YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 31 March 2018

Yarra Premier Australian Equities Fund

Total returns as at 31 March 2018

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	Since inception % p.a.*
Yarra Premier Australian Equities Fund	-2.81	-3.89	3.12	2.80	6.71	6.90
S&P/ASX 300 Accumulation Index	-3.73	-3.78	2.86	3.91	7.62	7.99
Excess return‡	0.91	-0.12	0.26	-1.11	-0.91	-1.09

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 Yarra Premier Australian Equities Fund: August 2010.
‡ Excess return: The difference between the Fund's return and the benchmark return (S&P/ASX 300 Accumulation Index).

Market review

Australian shares delivered their worst quarterly return in two and a half years in 1Q18 despite companies reporting better-than-expected February earnings results.

The S&P/ASX 300 Accumulation Index declined 3.8% in the three months to 31 March 2018, underperforming global indices with the MSCI World Index declining 2.1% and the S&P 500 falling 0.8%. Fears about a trade war sent global equities down after US President Trump announced a series of tariffs: 25% on steel imports, 10% on aluminium imports and 25% on $US50bn of Chinese imports.

During January and February, the ASX 300 had outperformed international equities as earnings generally exceeded expectations. In the large cap space, 33% of companies beat expectations versus 16% that missed[1]. Earnings expectations for FY18 held steady (they are normally revised downwards).

However, the ASX 300 fell 3.7% in March, with negative sentiment from the Banking Royal Commission weighing on Financials and the iron ore price – which declined 19% to $US65 – dragging Metals & Mining lower.

On a quarterly basis Banks (-7.0%) were the largest detractors from return, followed by Metals & Mining (-3.4%) and Real Estate (-5.2%). Telecommunications Services declined the most in value (-11.3%), as the sector continued to face significant competitive pressure.

Only three sectors generated positive returns in the quarter: Health Care (+6.6%), Information Technology (+1.9%) and Consumer Staples (+0.9%). Performance within the sectors was relatively concentrated, with strong returns from CSL (CSL, +10.7%), Altium (ALU, +50.8%) and A2 Milk (A2M, +55.5%) providing most of the support.

For the 12 months to 31 March 2018, the S&P/ASX 300 returned 2.9% – well below the CY17 return of 11.9%. Metals & Mining (+20.1%) and Health Care (+17.0%) were the top contributors to returns. In contrast, Banks (-11.0%) and Telecommunication Services (-26.4%) were the biggest detractors.

Portfolio review

Key contributors

ResMed (RMD, overweight) – the sleep apnoea device maker outperformed after delivering better-than-expected second-quarter results. Strong sales of both its airflow generators and masks supported revenue, with operating earnings coming in 3% above consensus. While the market is beginning to capture RMD's appealing growth characteristics, we see further upside as earnings growth rates accelerate over the next one to two years, with benefits accruing from a positive product cycle in the flow generator segment. While the US tax reform bill has created a number of one-off charges to net profit, we view the reform bill as neutral to positive for RMD's earnings going forward.

NextDC (NXT, overweight) – the data centre operator outperformed following a better-than-expected 1H18 result. The company reported strong revenue growth (up 17% year-on-year), margin expansion, record new contract sales and pricing power, with prices up 8% per megawatt. Furthermore, the implied 2H18 earnings guidance appears conservative in our view. We remain overweight NXT, as we believe the company is structurally set to benefit from increasing cloud technology adoption. NXT is accelerating its expansion to meet the demands of larger clients, including through building three new data centres which will support significant medium to longer term earnings growth. The outlook for NXT appears attractive given the company's growth profile and infrastructure-like characteristics at maturity.

JB Hi-Fi (JBH, overweight) – the electronics retailer outperformed in response to stronger consumer sentiment and Amazon's underwhelming December launch. The strengthening labour market (record jobs growth and surging participation) translated into improving consumer confidence. Meanwhile, Amazon launched a relatively narrow offering with

[1] Source : UBS

products priced less aggressively than expected. JBH also announced a mixed 1H18 result. While earnings modestly beat expectations in the period (+1%) due to a strong result in its core Australian business, FY18 net profit guidance of $235-240mn came in modestly below expectations for $242mn due to a -$50mn revision to sales expectations for The Good Guys. We remain overweight JBH despite the more conservative growth outlook for The Good Guys, as we still believe significant synergy, sales and margin opportunities exist following the acquisition of the company in November 2016. Our medium term investment thesis remains in place, being that concerns regarding Amazon's recent entry into the Australian market are overdone with respect to JBH. Compared to its overseas counterparts, JBH has a more resilient business to withstand new competition, with lower prices and costs, greater sales density and a more sophisticated online offering.

Key detractors

CSL (CSL, underweight) – the biotechnology company outperformed following a strong 1H18 result. The company beat consensus EPS by 23% in the period as both of its businesses generated stronger than expected results. CSL Behring benefited from sustained growth in immunoglobulin (IG) sales, supplemented by strong sales of higher-margin specialty and haemophilia products, while flu vaccine business Seqirus came in above already high expectations amid a severe flu season in the northern hemisphere. We remain underweight CSL based on valuation (29.8 times P/E and 20.8 times EV/EBITDA on a 12-month forward basis), which we believe more than captures the company's earnings growth outlook.

TPG Telecom (TPM, overweight) – the telecommunications company underperformed despite announcing a 1H18 result above expectations. EBITDA came in 2% ahead of consensus due to faster-than-expected cost reductions, a delay in the NBN roll-out and improved margins from the new NBN 50 plan. That being said, operationally the result was more negative. Gross profit in the consumer division declined, broadband subscribers fell by 8,000 (driven by iiNet) and the corporate division grew by 3.4% when expectations were for 4-4.5%. The stock remains a high-conviction holding in the portfolio, offering compelling value relative to its peers (at a forward P/E of 15.1 times) when considering its defensive characteristics and disruptive growth opportunities from its entry into the Mobile market. Furthermore, in our view consensus forecasts now capture a lower contribution from iiNet – which we believe will be offset by material cost synergies – and the detrimental impact of the NBN roll-out on margins.

Vocus (VOC, overweight) – shares in the telecommunications company declined after management downgraded EBITDA guidance by 2% and net profit guidance by 10% for FY18. While 1H18 EBITDA beat guidance by 2.4% due to growth from Enterprise & Wholesale (+11.2% year-on-year), VOC said this included large one-off contracts that won't be repeated in the second-half. Further, the Consumer business continues to face competitive pressure from the NBN and Energy. Subsequent to the result VOC announced the exit of its chief executive. Notwithstanding VOC's short-term challenges, we continue to believe the longer-term revenue and margin opportunities remain and that the share price (at 10.8 times forward earnings) currently capitalises limited future growth. VOC remains focused on integrating and simplifying its various acquired businesses, unifying its product offering and increasing customer product penetration.

Key purchases

Kathmandu (KMD) – we elected to participate in the outdoor adventure retailer's equity raising during the quarter following a strong 1H18 result and the announced acquisition of US hiking boots brand OBOZ. The $US75mn acquisition (financed 35% by equity) accelerates the company's expansion into footwear and the US wholesale market. The result and acquisition supported our thesis for holding an overweight position in the stock based on KMD's attractive category exposures, market share opportunities in Australia and internationally (from both the KMD and OBOZ brands), margin expansion potential and an attractive valuation (10.6 times forward P/E).

APN Outdoor (APO) – we increased the position size during the quarter. Outdoor advertising is expanding its share of the total advertising market (currently 5%) supported by increased penetration of digital boards. Following the appointment of a new CEO – a development we regard as positive – we remain optimistic on opportunities to increase market share. Given APO's high gross margins and largely fixed cost base, we expect the improved revenue outlook will support strong medium term earnings growth.

Macquarie Atlas Roads (MQA) – we increased the position size of the toll road operator during the quarter. We are positive towards MQA based on its appealing valuation (around an 11 times forward EV/EBITDA with a 7% FY20 dividend yield) and its strong asset base with the APRR in France (80% of value) continuing to generate strong traffic growth and internalisation initiatives, which we believe will be highly accretive.

Key sales

Incitec Pivot (IPL) – we reduced our holdings in the quarter for portfolio construction purposes but retain a smaller position size in the company. More signs of stability have emerged for IPL's key commodities, urea and diammonium phosphate (DAP), where prices have been at multi-year lows. IPL's other business, explosives, continues to enjoy a strong competitive position across most markets, where pricing and demand fundamentals have stabilised, adding further support to the stock. We do not believe consensus forecasts sufficiently capture the more stable outlook for IPL, particularly over the longer term.

Transurban (TCL) – we reduced our overweight position in the toll road operator for portfolio construction purposes, with our preferred exposure in Infrastructure Macquarie Atlas Roads (MQA). We remain positive towards TCL, as we believe it has a strong growth outlook (with a number of new project and expansion plans), offering asset diversification and an 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 TCL's revenue growth is largely linked to CPI.

Origin Energy (ORG) – we reduced the position size following a period of strong outperformance. Our overweight position remains premised on the positive outlook for ORG's Energy Markets business which, in our view, offers latent value underappreciated by the market. The simplification of the business through asset sales substantially reduces balance sheet leverage and focuses attention on ORG's key asset – the Energy Markets business. The implied valuation of both the Energy Markets business and APLNG appears overly conservative, with an eventual demerger of both businesses the critical next step in crystallising this value.

Market outlook

We believe fundamentals point to a strengthening earnings cycle for the Australian equity market, with upgrades to FY18 consensus estimates likely. Consensus sees Resources delivering high-single digit growth, with Industrials at mid-single digits and Financials at low-single digits.

Australian equities are priced modestly above their long-term averages based on forward earnings estimates, though valuations remain attractive relative to alternatives such as fixed interest. The S&P/ASX 200 Index yields 4.7% on a 12-month forward basis versus 2.6% from the Australian 10-year government bond yield.

At a global level, while an economic recovery and excitement about political change is driving valuations to elevated levels, we remain alert to economic and geopolitical risks, including surging interest rates and China's real rate of growth.

We see significant value in certain sectors but believe others to be overvalued based on our earnings and cash flow expectations. We are overweight in the Consumer Discretionary, Information Technology and Industrials sectors, but are underweight Metals & Mining, Real Estate and Consumer Staples.

Sector allocation

	Portfolio %	Benchmark %	Active %
Consumer Discretionary	15.18	4.87	10.31
Consumer Staples	3.17	7.75	-4.58
Energy	5.09	5.17	-0.09
Financials	30.59	34.08	-3.49
Health Care	10.02	7.79	2.22
Industrials	13.43	7.44	5.99
Information Technology	9.05	2.37	6.68
Materials	7.67	17.75	-10.08
Real Estate	0.00	8.03	-8.03
Telecommunication Services	4.51	2.76	1.76
Utilities	0.00	1.98	-1.98

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Commonwealth Bank of Australia	12.11	7.97	4.14
Westpac Banking	9.69	6.13	3.57
ANZ Banking	8.79	4.94	3.85
NextDC	6.02	0.12	5.91
Macquarie Atlas Roads	5.90	0.24	5.66

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
NextDC	6.02	0.12	5.91
Macquarie Atlas Roads	5.90	0.24	5.66
Resmed	5.89	0.39	5.49
Underweights			
BHP Billiton	0.00	5.69	-5.69
National Australia Bank	0.00	4.87	-4.87
CSL	0.00	4.42	-4.42

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.

Income and growth

	1 year %	3 years % p.a.	5 years % p.a.	Since inception % p.a.
Growth return	-0.49	-0.23	3.56	3.97
Distribution return	3.62	3.03	3.15	2.94

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 capital distributions.

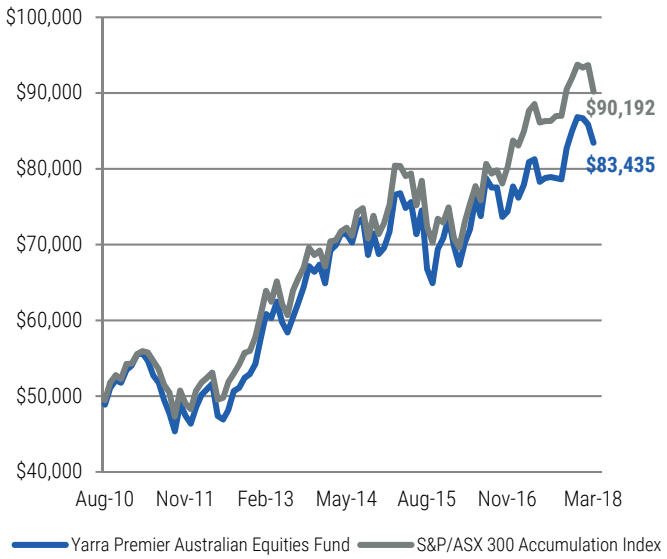
Features

Investment objective	To achieve medium-to-long term capital growth through exposure to companies listed on the Australian Securities Exchange. In doing so, the aim is to outperform the S&P/ASX 300 Accumulation Index over rolling 3-year periods.	
Recommended investment time frame	5 - 7 + years	
Fund inception	August 2010	
Fund size	Pooled Fund A$32.71 mn as at 31 March 2018	
APIR code	JBW0052AU	
Estimated management cost	1.30% p.a	
Buy/sell spread	+/- 0.15%	
Platform availability	Asgard BT Wrap BT Panorama Macquarie Wrap Consolidator	Macquarie Wrap Accumulator Hub24

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. Any mention of an investment decision is intended only to illustrate our investment approach or strategy, and is not indicative of the performance of our strategy as a whole. Any such illustration is not necessarily representative of other investment decisions. There is no guarantee that these objectives will be met

Investment performance comparison of $50,000

After fees, since inception of the Yarra Premier Australian Equities Fund, August 2010 to March 2018.



For illustrative purposes only. Past performance does not guarantee future results, which may vary. The total net fund returns shown are prepared on an exit to exit basis (i.e. they include all ongoing fees and expenses and assume reinvestment of all distributions). They do not take personal taxation into account. The comparison with the S&P/ASX 300 Accumulation Index is for comparative purposes only. Index returns do not allow for transactional, management, operational or tax costs. An index is not managed and investors cannot invest directly in an index.

Applications and contacts

Investment into the Yarra Premier Australian Equities Fund can be made by Australian resident investors only.

Website www.yarracm.com

Investor Services Team 1800 034 494 (Australia) +61 3 9002 1980 (Overseas) IST@yarracm.com