YARRA
CAPITAL MANAGEMENT

Investment Commentary
Month to 31 May 2018

Yarra Emerging Leaders Fund (Direct)

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 Emerging Leaders Fund (Direct)	1.22	4.20	17.43	8.38	11.88	5.16	11.75
Emerging Leaders Combined Benchmark†	1.91	2.07	19.55	12.11	12.31	3.73	8.58
Excess return‡	-0.69	2.13	-2.12	-3.72	-0.44	1.43	3.17

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 Emerging Leaders Fund (Direct): November 1994
† Comprising 50% S&P/ASX Midcap 50 Accumulation Index and 50% S&P/ASX Small Ordinaries Accumulation Index
‡ Excess return: The difference between the Fund's return and the benchmark return.

Market review

Australian small and mid-caps outperformed their larger peers in May, as strength in Consumer Discretionary and Diversified Financials outweighed weakness in Consumer Staples.

The Emerging Leaders Benchmark increased by 1.9% for the month to 30 May 2018, taking its 12-month return to 19.6%. In comparison, the S&P/ASX 200 Accumulation Index returned 1.1% in the month and 9.6% for the year.

The Federal Government's 2018-2019 budget was released during the month, with only a minor impact on equity markets. The government continues to focus on 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.

Consumer Discretionary (+3.3%) was the top contributor to the index's return in the month. Seven West Media (+47.7%) was the top performer after reaffirming FY18 EBIT at the midpoint of its previous guidance and delivering a positive assessment of its cricket broadcast rights deal. Outdoor media stocks oOH! Media (OML, +7.8%) and APN Outdoor (APO, +4.2%) also performed well.

In Diversified Financials (+6.8%), Challenger (CGF, +19.4%) rose in response to the budget's proposed retirement income reforms that provided regulatory certainty about annuities as a retirement product. Pendal (PDL, +8.4%), Netwealth (NWL, +25.7%) and HUB24 (HUB, +24.3%) were other strong performers.

In contrast, Consumer Staples declined 2.9% in the month. A2Milk (A2M, -12.2%) issued a worse-than-expected trading update, Metcash (MTS, -19.4%) lost a contract with Drakes Supermarkets and GrainCorp (GNC, -9.9%) released a mixed 1H18 result.

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.

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 expanding client base. The outlook for NXT appears attractive given the company's growth profile and infrastructure-like characteristics at maturity.

Saracen Minerals (SAR, overweight) – the gold miner outperformed after releasing a positive exploration update in the month. Drilling returned significant ore grade intercepts outside its existing Whirling Dervish's Reserve, which bodes well for SAR's larger exploration program along the greater mine corridor. We continue to prefer SAR amongst its peers when considering its organic production growth, increasing mine life, declining cost profile and net cash balance sheet position.

NO LONGER AVAILABLE FOR NEW INVESTMENT

Key detractors

CSR (CSR, overweight) – the building materials company underperformed during the month as the Aluminium division weighed on an otherwise solid FY18 result, with earnings broadly in line with expectations and management providing an upbeat FY19 outlook for its core building products division. In aluminium, there were higher than anticipated costs as part of a revised power contract with AGL Energy (AGL). Management commented that recent building approvals for detached housing remained high, supporting activity for the current financial year. We remain overweight the stock based on three factors: a more positive outlook on the Building Products division than consensus as a result of an improved competitive landscape and market structure in bricks, management's strong operational expertise across all divisions (including Aluminium where earnings are being optimised through proactive hedging strategies and efficiency measures) and CSR's strong balance sheet which enables the pursuit of selective bolt-on acquisitions and capital management initiatives.

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.

MYOB Group (MYO, overweight) – the accounting software company underperformed in the month after terminating the acquisition of Reckon's Accountant Practice Management business due to delays in regulatory approvals. We believed the acquisition would have likely been rejected by the ACCC on competition concerns given MYO already had 50-60% practice management market share. With the deal terminated, MYO will have to increase its R&D expenditure, though 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 purchases

Eclipx (ECX) – we established a position in the sales financing group in the month. We hold a positive view towards ECX's core vehicle leasing business, where the company should continue to take market share (with high single-digit volume growth and stable pricing) and where there is a large cost-out opportunity from upgrading existing systems. Additionally, ECX is well positioned to capitalise on the major banks pulling back from lending in this industry. In our view the risk associated with ECX's products is relatively low: the products are largely operating leases, the customers are mostly corporate and bad debts are benign at 15 basis points. ECX's valuation appears attractive, with the stock trading at 10.5 times on a FY19 basis – a material discount to peers at 13 to 17 times.

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 (22 times forward earnings), this premium falls to a discount when adjusted for WOR's strong growth potential.

Independence Group (IGO) – we took the nickel miner's underperformance as an opportunity to increase our holding during the month. We remain overweight IGO based on our positive view of Nova and Tropicana – its two world-class assets – which support an increasing production profile (Jaguar was divested during the month for $73mn). After a slower than expected start-up from Nova, we believe its issues have been largely resolved, with increasing production and higher commodity prices supporting material cash flow over the medium to long-term. Meanwhile, we expect higher grades and production at a lower cost from Tropicana. IGO's balance sheet is well capitalised, with net debt at $73mn.

Key sales

Western Areas (WSA) – we exited our position in the nickel miner during the month. While we continue to hold a positive view towards the commodity and the company's operations, we believe the market has fully captured WSA's strong earnings and production outlook, with the stock now trading at 21 times forward earnings. Our preferred exposure to nickel remains Independence Group (IGO), which trades at a more compelling 16 times and is well placed to deliver material cash flow in the medium term from higher production with operational issues now largely resolved.

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.

Bank of Queensland (BOQ) – we reduced the position size during the month but maintain a small overweight position. BOQ has a high-quality management team that can deliver organic growth and reduce costs within sensible risk parameters. Its asset book has dramatically reduced in risk, notwithstanding the concentration issues currently facing all regional banks. Lastly, a rising yield environment is most favourable for regional banks, which are most levered to improving margins.

Key active overweights

NextDC (NXT) – we see further upside in the data centre operator. In our view, the business is structurally set to benefit from the increasing adoption of cloud technology and is accelerating its expansion to meet the demands of its larger clients. To this end, the company is currently building three new data centres which will support significant medium to longer term earnings growth. Overall, the outlook for NXT appears attractive given the company's growth profile and infrastructure-like characteristics at maturity, and valuation remains supportive.

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.

CSR (CSR) – we are overweight the stock because we are more optimistic than consensus expectations concerning the company's Building Products division. We expect continued strong EBIT in FY19 as a result of an improved competitive landscape and market structure in bricks, while consensus is currently more pessimistic. CSR demonstrates strong operational expertise across its divisions, including the Aluminium division where management continues to optimise earnings from its Tomago plant through proactive hedging strategies and efficiency measures to drive down costs. Lastly, the company's strong balance sheet – it is effectively debt free – leaves it well placed to pursue selective bolt-on acquisitions or capital management initiatives.

Key active underweights

Cochlear (COH) – our underweight position reflects our view that the current share price is efficiently capturing the growth characteristics of the company and its market leadership position. In the near term, the processor upgrade cycle is likely to provide additional earnings momentum, which we believe is already captured in high earnings growth and multiple expectations.

Bluescope Steel (BSL) – while our view towards the stock has recently improved, we currently maintain an underweight position. BSL's earnings remain subject to volatile commodity prices, though its recent cost-reduction programs and ongoing shift in business mix means that its earnings appear more resilient at this time compare to previous cycles.

Tabcorp (TAH) – we are underweight the gambling services provider because we believe earnings expectations are too optimistic and the market's valuation, at 21.1 times 12-month forward P/E, is stretched. Our key concern is the outlook for the conventional wagering business, which operates in a low growth industry and with high levels of competition, placing intense pressure on its traditional retail distribution strategy. The merger of TAH and Tatts Group doesn't alter our view of the structural headwinds in wagering, with the high acquisition price and high gearing more than offsetting targeted cost synergies in our view.

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 our earnings and cash flow expectations. We are overweight the Information Technology, Telecommunications Services and Consumer Discretionary sectors, but are underweight Real Estate, Metals & Mining and Consumer Staples.

Sector allocation

	Portfolio %	Benchmark %	Active %
Consumer Discretionary	22.93	16.02	6.91
Consumer Staples	4.63	7.49	-2.86
Energy	1.96	3.94	-1.98
Financials	9.87	11.55	-1.68
Health Care	10.66	9.33	1.33
Industrials	12.67	11.59	1.08
Information Technology	11.16	7.92	3.24
Materials	17.81	22.00	-4.19
Real Estate	1.44	6.57	-5.13
Telecommunication Services	5.70	1.79	3.91
Utilities	0.00	1.80	-1.80

Top 5 holdings

	Portfolio %	Benchmark %	Active %
NextDC	5.86	0.66	5.20
Atlas Arteria	5.44	1.03	4.41
Resmed	4.54	1.61	2.93
CSR	4.23	0.61	3.62
Ansell	4.17	0.88	3.29

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
NextDC	5.86	0.66	5.20
Atlas Arteria	5.44	1.03	4.41
CSR	4.23	0.61	3.62
Underweights			
Cochlear	0.00	2.63	-2.63
Bluescope	0.00	2.28	-2.28
Tabcorp Holdings	0.00	2.06	-2.06

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	16.05	7.46	10.57	2.83
Distribution return	1.38	0.93	1.30	2.34

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.

Features

Investment objective	To achieve medium-to-long term capital growth through exposure to small and medium sized Australian companies that are considered to possess strong capital growth potential. In doing so, the aim is to outperform the benchmark over rolling 3-year periods.
Recommended investment time frame	5 - 7 + years
Fund inception	November 1994
Fund size	Pooled Fund A$158.68 mn as at 31 May 2018
APIR codes	JBW0007AU
Estimated management cost	2.25% p.a.
Buy/sell spread	+/- 0.20%

The Yarra Emerging Leaders Fund (Direct) is not available for new investment. Where existing reinvestment instructions are in place, distributions may be reinvested.

Applications and contacts

The Yarra Emerging Leaders Fund (Direct) is no longer available for new investment. The reinvestment of distributions is still allowed where an existing reinvestment instruction is in place.

Website www.yarracm.com

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