YARRA
CAPITAL MANAGEMENT

Investment Commentary
Month to 31 May 2018

Yarra Australian Real Assets Securities Fund

Total returns as at 31 May 2018

	From December 17 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	8.91	1.96	5.66	1.00	4.10	8.74	6.52	7.48
S&P/ASX Custom Infrastructure, Utilities and A-REITs Index*	9.65	2.24	5.81	1.47	NA	NA	NA	NA
Excess Return†	-0.74	-0.28	-0.15	-0.47	NA	NA	NA	NA
Growth Return‡	NA	NA	NA	-13.15	-3.87	2.38	1.10	2.21
Distribution Return‡	NA	NA	NA	14.15	7.97	6.36	5.42	5.28

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 May as a number of corporate actions supported the benchmark.

The S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Accumulation Index rose 2.2% in the month compared to 1.2% from the S&P/ASX 300. The benchmark also outperformed international indices, with the MSCI World Index returning 1.4%.

REITs (+3.0%) generated positive returns for the third consecutive month in May. Investa Office Fund (IOF, +15.0%) 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 contributed heavily to the Index's return with all but one constituent rising in the period. Shopping mall owner Vicinity Centres (VCX, +9.4%) rose sharply after tightening FY18 funds from operations (FFO) guidance to the top end of its previously stated range. Elsewhere, Westfield (WFD) successfully gained approval from its shareholders to merge with Unibail-Rodamco (UNBP).

Infrastructure & Utilities (+1.3%) also generated solid returns. Transportation Infrastructure (+2.3%) supported the benchmark, with strong performances from toll road operators Transurban (TCL, +2.3%) and Atlas Arteria (ALX, +3.4%) as well as airport operator Sydney Airport (SYD, +2.1%). During the month ALX was renamed from Macquarie Atlas Roads after shareholders approved the internalisation of management at the company's AGM, a change which in our view unlocks significant value. SYD continued to report strong traffic trends as its asset benefits from increased visitations from Asia, while TCL was given the amber light for its bid for the WestConnex toll road from the ACCC; ultimately we do not believe TCL's participation will be blocked.

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 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).

NextDC (NXT, overweight) – the data centre operator outperformed without any company-specific news in the month. We remain overweight NXT based on our view the company is structurally set to benefit from increasing adoption of cloud technology and is accelerating its expansion to meet the demands of its growing client base. The outlook for NXT appears attractive given the company's growth profile and infrastructure-like characteristics at maturity.

GPT Group (GPT, overweight) – the REIT outperformed in response to M&A activity in the Office sector during the month, with Investa Office Fund (IOF) receiving a takeover proposal from Blackstone at a 13% premium to its last traded price. We remain overweight GPT based on its high-quality assets and

less aggressive guidance than some peers, with minimal reliance on asset transactions. 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 5.4% as attractive in the current environment.

Key detractors

Vicinity Centres (VCX, underweight) – the shopping mall owner outperformed after reaffirming guidance at the top end of its previous range (18.0 to 18.2 cents per security), continuing the sell-down of its non-core assets and announcing improved retail sales growth. Management reported the sale of Brandon Park at a 3.8% premium to the December 2017 book value and said specialty retail sales grew 0.4% for the 12 months to 31 March 2018 compared to -0.7% in the prior quarter. We remain underweight the stock as we believe the outlook for second-tier malls is worsening. For reference, 33 of VCX's 75 shopping centres are sub-regional by classification (44% by value). Though VCX is lifting the quality of its portfolio by focusing on the development of its best assets and divesting its lower-quality centres, we do not believe this will offset the continued decline in value from its second-tier assets.

Folkestone Education Trust (FET, overweight) – the childcare property owner underperformed without any material company-specific news in the month. We remain overweight the stock based on its exposure to attractive, diverse assets and the favourable demand backdrop, with childcare centres a growing and government-supported industry in Australia. FET owns more than 400 centres across Australia that have yields of 6%, rental growth of 3%, high occupancy at more than 99% and long lease terms at 9.1 years. Given these metrics, we find its valuation compelling at a P/NTA of 1.0 times with a forecast dividend yield of 6.0%.

Aurizon (AZJ, overweight) – The rail freight operator underperformed due to uncertainty over the Queensland Competition Authority's draft decision for what it can charge customers for the use of its network. AZJ is appealing the draft and is also seeking a judicial review on the grounds of conflict of interest (the chair of QCA also chairs the Port of Newcastle). If the Queensland Supreme Court determines there is a conflict, the decision could be set aside and the process restarted. Notwithstanding the regulatory uncertainty, we believe the outlook for AZJ remains positive, with several near-term catalysts in its above-rail business (including higher volumes and multiple large tenders) and medium-term upside from its efficiency programs and rationalisation of its bulk division. AZJ trades at an attractive EV/EBITDA of 8.2 times and a 12-month forward dividend yield of 5.7%, which fully factors in the negative impact from the draft decision despite the uncertainty over the ultimate outcome.

Key purchases

Ausnet (AST) – we established an overweight position in the electric utilities company during the month. 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 upgrades its 2021 target of $1bn given a healthy pipeline of predominantly renewable connections. Furthermore, as a result of simplifying its legal structure several years ago, AST is fully tax paying and doesn't have any risk from the Australian Energy Regulator's (AER) review of tax allowances – unlike peer Spark Infrastructure (SKI) which currently pays no tax but still receives a benefit. AST currently trades at 1.3 times its Regulated Asset Base (RAB) and at a 12-month forward 7.0% gross dividend yield with 4-5% per annum growth over the next three years.

Dexus Property (DXS) – we established a position in the office REIT during the month. 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.

GDI Property (GDI) – we increased our overweight position during the month. We continue to believe GDI's property portfolio is in an attractive sub-sector (office) and is well placed geographically, with the company overweight properties in Perth, a market which has passed through the bottom of the cycle and is recovering slowly. GDI is internally managed and has a management team that is strongly aligned with its shareholders. Furthermore, GDI trades at an attractive valuation at 1.1 times last tangible book value and with a 12-month forecast dividend yield of around 6.3%.

Key sales

Investa Office Fund (IOF) – we exited our overweight position after IOF announced it had received 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).

Spark Infrastructure (SKI) – we reduced the position size in the electric utilities company during the month. In our view regulatory uncertainty has increased for the company. In addition to the Australian Energy Regulator (AER)'s forthcoming report on the cost of capital guidelines (which is 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 AST as a result of contracted asset growth from its exposure to non-regulated renewables.

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 0.98 times NTA – and view its prospective dividend yield of 5.4% 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.

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.

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.

Key active underweights

Goodman Group (GMG) – our underweight position reflects our more cautious outlook for development earnings and GMG's premium share price valuation of 18.5 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.

Vicinity Centres (VCX) – our underweight position is based on our belief that the outlook is deteriorating for the company's second-tier assets, with fewer buyers and more sellers (VCX was unable to achieve its target of selling four non-core malls before Christmas). Though VCX is lifting the quality of its portfolio through focusing on the development of its best assets – which have a more positive outlook – and divesting its lower-quality centres, we do not believe this will offset the continued decline in values from its second-tier assets. VCX trades at 0.9 times its net tangible assets with a 6.2% dividend yield, which we find unappealing against this challenging backdrop.

Mirvac (MGR) – we are underweight MGR based on our belief that its valuation (at 1.0 times NTA with a 5.1% dividend yield on a forecast basis) is capturing strong earnings growth and an optimistic cash flow outlook over the next two years, driven by elevated apartment and commercial property development profits. However, in our view residential earnings are at peak levels and will moderate over time, which is at odds with optimistic consensus forecasts. Furthermore, in our view passive property valuations are approaching the top of the cycle.

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 5.2%, 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 around 15% 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	9.43	4.15	5.28
Atlas Arteria	7.17	2.02	5.16
Transurban	17.22	12.10	5.12
Underweights			
Goodman	2.51	6.88	-4.37
Vicinity Centres	0.00	3.94	-3.94
Mirvac	0.00	3.92	-3.92

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	41.44	28.44	13.00
Airport Services	6.20	7.70	-1.50
Highways & Railtracks	24.39	14.12	10.27
Telecommunication Services	1.45	1.16	0.29
Railroads	6.63	3.99	2.64
Marine Ports & Services	0.00	1.47	-1.47
Information Technology	2.77	0.00	2.77
Utilities	9.34	14.86	-5.51
Electric Utilities	3.71	3.13	0.57
Gas Utilities	2.39	4.71	-2.32
Independent Power and Renewable Electricity Producers	0.00	0.33	-0.33
Multi-Utilities	3.25	6.68	-3.43
Real Estate Investment Trusts (REITs)	46.88	56.71	-9.82
Specialized REITs	5.80	1.78	4.02
Diversified REITs	17.25	15.37	1.88
Industrial REITs	2.51	7.40	-4.89
Office REITs	5.20	7.04	-1.84
Retail REITs	16.12	24.61	-8.48
Other	0.00	0.51	-0.51
Cash and receivables	2.33	0.00	2.33

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$45.64 mn as at 31 May 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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