YARRA
CAPITAL MANAGEMENT

Investment Commentary
Quarter to 30 June 2018

Yarra Leaders Fund

Total returns as at 30 June 2018

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Leaders Fund^	2.43	6.50	10.67	6.52	8.22	6.20	9.71
S&P/ASX 100 Accumulation Index	3.46	8.45	12.05	8.56	9.81	6.64	9.76
Excess return‡	-1.03	-1.95	-1.38	-2.05	-1.59	-0.43	-0.05

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 Leaders Fund: October 1998
^ This Fund is no longer available for new investment. The Reinvestment of distributions is still allowed where an existing Reinvestment instruction is in place.
‡ Excess return: The difference between the Fund's return and the benchmark return (S&P/ASX 100 Accumulation Index).

Market review

The Australian equities market rallied in the June quarter, generating its best quarterly return since March 2015.

The S&P/ASX 100 Accumulation Index returned 8.4% in the three months to 30 June 2018, taking its 12 month return to 12.1%. The local index outperformed global indices, with the MSCI World Index returning 3.8% in the quarter and 11.5% for the year.

The Federal Government's 2018-2019 budget was released during the quarter, with only a small 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 lower and middle income earners, which may incentivise higher consumer spending over the long-term.

Resources stocks contributed most to the index's return in the quarter. Iron ore majors BHP Billiton (BHP, +20.2%) and Rio Tinto (RIO, +14.8%) supported Metals & Mining (+16.2%) as the iron ore price remained at around $US65 per tonne, defying expectations for it to decline. BHP also benefited from its exposure to oil as WTI crude lifted 14% to $US74 per barrel. Energy (+18.5%) was the top performer with all constituent companies – including Woodside (WPL, +21.3%), Origin Energy (ORG, +15.3%) and Oil Search (OSH, +24.5%) – rising during the period.

In the Industrials space, the Banks (+3.4%) saw relief in the quarter while Health Care (+17.2%) generated strong returns driven by CSL (CSL, +23.9%). The biotechnology company upgraded its FY18 guidance in response to faster-than-expected take up of its new products. The only sector to decline in the quarter was Telecommunication Services (-16.0%). Telstra (TLS, -16.6%) downgraded its FY19 earnings guidance due to weakness from its Mobile division, which management is relying upon to drive earnings growth.

Portfolio review

Key contributors

Telstra (TLS, underweight) – the telco underperformed following a series of negative trading updates. In May the company provided a worse-than-expected 3Q18 trading update and, at its strategy day in June, announced a 15% downgrade to FY19 earnings (at the midpoint). 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 13.6 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 do not regard NAB's valuation – at 11.6 times forward earnings and 1.4 times book value – as being appealing when considering these headwinds.

NO LONGER AVAILABLE FOR NEW INVESTMENT.

AMP (AMP, underweight) – AMP fell sharply in value early in the quarter after being found by the Financial Services Royal Commission to have misled corporate regulators over misconduct in its advice business. As a result of the revelations the chief executive and chair stepped down and a comprehensive and independent review was announced into AMP's regulatory reporting and governance processes. We remain underweight the stock. In our view the reputational damage may limit growth opportunities, increase costs, inhibit AMP's ability to sell businesses and will constrain the stock's valuation (currently at a 12-month forward multiple of 10.5 times). Outside of this AMP's business remains structurally pressured, with continued margin compression in its wealth management division.

Key detractors

CSL (CSL, underweight) – the company outperformed after upgrading FY18 net profit guidance by 7-8% to between $1.68-$1.71bn, 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 (32.9 times P/E and 23.1 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.

BHP Billiton (BHP, underweight) –the company outperformed in response to the higher oil price – WTI crude rose 14.3% to $US74 per barrel – and the iron ore price remaining firm at around $US65. BHP's 3Q18 production report was largely in line with expectations, with copper guidance slightly upgraded but iron ore guidance downgraded by 1-2% for FY18 as a result of operational issues. We maintain a 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 historic levels.

Star Entertainment (SGR, overweight) – the casino operator underperformed following a mixed trading update in the quarter. SGR's Sydney casino, the Star, weighed on revenue due to below average table hold rates in the top private gaming room tier. SGR also announced an expanded strategic partnership with Chow Tai Fook Enterprises and Far East Consortium International. Under the deal the pair take a combined 9.99% ownership in SGR through an equity placement. We remain overweight SGR as 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 upside opportunities in the medium to longer term.

Key purchases

Clydesdale (CYB) – we established a position in the UK bank following its £1.7bn takeover of Virgin Money in June. We see strong merit in the tie-up, which addresses CYB's lack of a strong retail brand outside of North England. The acquisition should also be materially accretive for CYB given the estimated £70mn of synergies from lowering costs in the combined group. On a stand-alone basis CYB is set to benefit from cost reduction initiatives, higher margin asset growth from small to medium enterprises and the return of excess capital following a move to advanced accreditation.

Westpac (WBC) – we increased our position in the bank during the quarter. 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 6.6% fully franked dividend yield with low-single digit earnings growth. While outcomes for the Financial Services 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 11.9 times earnings on a 12-month forward basis.

Seek (SEK) – we increased our position in the quarter. We continue to hold a positive view towards SEK's products, following sustained and significant investment. We expect new product developments will deliver material new revenue opportunities and strengthen its 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 their strong track record and the current earnings upside (FY18 earnings guidance implies early stage losses will detract 12% from group reported NPAT). Finally, SEK has a strong balance sheet (FY17 net debt to EBITDA 0.8 times) which will support further accretive acquisitions, including through lower risk increases to existing investments.

Key sales

GrainCorp (GNC) – we exited 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. Furthermore, we believe the Malts business faces increased headwinds across its Australian operations, with competition creating both pricing and utilisation pressures.

Incitec Pivot (IPL) – we exited our holding in the quarter 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.

Fortescue Metals Group (FMG) – we reduced our position in the iron ore miner in the quarter. Chinese steel market dynamics have not played out in line with our expectations, with the grade discount in FMG's 58% Fe product remaining at record levels. Chinese steel margins remain elevated and winter capacity closures are once again approaching, which will likely sustain the current dynamic. Chinese steel mills also demand more high-grade Fe units as they maximise production volumes during the months for which they are allowed to operate, sacrificing margin to maintain market share. Lastly, we remain wary of a potential correction in the 62% Fe iron ore market, which would drive prices for all products lower.

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 2017 – 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 through lower risk increases to existing investments.

James Hardie (JHX) – we hold a positive view of both JHX's domestic (approximately 20% of earnings) and US operations (70% of 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 (32.9 times P/E and 23.1 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 11.6 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 4.4% on a 12-month forward basis (before franking) versus 2.6% from the Australian 10-year government bond yield.

At a global level, while an economic recovery outlook 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 Industrials, Consumer Discretionary and Information Technology sectors, but are underweight Real Estate, Metals & Mining and Consumer Staples.

Sector allocation

	Portfolio %	Benchmark %	Active %
Consumer Discretionary	6.93	3.23	3.70
Consumer Staples	0.00	7.97	-7.97
Energy	7.60	5.68	1.92
Financials	37.61	35.70	1.90
Health Care	6.20	8.63	-2.43
Industrials	13.48	7.02	6.46
Information Technology	4.42	1.71	2.71
Materials	16.25	18.36	-2.12
Real Estate	0.00	7.34	-7.34
Telecommunication Services	3.67	2.17	1.50
Utilities	0.00	2.18	-2.18

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Commonwealth Bank of Australia	11.16	8.46	2.70
Westpac Banking	9.33	6.62	2.72
ANZ Banking	8.64	5.39	3.25
Origin Energy	4.41	1.16	3.25
Atlas Arteria	4.41	0.28	4.13

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	4.41	0.28	4.13
Seek	4.39	0.50	3.88
James Hardie Industries	4.26	0.66	3.60
Underweights			
CSL	0.00	5.75	-5.75
National Australia Bank Limited	0.00	4.92	-4.92
BHP Billiton	2.81	7.18	-4.37

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	-0.36	-2.48	-2.27	-3.79
Distribution return	11.03	9.00	10.49	10.00

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 by investing in larger companies listed on the Australian Securities Exchange, and in doing so outperform the S&P/ASX 100 Accumulation Index over rolling 3-year periods.
Recommended investment time frame	5 - 7 + years
Fund inception	October 1988
Fund size	A$62.21 mn as at 30 June 2018
APIR codes	JBW0011AU
Estimated management cost	1.80% p.a.
Buy/sell spread	+/- 0.15%

Applications and contacts

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

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