Index's return amid stronger than expected retail sales data, with all constituents rising in the period. Meanwhile, Westfield (WFD) successfully gained approval from its shareholders to merge with Unibail-Rodamco (UNBP).

Infrastructure & Utilities (+8.4%) also generated strong returns. Within Infrastructure, top performers included Transurban (TCL, +7.3%), Atlas Arteria (ALX, +13.7%) and airport operator Sydney Airport (SYD, +9.4%). ALX was renamed from Macquarie Atlas Roads after shareholders approved the internalisation of management at the company's AGM in May. Within Utilities, APA Group (APA, +28.1%) outperformed after receiving a takeover bid from a consortium led by CK Infrastructure. The offer was at $11.00 per stapled security – a 33% premium to the stock's last traded price – plus a 24 cent dividend for APA shareholders.

Portfolio review

Key contributors

Investa Office Fund (IOF, overweight) – the office REIT outperformed after receiving a non-binding, all-cash takeover proposal from Blackstone at $5.25 per unit, a 13% premium to IOF's last traded price and an effective 4% premium to Net Tangible Assets (NTA). IOF's directors have unanimously endorsed the proposal subject to the independent expert report and absent a superior proposal. We have subsequently exited the position as we believe there are a number of execution risks, with 75% shareholder approval required and a number of important deal aspects unresolved. Moreover, an interloper is unlikely to emerge since Blackstone secured a 'no shop provision' – meaning IOF cannot seek alternative acquisition proposals. As a result, we see better opportunities elsewhere in the Office sector, including GDI Property (GDI), Dexus (DXS) and GPT Group (GPT).

Atlas Arteria (ALX, overweight) – the toll road operator rose in value after securityholders approved ALX's planned management internalisation in May, a change we believe will be highly value accretive. We maintain a favourable view towards ALX based on its steep discount to intrinsic value and attractive, long-dated assets. ALX trades at an FY18 EV/EBITDA ratio of around 11 times, well below comparable asset transactions.

Mirvac (MGR, underweight) – the real estate group underperformed despite tightening FY18 earnings guidance to 15.6 cents per stapled security, at the top end of its previous range of 15.3 to 15.6 cents. Instead investors were focused on the outlook of the group's residential division for FY19 amid heightened concerns over the house price environment and tightening credit conditions. In our view residential earnings are at peak levels and will moderate over time, which has been at odds with optimistic consensus forecasts. Furthermore, we

believe passive property valuations are approaching the top of the cycle.

Key detractors

APA Group (APA, underweight) – the gas pipeline owner outperformed after receiving a takeover bid from a consortium led by CK Infrastructure (CKI). The offer was priced at $11.00 per stapled security – a 33% premium to the last traded price – plus a 24 cent dividend for APA shareholders. However, the proposal is subject to several hurdles including regulatory approvals from the Foreign Investment Review Board (FIRB) and the Australian Competition and Consumer Commission (ACCC). CKI plans on divesting some of APA's Western Australian assets that could compete with CKI's assets, aiming to alleviate ACCC concerns.

Spark Infrastructure (SKI, overweight) – the electric utilities company underperformed in response to higher regulatory uncertainty. In addition to the Australian Energy Regulator (AER)'s forthcoming report on the rate of return guidelines, a significant driver for SKI's regulated revenue stream, the AER is set to review tax allowances in the sector, from which SKI benefits significantly despite currently paying no tax. We exited our position in the quarter.

Goodman Group (GMG, underweight) – the commercial property group outperformed in the quarter, during which it released its third-quarter update. Management reaffirmed FY18 EPS guidance of 46.5 cents per share, representing 8% growth on FY17, and also reaffirmed its target of greater than $50bn of AUM over the next five years (total AUM increased to $36.8mn in the quarter, up 6.4% on 1H18). We remain negative towards GMG at its current valuation: we see the outlook for development earnings – which account for over 40% of total EBITDA – moderating with commencements already beginning to soften in 1H18, and believe the tailwind from Amazon's entry to the Australian market is overblown in the context of GMG's Australian business.

Key purchases

Dexus Property (DXS) – we established an overweight position in the office REIT during the quarter. DXS provides a high quality exposure to Sydney and Melbourne offices, markets which have the most attractive supply and demand fundamentals. Both markets should generate rental growth in the next 12 to 18 months and have low vacancy rates, with Melbourne forecast to fall to 4.0% from 4.6% in June 2018. While the stock now trades at a premium to NTA (5%+), we expect NTA to rise at the full-year results.

Ausnet (AST) – we established an overweight position in the electric utilities company during the quarter. AST offers a superior total return outlook compared to its peers as a result of contracted asset growth from its exposure to non-regulated renewables. After securing $300mn of contracted assets in the last 12 months, we believe it is likely the company will upgrade its 2021 target of $1bn given a healthy pipeline of predominantly renewable connections. Furthermore, we believe there are solid prospects for expansion of AST's regulated network as the system accommodates the growing penetration of renewable energy generation in Victoria. AST currently trades at 1.3 times its Regulated Asset Base (RAB) and at a 12-month forward gross dividend yield of 7.0% that has 4-5% per annum growth expected over the next three years.

Australian Unity Office Fund (AOF) – we established a position in the office REIT during the quarter. We believe AOF has a solid net tangible asset (NTA) growth outlook (5%-plus), driven by its underlying Sydney exposures, in particular Parramatta which comprises 25% of the group's NTA. The Parramatta office market has attractive supply and demand fundamentals, with high population growth and significant new infrastructure (e.g. Badgery's Creek airport and new light rail). More broadly, we expect the Sydney office market to generate rental growth in the next 12 to 18 months and have low vacancy rates. With these tailwinds we see AOF's valuation as attractive at an NTA 0.9 times and with a 12-month forward dividend yield of 6.4%.

Key sales

Spark Infrastructure (SKI) – we exited the position in the electric utilities company during the quarter. In our view regulatory uncertainty has increased for the company. In addition to the Australian Energy Regulator (AER)'s forthcoming report on the rate of return guidelines, a significant driver for SKI's regulated revenue stream, the AER is set to review tax allowances in the sector, from which SKI benefits significantly despite currently paying no tax. Within the Electric Utilities sector we prefer Ausnet (AST), which offers a superior total return outlook compared to SKI as a result of contracted asset growth from its exposure to non-regulated renewable connections and regulated network expansion.

Investa Office Fund (IOF) – we exited our overweight position after IOF announced a non-binding, all-cash takeover from Blackstone at $5.25 per unit, a 13% premium to its last traded price. We believe there are a number of execution risks, with 75% shareholder approval required and a number of important deal aspects unresolved. Moreover, an interloper is unlikely to emerge since Blackstone secured a 'no shop provision' – meaning IOF cannot seek alternative acquisition proposals. As a result, we see better opportunities elsewhere in the Office sector, including GDI Property (GDI), Dexus (DXS) and GPT Group (GPT).

Scentre Group (SCG) – we increased our underweight to the shopping mall owner during the quarter. Recent transactional data both domestically and overseas highlights the structural pressures impacting mall valuations, with further evidence of net mall sellers (such as from peer Vicinity Centres (VCX)). SCG has rallied to 0.97 times NTA with a 5.1% forward dividend yield, which we do not believe is warranted when considering the ongoing headwinds facing the company, including higher capex requirements, a tough environment for second-tier assets and an oversupply of fashion retailers.

Key active overweights

GPT Group (GPT) – we believe GPT offers investors exposure to a high-quality, diversified commercial real estate portfolio. We view GPT's financial guidance as being less aggressive than some peers, with minimal reliance on asset transactions

to meet guidance. We see the current valuation as favourable – a factor which is not reflected in the market's valuation at around 0.96 times NTA – and view its prospective dividend yield of 5.1% as attractive in the current environment. GPT's balance sheet is also stronger than many of its peers (due to low gearing of approximately 25%) which provides flexibility for selective strategic acquisitions.

Transurban (TCL) – we are overweight TCL due to its strong growth outlook (with a number of new project and expansion plans), asset diversification and attractive risk adjusted total return. If inflation returns, its compounding effect will provide a meaningful offset to higher discount rates (on a net present value basis), given the majority of TCL's revenue growth is linked to CPI.

Atlas Arteria (ALX) – we maintain a favourable view towards ALX based on its steep discount to intrinsic value and attractive, long-dated assets. ALX trades at an FY18 EV/EBITDA ratio of around 11 times, well below comparable asset transactions. Securityholders approved ALX's planned management internalisation in May, a change we believe will be highly value accretive, avoiding fee leakage and potentially opening up a pathway for value realisation.

Key active underweights

Scentre Group (SCG) – we are underweight the shopping mall owner based on our negative view of retail REITs. SCG faces significant headwinds as changing consumer preferences direct an increasing proportion of retail sales away from malls to online. Implications include higher capex requirements and a more challenging leasing and transaction backdrop (particularly for second-tier assets). We do not believe SCG's valuation – at 0.97 times NTA and with a 5.1% forward dividend yield – properly accounts for these headwinds.

AGL Energy (AGL) – we are underweight AGL because we believe the business faces significant earnings headwinds in future years. Firstly, we believe wholesale electricity prices are set to retreat from all-time highs. Secondly, AGL's retail margins are under pressure from increased competition and regulatory scrutiny, particularly for customers not receiving a discount. We also believe AGL's transition away from being a fully integrated electricity generator is likely to create material earnings pressure over time. Finally, we expect earnings to be negatively impacted as its low cost gas contracts roll off.

Goodman Group (GMG) – our underweight position reflects our more cautious outlook for development earnings and GMG's premium share price valuation of 19.3 times earnings and at 2.0 times net tangible assets. We see the outlook for development earnings – which account for over 40% of total EBITDA – moderating with commencements beginning to fall. As a result, we are sceptical that development work in progress (WIP) can be maintained at current elevated levels ($3.5-3.6bn in FY18) over the medium term. Lastly, we believe the tailwind from Amazon's entry into the Australian market (i.e. generating more demand for warehousing space) is overblown in the context of GMG's Australian business.

Market outlook

Our conviction in the Real Assets sector is underpinned by attractive underlying valuation support. The S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Accumulation Index offers an attractive forecast dividend yield of 5.3%, an appealing 2.6% premium above the 10-year Australian bond rate.

Within Infrastructure, we believe strong fundamentals and attractive growth opportunities should continue to support the likes of Transurban (TCL) and Atlas Arteria (ALX). We remain cautious towards infrastructure providers with exposure to cyclical end markets such as AGL Energy (AGL).In particular, AGL trades on a relatively high valuation when considering these headwinds. Within Utilities we prefer Ausnet (AST), which offers a superior total return outlook compared to its peers as a result of contracted asset growth from its exposure to non-regulated renewables.

With A-REITs now trading at average premiums of approximately 20% to last stated tangible book values, at this point in the cycle we continue to prefer exposure to high quality asset owners at more attractive valuations such as GPT Group. We believe structural headwinds for shopping mall owners are likely to persist – changing consumer preferences are directing an increasing proportion of retail sales away from malls to online – and we maintain our highly selective approach across the sector, steering away from owners of malls lacking strong barriers to competition. We expect growth in sector earnings and distributions in coming periods, albeit at slower rates than past years as interest expense reduction tailwinds fade. Robust balance sheets (average gearing levels below 30% net debt / total assets) and strong in-place occupancy levels suggest future returns in-line with those of the underlying real estate.

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
GPT	9.32	4.26	5.06
Transurban	17.36	12.47	4.89
Atlas Arteria	6.81	1.99	4.82
Underweights			
Scentre	5.48	10.98	-5.49
AGL Energy	2.08	6.95	-4.86
Goodman	2.54	7.24	-4.70

Portfolio holdings may not be representative of current or future investments. The securities discussed may not represent all of the portfolio's holdings and may represent only a small percentage of the strategy's portfolio holdings. Future portfolio holdings may not be profitable.

Sector allocation

	Portfolio %	Benchmark %	Active %
Infrastructure	40.13	29.02	11.11
Airport Services	5.06	7.75	-2.69
Highways & Railtracks	24.18	14.46	9.71
Telecommunication Services	1.41	1.22	0.19
Railroads	6.74	4.05	2.69
Marine Ports & Services	0.00	1.54	-1.54
Information Technology	2.75	0.00	2.75
Utilities	9.11	15.95	-6.83
Electric Utilities	3.26	3.24	0.01
Gas Utilities	3.77	5.46	-1.69
Independent Power and Renewable Electricity Producers	0.00	0.30	-0.30
Multi-Utilities	2.08	6.95	-4.86
Real Estate Investment Trusts (REITs)	48.18	55.03	-6.85
Specialized REITs	5.89	1.89	4.00
Diversified REITs	16.67	15.34	1.33
Industrial REITs	2.54	7.78	-5.24
Office REITs	10.88	7.18	3.70
Retail REITs	12.20	22.29	-10.08
Other	0.00	0.56	-0.56
Cash and receivables	2.57	0.00	2.57

Features

Investment objective	To achieve a balance of income and medium-to-long term capital growth by investing primarily in Australian listed infrastructure, utilities and REIT securities. In doing so, we aim to outperform the S&P/ASX 300 Custom Infrastructure, Utilities and A-REITS Index over rolling three year periods.	
Recommended investment time frame	5 - 7 + years	
Fund inception	December 2005	
Fund size	A$45.53 mn as at 30 June 2018	
APIR code	JBW0030AU	
Estimated management cost	0.85% p.a.	
Buy/sell spread	+/- 0.15%	
Platform availability	Asgard BT Wrap BT Panorama Colonial FirstWrap IOOF Pursuit Select Macquarie Wrap Consolidator	PowerWrap SmartWrap OneVue Hub24

Applications and contacts

Investment into the Yarra Australian Real Assets Securities Fund can be made by Australian resident investors only.

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