YARRA
CAPITAL MANAGEMENT

Investment Commentary
Month to 31 May 2018

Yarra Australian Equities Fund

Total returns as at 31 May 2018

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Australian Equities Fund	0.13	0.97	9.13	5.07	8.19	6.01	10.21
S&P/ASX 200 Accumulation Index†	1.09	1.08	9.63	5.93	8.76	5.24	9.42
Excess return‡	-0.96	-0.11	-0.49	-0.87	-0.57	0.77	0.79

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 Australian Equities Fund: July 1996
† The benchmark for the Yarra Australian Equities Fund has been amended since the Fund's inception. Effective 28 February 2008 the benchmark is the S&P/ASX 200 Accumulation Index, replacing the S&P/ASX 200 ex Property Accumulation Index Monthly. Further information on changes to the Fund's benchmark is available upon request.
‡ Excess return: The difference between the portfolio's return and the benchmark return.

Market review

The Australian share market rose modestly in May amid the release of a reasonably benign FY19 federal budget.

The S&P/ASX 200 Accumulation Index increased by 1.1% in the month to May 31, taking its 12 month return to 9.6%. The local index underperformed global indices in the month, with the MSCI World Index returning 1.4% and the S&P500 returning 2.4%.

The Federal Government's May budget only had a minor impact on equity markets. The government continues to focus on supporting infrastructure projects (positive for engineering and construction companies) and announced plans for tax relief for low and middle income earners, which may incentivise higher consumer spending over the long-term.

While most sectors rose in the month, Health Care (+5.6%) contributed most to the ASX 200's return, almost entirely due to CSL (+9.1%). The biotechnology company upgraded FY18 guidance in response to faster-than-expected take up of its new products.

Metals & Mining (+3.5%) was another strong contributor to the index's rise. BHP Billiton (BHP, +5.9%) and Rio Tinto (+3.9%) rose in value despite the spot iron ore price declining 1.2% to $US65 per tonne.

In contrast, Telecommunication Services declined 10.2% as Telstra (TLS, -11.9%) downgraded its FY18 earnings guidance. Weakness from its Mobile division, which management is relying upon to drive earnings growth, was the primary reason for the downgrade.

The Banking sector (-1.0%) also declined, with weakness from National Australia Bank (NAB, -4.1%) and Commonwealth Bank (CBA -3.5%) outweighing a strong performance from ANZ Bank (+4.3%). NAB and CBA released a disappointing 1H18 result and 3Q18 trading updates respectively, the Australian Prudential Regulation Authority (APRA) released a report critical of CBA's culture and the Financial Services Royal Commission continued to create negative sentiment towards the sector.

Portfolio review

Key contributors

Super Retail (SUL, overweight) – the retailer outperformed after announcing a trading update ahead of expectations. The Auto and Sports divisions drove implied FY18 EPS 1-2% ahead of analyst forecasts, more than offsetting the weaker result from BCF (Boating, Camping and Fishing). Three-year earnings guidance was also above what the market had anticipated; management expects revenue growth of 4-6% year-on-year and EBIT margin expansion of 20 basis points per annum, with Macpac earnings growing 12% on a compound annual growth rate (CAGR). We remain overweight SUL, as we believe the market has overreacted to Amazon's arrival and undervalued the Macpac acquisition. SUL provides a diversified discretionary retail exposure (across Auto, Sport and Leisure) which should support mid to high single-digit earnings growth from both sales and margin opportunities over the medium to long term. The stock now trades at 11.0 times earnings on a 12-month forward basis – a steep discount to its discretionary retail peers.

Telstra (TLS, underweight) – the telco underperformed after providing a negative 3Q18 trading update. Management now anticipates FY18 EBITDA at the bottom end of its $10.1-10.6bn guidance range, approximately 2% below consensus forecasts of $10.3bn. Weak performance from its Mobile division (47% of underlying EBITDA) was primarily responsible for the downgrade. Management was relying on Mobile to drive earnings growth during the NBN roll-out period but the division, as a result of significant competitive pressure, will now drag on earnings. The update supported our thesis that TLS faces earnings headwinds across all divisions. Competition is intensifying as TPG Telecom (TPM) enters the mobile market, increasing pressure on TLS's market share and margins, and the fixed line businesses face significant structural and

competitive challenges. We also believe there are risks of lower future NBN payments and remain sceptical that TLS can fill its $2-3bn EBITDA shortfall when NBN payments conclude and the company faces higher access costs. Consequently, we do not believe the headline 12-month forward P/E of 9.1 times provides appropriate valuation support.

National Australia Bank (NAB, underweight) – the bank underperformed following an underwhelming 1H18 result. While headline metrics were in line with expectations, there was little revenue momentum with net interest income falling 0.3% and consumer interest income flat. NAB reiterated its guidance for expenses to grow 5-8% in FY18 and remain flat in FY19 and FY20, which we believe is not sustainable given significant catch-up investment is required. The company also announced its planned divestment of wealth business MLC by way of either an IPO, demerger or a trade sale. In our view this will be a complicated business extraction, will likely result in further restructuring charges and could become capital consuming. We don't regard NAB's valuation – at 11.4 times forward earnings and 1.4 times book value – appealing when considering these headwinds.

Key detractors

CSL (CSL, underweight) – the company outperformed after upgrading FY18 net profit guidance by 7-8% to between $1,680 and $1,710m, which was 3.5% ahead of consensus expectations. A faster sales ramp-up in CSL's Idelvion and Haegarda businesses and more demand for Seqirus's higher value flu products drove the upgrade. We remain underweight CSL based on its forward valuation (32.8 times P/E and 23.0 times EV/EBITDA on a 12-month forward basis), which we believe fully captures the earnings growth outlook. Growth rates may also prove more challenging to achieve in the longer term given new product growth across the industry will largely come from the more competitive recombinant portfolio sector, where CSL's plasma product economics and relative competitive advantage are less relevant.

GrainCorp (GNC, overweight) – the grain handling company underperformed following the release of a mixed 1H18 result. Earnings came in 4% below consensus expectations, driven by weakness across the Grains, Malts and Oils divisions. Management confirmed FY18 guidance for EBITDA of $240-265mn and net profit of $50-70mn, though did flag that the smaller crop season would impact the Grains division more than previously anticipated. While the crop outlook for FY18 is now less than half that of FY17, we remain overweight the stock with earnings growth expected from the return to a more normal season. We expect free cash flow to improve as GNC's investment program winds down, which should allow for further improvements to its balance sheet. Looking beyond the current crop season, however, we believe GNC will have difficulty realising the value of its infrastructure assets given their deep integration with operations, with the company unlikely to make significant changes to unlock this value in the near term. As a result we have reduced our position size.

James Hardie (JHX, overweight) – the building materials company underperformed after its FY18 result led to modest consensus downgrades to FY19. Drivers for the downgrade included JHX guiding to full year volume growth 1-2% below consensus forecasts, and costs associated with the recent acquisition of Fermacell. We remain confident in the outlook for JHX's US business. After resolving its operational issues, the company is well placed to win back customers and grow its already strong order book. With improved visibility on pricing, we believe JHX can deliver margins at the top end of management's targeted range. Finally, in our view JHX's product development should support demand growth in the north of the US, which so far has proven elusive.

Key purchases

WorleyParsons (WOR) – we established a position in the engineering services company during the month. We expect WOR to benefit from its exposure to oil & gas (primarily through its Hydrocarbons business which comprises 70% of group EBIT), which we believe stands to benefit from increased capex across the industry. As activity levels increase, strong operating leverage – driven by management's focus on controlling overhead costs and maintaining high staff utilisation – should drive earnings above consensus expectations. While WOR trades at a premium to peers based on consensus expectations (21.9 times forward earnings), this premium falls to a discount when adjusted for WOR's strong growth potential.

Star Entertainment (SGR) – we increased our position in the casino operator during the month. We believe the market currently underestimates SGR's ability to enhance asset performance through operational improvements and capex programs. The company's brownfield developments – the expansion in Sydney, the redevelopment in the Gold Coast and the Queen's Wharf in Brisbane – provide meaningful opportunities for upside in the medium to longer term.

Westpac (WBC) – we modestly increased our overweight position in the bank during the month. We believe WBC's favourable business mix, namely an overweight to retail banking, offers an attractive medium-term risk adjusted growth profile. Bad debt levels have declined to benign levels after rising in prior periods due to large single name exposures, further strengthening our conviction in the stock. We believe WBC offers an attractive total return, trading on a forward 6.9% fully franked dividend yield with low-single digit earnings growth. While outcomes for the Royal Commission will likely result in structural and behavioural changes, we believe this is more than fully captured by the market, with the stock trading at 11.3 times earnings on a 12-month forward basis.

Key sales

GrainCorp (GNC) – we reduced our position following the company's 1H18 result. Looking beyond the current crop season, we believe it will be difficult for GNC to realise the value of its infrastructure assets given their deep integration with operations, with the company unlikely to make significant changes to unlock this value in the near term. However, while the crop outlook for FY18 is now less than half that of FY17, we remain overweight the stock with earnings growth expected from the return to a more normal season. We expect free cash flow to improve as GNC's investment program winds

down, which should allow for further strengthening of its balance sheet.

Incitec Pivot (IPL) – we exited our holding in the month to pursue better opportunities elsewhere following a weakening outlook for IPL's key commodities, urea and diammonium phosphate (DAP). IPL's other business, explosives, enjoys a strong competitive position across most markets, but moderate risks have now emerged following WA contract losses announced in 1H18, with other key contracts coming up for renewal in the short term.

MYOB (MYO) – we reduced our holding during the month, but retain a smaller overweight position in the company. Following the termination of the RKN acquisition, MYO will have to increase its R&D expenditure, however this appears to be captured in consensus expectations. Though pressure from competition has mounted (as shown in lower average revenue per user and slower subscriber growth), we continue to believe MYO has the potential to produce relatively defensive, mid to high single-digit earnings growth as customers are drawn to the functionality of its cloud-based products. MYO's product suite has strong pricing power and annuity-like characteristics, supported by a strong and accelerating product cycle over the next 1-2 years)

Key active overweights

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, which in part reflects the external management structure of the vehicle. Securityholders approved ALX's planned management internalisation in May, a change we believe will be highly value accretive. Not only have large fees leaked significant value over time, but the external structure and MQG's ownership stake – which was sold in December – represented a roadblock for any potential acquirer and, in our view, had prevented ALX's assets from being appropriately valued.

Seek (SEK) – our overweight position reflects our positive view towards the online recruitment company's products, following sustained and significant investment. We expect new product developments will deliver material new revenue opportunities and strengthen the existing businesses, both domestically and internationally. The structural growth of SEK's earlier stage markets should also support international growth, in our view, with synergies from recent acquisitions adding to earnings growth. The company's early stage businesses also contain latent value given its strong track record and the current earnings losses (FY18 earnings guidance implies early stage losses will detract 12% from group reported NPAT). SEK has a strong balance sheet (FY17 net debt to EBITDA 0.8 times) which will support further accretive acquisitions, including lower risk increases to existing investments.

James Hardie (JHX) – we hold a positive view of both JHX's domestic (approximately 30% of group earnings) and US operations (70% of group earnings) as management pursues ongoing pricing, market share and plant optimisation initiatives. We expect resolution of US supply and manufacturing issues will assist in driving market share growth in coming periods, with EBIT margins set to improve due to a positive pricing environment and improving per unit operating costs. While representing less than 10% of the overall combined business value, we are supportive of JHX's purchase of EU-based Fermacell in the December quarter, given its market leading position and strong product offering.

Key active underweights

CSL (CSL) – we remain underweight CSL based on its forward valuation (32.8 times P/E and 23.0 times EV/EBITDA on a 12-month forward basis), which we believe more than captures the earnings outlook. Growth rates may also be more challenging to achieve in the longer term given new product growth across the industry will largely come from the more competitive recombinant portfolio sector, where CSL's plasma product economics and relative competitive advantage are less relevant.

National Australia Bank (NAB) – we do not hold a position in the bank, with our preferred banking exposures being ANZ Bank (ANZ), Commonwealth Bank (CBA) and Westpac (WBC). NAB's domestic business is a clear underperformer relative to peers, with pre-provision earnings stagnant over a number of years and significant catch-up investment required as evident by its move to accelerate costs and investment in FY18 along with a large ($755mn) restructuring charge. After a large 5-8% step-up in costs in FY18, NAB has guided to flat cost growth in FY19 and FY20, which we believe is unsustainable. We don't regard NAB's valuation – at 11.4 times forward earnings and 1.4 times book value – appealing when considering these headwinds.

BHP Billiton (BHP) – our underweight position reflects our cautious medium to longer term view towards BHP's commodity exposures, particularly iron ore and coal. We believe fundamentals point to lower prices as new supply comes onto the market and China's demand wanes from strong, stimulus-induced levels. Furthermore, the ability for BHP to support earnings through lower costs appears increasingly challenged – cost inflation is building (as evidenced in the 1H18 results) and capex will need to increase to more normal levels.

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 average based on forward earnings estimates, though valuations remain attractive relative to alternatives such as fixed interest. The S&P/ASX 200 Index yields 4.5% on a 12-month forward basis (before franking) versus 2.7% 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, which include rising interest rates and China's real rate of growth.

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

Sector allocation

	Portfolio %	Benchmark %	Active %
Consumer Discretionary	10.39	4.80	5.59
Consumer Staples	1.01	7.78	-6.77
Energy	8.30	5.47	2.83
Financials	33.15	32.70	0.45
Health Care	5.97	8.47	-2.50
Industrials	12.53	7.33	5.20
Information Technology	5.09	2.17	2.92
Materials	17.63	18.78	-1.15
Real Estate	0.00	8.07	-8.07
Telecommunication Services	3.83	2.45	1.38
Utilities	0.00	1.98	-1.98

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Commonwealth Bank of Australia	9.97	7.55	2.43
Westpac Banking	8.33	5.87	2.46
ANZ Banking	7.82	4.92	2.90
Atlas Arteria	4.28	0.27	4.01
Origin Energy	3.96	1.04	2.92

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	4.28	0.27	4.01
Seek	3.79	0.44	3.35
James Hardie Industries	3.91	0.61	3.31
Underweights			
CSL	0.00	5.20	-5.20
National Australia Bank	0.00	4.51	-4.51
BHP Billiton	2.55	6.51	-3.97

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.

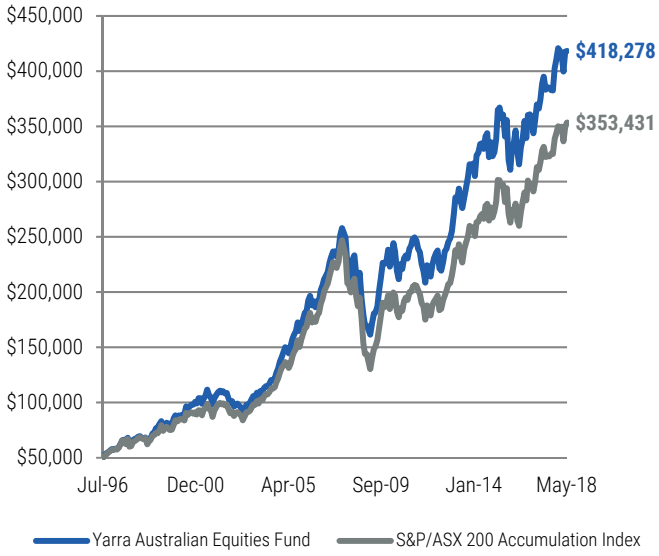
Income and growth

	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.
Growth return	5.01	0.02	1.57	-2.68
Distribution return	4.13	5.04	6.61	8.69

The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), 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.

Investment performance comparison of $50,000

After fees, since inception of the Yarra Australian Equities Fund, July 1996 to May 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 200 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.

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 200 Accumulation Index over rolling 3-year periods.	
Recommended investment time frame	5 - 7 + years	
Fund inception	July 1996	
Fund size	Pooled Fund A$568.23 mn as at 31 May 2018	
APIR codes	JBW0009AU	
Estimated management cost	0.95% p.a.	
Buy/sell spread	+/- 0.15%	
Platform availability	AMP PortfolioCare AMP Wealthview AMP Flexible Lifetime North Asgard BT Wrap BT Panorama Colonial FirstWrap IOOF Pursuit Select Macquarie Wrap Consolidator	Macquarie Wrap Accumulator OnePath PortfolioOne Oasis ANZ Grow Wrap Netwealth SimpleWrap PowerWrap SmartWrap Hub24

Applications and contacts

Investment into the Yarra Australian Equities Fund can be made by Australian and New Zealand resident investors only.

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