YARRA
CAPITAL MANAGEMENT

Investment Commentary
Month to 31 August 2018

Yarra Australian Equities Fund

Total returns as at 31 August 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	2.53	6.50	16.34	11.70	8.66	7.43	10.40
S&P/ASX 200 Accumulation Index†	1.42	6.19	15.40	11.45	8.93	6.77	9.60
Excess return‡	1.11	0.31	0.94	0.24	-0.28	0.67	0.80

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 in August as a relatively benign reporting season overshadowed divergent trends among stocks and sectors.

The S&P/ASX 200 Accumulation Index returned 1.4% in the month, taking its total return for 12 months to 15.4%. The monthly return was in line with overseas indices, with the MSCI World Index also returning 1.4%.

In aggregate the Australian reporting season was in line with expectations, with 29% of companies beating expectations and 28% missing[1] across the ASX 200. FY19 earnings were revised 1% lower for companies that reported[2].

Momentum dominated returns in the month, with the top P/E quintile outperforming the ASX 200 by 6.2% and the bottom quintile underperforming by 3.3%. Banking and Resources – which comprise almost half of the market –declined 1.2% and 4.4%. These sectors, which trade at forecast P/E's of 12 and 13 times respectively, usually determine the direction of the local market.

Instead Health Care (+10.7%), Telecommunication Services (+13.1%) and Information Technology (+12.9%) supported the market. CSL (CSL, +15.6%) was largely responsible for Health Care's contribution, while the telco sector re-rated following the proposed "merger of equals" between TPG Telecom (TPM, +50.0%) and Vodafone. IT stocks also enjoyed widespread gains, led by Xero (XRO, +19.3%), Altium (ALU, +37.4%), Wisetech Global (WTC, +40.1%), Computershare (CPU, +6.8%), Afterpay (APT, +27.9%) and Appen (APX, +41.2%).).

Portfolio review

Key contributors

TPG Telecom (TPM, overweight) – the company outperformed during the month after announcing a proposed merger of equals with Vodafone, with TPM to own 49.9% and Vodafone Holdings the remaining 50.1%. The merger, which is expected to become effective in 2019, consolidates the telco industry to three large players, with the combined entity (to be called TPG Telecom) becoming a strong challenger to incumbents Telstra (TLS) and Optus. The entity will have an enterprise value of $15bn, comprising debt of $4.1bn (2.2x EBITDA) and equity of $10.9bn. We support the merger, which we expect will unlock significant synergies and provide the entity with the infrastructure, scale and balance sheet to maintain its disruptive nature. As a result we anticipate market share gains will accelerate across the Mobile, Fixed and Corporate divisions.

Vocus Group (VOC, overweight) – the telco outperformed after delivering a better-than-expected FY18 result. Though management delivered FY18 EBITDA in line with expectations and guided to FY19 EBITDA of $350-370mn, 5% below forecasts at the midpoint, cash conversion for the period increased from 68% to 110%. The improvement alleviated concerns in the market that VOC would need to raise capital to avoid breaching its debt covenants. We remain positive towards the stock premised on the combination of new management, improving fundamentals and quality of the asset base. The new management team is focused on integrating and simplifying its various acquired businesses, unifying its product offering and increasing customer product penetration. We remain confident in the longer-term revenue and margin opportunities and believe that the share price (at 16.0 times forward earnings) currently capitalises only limited future growth.

[1] Source: JPMorgan Research
[2] Source: UBS

Star Entertainment (SGR, overweight) – the casino operator outperformed after announcing FY18 earnings ahead of analyst forecasts in its full-year result and making positive outlook comments for FY19. EBITDA grew 14% – ahead of consensus by 2.7% – driven by 55% growth in VIP turnover and cost control in Sydney. Management expects all properties and products to return to growth in FY19, with table hold rates rebounding to above long-term trend levels. We remain overweight the stock, as we continue to 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 detractors

CSL (CSL, underweight) – the company outperformed despite delivering an FY18 result broadly in line with expectations. Revenue rose 11% to $7,717mn for the period and net profit increased by 29% to $1,729mn. While CSL was conservative with its FY19 guidance, forecasting 10-14% underlying net profit growth (1% within consensus forecasts), management delivered a confident narrative referencing growing markets, investment levels, their commitment to R&D and the positive pricing environment. We continue to view CSL as a quality franchise that operates in a largely rational industry structure with a strong product demand outlook, but believe this is more than fully reflected in its valuation at a 12-month forward P/E of 37.0 times.

Origin Energy (ORG, overweight) – the energy company underperformed following disappointing FY19 guidance in its FY18 result. While FY18 EBITDA was also below expectations, this was largely due to its APLNG business where ORG doesn't provide guidance and included $70mn of legacy gas site remediation costs. ORG's FY19 outlook for Energy Markets, however, was 7% below consensus forecasts. Management said absorbing the retail price increases in NSW was primarily responsible, with the company's retail cost to serve jumping $48mn to $317mn in the second half of the year. Conversely, management commentary on APLNG for FY19 was positive, with the project expected to continue to deliver significant free cash flow (and strong distributions to ORG) at current oil prices. With ORG trading at 11 times forward earnings we believe the implied valuation of both the Energy Markets business and APLNG remains conservative, with an eventual demerger of both businesses or sale of APLNG the critical next step in crystallising this value.

Iluka Resources (ILU, overweight) – the mineral sands producer underperformed after announcing 1H18 net profit 5-7% below analyst forecasts and guiding to higher costs for FY18. ILU expects operating costs to increase by 11% and increased its capital expenditure for Sierra Rutile – a project which it purchased in late 2016 – by 50%. On the other hand, ILU also increased its zircon price by 12% for the next six months, lifted zircon production for the next three years, guided to lower capex at its flagship Jacinth-Ambrosia mine and deferred the Balranald project. We continue to hold an overweight position in ILU, which remains a relative safe haven in Metals & Mining given its visibility over commodity pricing for the foreseeable future.

Key purchases

JB Hi-Fi (JBH) – we increased our position in the electronics retailer during the month as the FY18 result increased our conviction in our investment thesis. While The Good Guys has a more conservative outlook amid heightened price competition, we believe the business is better equipped to deal with these issues through its new sales commission system and that significant synergy, sales and margin opportunities remain. Our medium-term investment thesis remains in place, being that concerns regarding Amazon's entry into the Australian market are overplayed 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.

oOH! Media (OML) – we increased our position in the outdoor media company during the month due to our optimistic view of the sector. Outdoor advertising is expanding its share of the total advertising market (currently 5%) supported by increased penetration of digital boards. Given OML's high gross margins and its largely fixed cost base, we expect the positive revenue outlook will support strong medium-term earnings growth. We support the company's recent acquisition of Adshel, given it is mid-single digit earnings accretive and has strong strategic rationale, with clear revenue and cost synergies.

Star Entertainment (SGR) – we increased our position size during the month as the casino operator's FY18 result supported our investment thesis. We continue to believe the market 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 sales

APN Outdoor (APO) – we exited the position after the ACCC approved JCDecaux's takeover bid at $6.70 per share for the company. We believe a competing bid is unlikely in the context of the strong bid from the French suitor, with implementation before the end of CY2018. However, we remain positive towards the outdoor media industry, and subsequently increased our position in peer oOH! Media (OML).

Macquarie Group (MQG) – we reduced our position size in the month following recent outperformance. While MQG's announcement at its 1Q19 update that its chief executive would retire was unexpected and is modestly negative, it doesn't change our view on the stock. MQG maintains a robust capital position, which management has been able to utilise effectively for growth initiatives. We believe earnings upgrades are likely for FY19 given the group's robust operating momentum and outlook (MQG should be a beneficiary of improving global growth). The stock now trades on 15.8 times forward earnings and 2.4 times book value, which is not too

demanding given the group generates more than 15% return on equity.

Downer EDI (DOW) – we modestly reduced our position in the month but remain positive towards the company. We continue to hold a positive view of the 2017 Spotless (SPO) acquisition and see encouraging signs of stability across DOW's legacy businesses, particularly in mining, which are still not fully reflected in market estimates. In our view DOW will more effectively manage SPO's core businesses with multiple potential cross-selling opportunities, and we believe DOW's decision to pivot more towards its infrastructure division, where a significant pipeline of new projects exists, provides an attractive future growth opportunity.

Key active overweights

Atlas Arteria (ALX) – we maintain a favourable view towards ALX based on the continued strong operational performance of its attractive, long-dated assets and its discounted valuation of 11 times EV/EBITDA, which is in part due to the complicated ownership structures of its assets. Securityholders approved the internalisation of ALX's management in May, a change we believe is a significant step towards ultimately simplifying the ownership structures of ALX's two key assets and, in doing so, fully reflecting their intrinsic value. ALX now has a credible strategy for achieving this goal over the next 12 months which we believe will result in significant upside.

Seek (SEK) – our overweight position reflects our positive view towards the online recruitment company's products following sustained and significant investment. We expect product developments will deliver 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, particularly in China. The company's early stage businesses also contain latent value when considering SEK's strong track record and current earnings losses (FY18 earnings guidance implies early stage losses will detract 12% from group reported NPAT). SEK has a strong balance sheet (FY18 net debt to EBITDA 1.2 times) which can support further accretive acquisitions, including through lower risk increases to existing investments.

TPG Telecom (TPM) – our overweight position is based on a positive view of the proposed merger with Vodafone. We expect the combined entity to unlock significant synergies and harness its infrastructure, scale and balance sheet to disrupt incumbents Telstra (TLS) and Optus through its lower-cost structure. As a result, we anticipate market share gains will accelerate across the Mobile, Fixed and Corporate divisions. Furthermore, we expected the combined entity will now be able to acquire 5G spectrum at a lower cost in the upcoming auction.

Key active underweights

CSL (CSL) – we remain underweight CSL based on its forward valuation (37.0 times P/E and 25.8 times EV/EBITDA on a 12-month forward basis), which we believe more than captures the earnings outlook. The growth outlook for CSL's key plasma products remains robust with the Company continuing to strengthen its relative market position through long-term investment in capacity, product innovation and collection centres.

National Australia Bank (NAB) – we do not hold a position in the bank, with our preferred banking exposures being Commonwealth Bank (CBA), Westpac (WBC) and ANZ Bank (ANZ). 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 do not regard NAB's valuation – at 11.8 times forward earnings and 1.5 times book value – as being 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 company's FY18 results) and capex will need to increase to more historic levels.

Market outlook

We believe fundamentals point to a strengthening earnings cycle for the Australian equity market. Consensus sees Resources and Industrials ex-Financials driving high single-digit earnings growth, moderated by more modest earnings growth in Financials.

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 2.5% 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, including 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 Consumer Discretionary, Industrials and Telecommunication Services sectors, but are underweight Real Estate, Metals & Mining and Consumer Staples.

Sector allocation

	Portfolio %	Benchmark %	Active %
Consumer Discretionary	10.95	4.90	6.05
Consumer Staples	0.00	8.00	-8.00
Energy	8.17	5.55	2.62
Financials	33.92	32.78	1.13
Health Care	5.71	9.38	-3.66
Industrials	12.39	7.38	5.00
Information Technology	4.91	2.61	2.31
Materials	14.85	17.27	-2.42
Real Estate	0.00	7.56	-7.56
Telecommunication Services	6.41	2.61	3.80
Utilities	0.00	1.95	-1.95

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Commonwealth Bank of Australia	9.85	7.40	2.45
Westpac Banking	8.10	5.79	2.31
ANZ Banking	8.03	5.04	2.99
Atlas Arteria	4.53	0.27	4.26
Seek	4.07	0.46	3.60

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	4.53	0.27	4.26
Seek	4.07	0.46	3.60
TPG Telecom	3.73	0.17	3.55
Underweights			
CSL	0.00	6.07	-6.07
National Australia Bank	0.00	4.57	-4.57
BHP Billiton	2.42	6.29	-3.87

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	11.03	7.20	2.35	-0.07
Distribution return	5.31	4.50	6.30	7.50

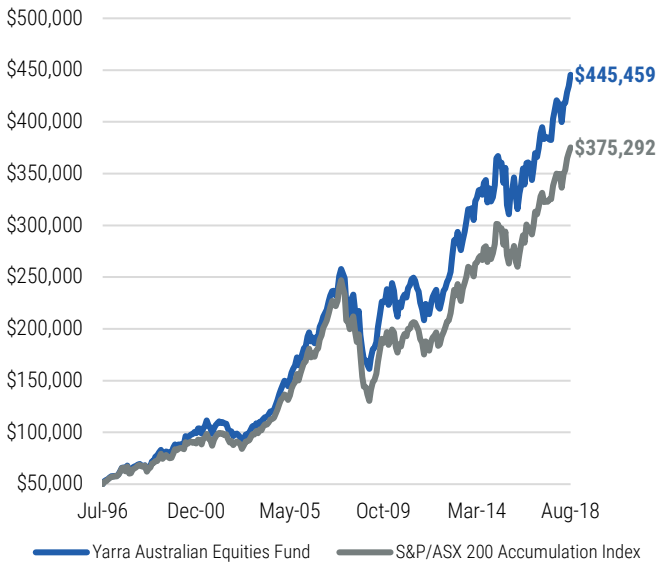
The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders 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 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$601.85 mn as at 31 August 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

Investment performance comparison of $50,000

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

Applications and contacts

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

Website www.yarracm.com

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