YARRA
CAPITAL MANAGEMENT

Investment Commentary
Month to 31 August 2018

Yarra Emerging Leaders Fund (Direct)

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 Emerging Leaders Fund (Direct)	4.59	4.86	21.85	11.20	12.79	7.36	11.84
Emerging Leaders Combined Benchmark†	2.72	4.55	21.42	17.56	12.53	5.37	8.69
Excess return‡	1.87	0.32	0.42	-6.36	0.25	1.99	3.16

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

Small caps outperformed their larger peers during the August reporting season as Australia's nascent Information Technology sector delivered a 14.0% return for the month.

The Emerging Leaders Benchmark rose 2.7% in the month, outperforming the S&P/ASX 200 which returned 1.4%. On a 12-month basis the benchmark remain sharply higher, generating a 21.4% return versus 15.4% from the ASX 200.

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. Momentum once again dominated returns; the top P/E quintile outperformed the ASX200 by 6.2% and the 5th quintile underperformed by 3.3%.

Within the benchmark, six out of the top 10 performers during the month belonged to the Information Technology sector: Appen (APX, +41.2%), Wisetech Global (WTC, +40.1%), Altium (ALU, +37.4%), Infomedia (IFM, +36.8%), Bravura Solutions (BVS, +30.6%) and Afterpay (APT, +27.9%). The market amply rewarded FY18 results, with those six stocks trading at an average 12-month forward P/E multiple of 62 times as at 31 Aug 2018.

Telecommunication Services (+11.3%) and Consumer Discretionary (+5.4%) also supported the Index's return. The former re-rated following the proposed "merger of equals" between TPG Telecom (TPM, +50.0%) and Vodafone. The latter outperformed amid a strong results from Star Entertainment (SGR, +11.3%), Tabcorp (TAH, +5.0%), JB Hi-Fi (JBH, +12.7%) and Webjet (WEB, +27.3%).

Conversely, Metals & Mining (-6.0%) detracted the most from the Index's return in August, with most commodities declining in value and results highlighting emerging cost pressures. The largest detractors from the sector were Sims Metals Management (SGM, -26.8%), Iluka Resources (ILU, -18.1%), Mineral Resources (MIN, -5.9%) and Western Areas (WSA, -18.8%).

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

[1] Source: JPMorgan Research

NO LONGER AVAILABLE FOR NEW INVESTMENT

forward earnings) currently capitalises only limited future growth.

Scottish Pacific (SCO, overweight) – the debtor finance company outperformed after delivering a better-than-expected FY18 result. SCO reported that FY18 core NPATA grew 15% to $33.8mn in the period (5% above consensus) as net interest margins improved and the group generated double-digit growth in Trade Finance. SCO also guided to low double-digit NPATA growth in FY19, with management indicating a strong start in July 2018 and a solid pipeline of new opportunities. The result supported our view that the industry has consolidated, Australian product penetration is low compared to other developed economies, bad debt experiences are benign and competitors (i.e. the big banks) are rational, focusing on servicing existing bank clients in other products and losing market share. We regard the valuation as being attractive at a 12-month forward P/E multiple of 13.3 times.

Key detractors

Eclipx Group (ECX, overweight) – the sales financing group declined in value following a disappointing FY18 trading update. Management downgraded FY18 NPATA by 11% versus earlier guidance and market expectations. The Graysonline and Right2Drive businesses were responsible, with the core Australian and New Zealand Commercial businesses (70% of group earnings) generating earnings growth of 5%. We continue to hold a positive view towards ECX's core business: 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. Subsequent to the downgrade the company received a takeover offer from fleet peer, SGFleet. The logic for industry consolidation is compelling with significant synergies available to the merged entity. With the stock trading at a P/E of 10.4 times on a 12-month forward basis – a material discount to its peers (13 to 17 times) will continue to hold the position.

Ansell (ANN, overweight) – the protective clothing manufacturer underperformed following an underwhelming FY19 outlook. While management reported solid FY18 results, with EPS of $US1.02 in the middle of guidance, ANN guided to FY19 EPS of $US1.06 (at the midpoint) – short of consensus at $US1.10. Reasons included a higher effective tax rate, higher raw materials costs and uncertainty surrounding the potential introduction of new tariffs. We believe guidance is conservative, since it ignores any benefit from the ongoing share buy-back, M&A or additional price increases to recover rising input costs and tariffs.

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

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.

Alumina (AWC) – we increased our position size during the month. We are overweight AWC based on a positive view of the commodity and AWC's high-quality assets, with earnings, cash flow and capital management upside versus consensus expectations. The aluminium market remains very tight, with the approaching Chinese winter closures again having the potential to be even more restrictive. We believe that AWC is undervalued at 10.8 times forward P/E when considering the strategic appeal of its assets.

EBOS Group (EBO) – we continued to increase our position size after EBO announced it had won the contract to distribute pharmaceuticals to Chemist Warehouse. In our view this contract will help to underwrite several years of growth for EBO, increasing FY20 EPS by 12.4% and lifting organic EPS growth to 4.5% p.a. thereafter. More broadly, we are positive towards the company based on its defensive earnings profile, its leading position in a consolidating industry (with the potential for accretive acquisitions), a strong management team and a supportive valuation (19.5 times 12-month forward earnings).

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).

NEXTDC (NXT) – we reduced our position size following recent outperformance, prior to the company's FY18 result. While more of the company's positive outlook is captured by consensus at current levels, we continue to see upside in the business, which is structurally set to benefit from the increasing adoption of cloud technology and is accelerating its expansion to meet the demands of its 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 remains attractive given

the company's growth profile, infrastructure-like characteristics at maturity, and supportive valuation.

Independence Group (IGO) – we reduced our position in the nickel-gold miner during the month in favour of increasing our holding in Alumina (AWC), where we have higher conviction in the commodity outlook. That being said, we remain overweight IGO based on our positive view of the Nova and Tropicana assets – two world-class reserves – which support an increasing production profile (Jaguar was divested during the June quarter 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 remains well capitalised, with net debt of $4mn.

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.

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.

Ooh! Media (OML) – we are overweight the outdoor media company based on 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 its high gross margins and its largely fixed cost base, we expect OML's positive revenue outlook will support strong medium term earnings growth. We also 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.

Key active underweights

Tabcorp (TAH) – we are underweight the gambling services provider because we believe earnings expectations are too optimistic and the market's valuation, at 22.9 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 in December 2017 doesn't alter our view of the structural headwinds in wagering, with the lofty acquisition price and high gearing more than offsetting targeted cost synergies in our view.

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 compared to previous cycles.

A2 Milk (A2M) – we believe the stock's current valuation – trading at a forecast P/E of 33.6 times – fully captures the company's positive outlook. A2M's earnings growth over recent years has been underpinned by Chinese infant formula sales which have grown significantly, however we are cautious to capitalise this earnings momentum given questions regarding the sustainability of the current distribution channels (in particular via daigous), an increasing competitor presence and the fickle nature of the Chinese consumer.

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

Sector allocation

	Portfolio %	Benchmark %	Active %
Consumer Discretionary	23.88	16.78	7.10
Consumer Staples	2.57	7.33	-4.76
Energy	2.81	4.30	-1.49
Financials	11.17	11.56	-0.39
Health Care	11.39	6.96	4.43
Industrials	13.37	12.21	1.16
Information Technology	8.21	9.21	-1.00
Materials	14.29	21.32	-7.03
Real Estate	0.97	6.54	-5.58
Telecommunication Services	8.29	2.00	6.29
Utilities	0.00	1.78	-1.78

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Atlas Arteria	6.01	1.02	4.99
TPG Telecom	5.39	0.66	4.73
Resmed	4.58	1.76	2.82
Star Entertainment	4.41	0.99	3.41
Seek	4.16	1.76	2.40

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	6.01	1.02	4.99
TPG Telecom	5.39	0.66	4.73
Ooh! Media	3.99	0.29	3.70
Underweights			
Tabcorp Holdings	0.00	2.16	-2.16
Bluescope	0.00	2.14	-2.14
a2 Milk Company	0.00	2.16	-2.16

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	20.80	10.25	11.68	5.66
Distribution return	1.05	0.95	1.11	1.70

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$160.70 mn as at 31 August 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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