YARRA
CAPITAL MANAGEMENT

Investment Commentary
Quarter to 30 June 2018

Yarra Ex-20 Australian Equities Fund

Total returns as at 30 June 2018

	From 25 June 2018^	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	Since inception % p.a.*
Yarra Ex-20 Australian Equities Fund	-0.99	2.87	7.69	14.05	7.97	8.99	7.68
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	-0.69	NA	NA	NA	NA	NA	NA
Excess return‡	-0.30	NA	NA	NA	NA	NA	NA

^ Effective 25 June 2018 the Fund's investment strategy, name and benchmark was changed. Performance prior to 25 June 2018 is provided here for consistency purposes only – the historical performance data shown relates to the previous strategy and should not be used to assess past or future performance of the Fund. See here for further information. Performance data relating to the previous strategy is available upon request. 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 Ex-20 Australian Equities Fund: August 2010.

The benchmark for the Yarra Ex-20 Australian Equities Fund has been amended since the Fund's inception. Effective 25 June 2018, the benchmark is the S&P/ASX 300 ex S&P/ASX 20 Accumulation Index, replacing the S&P/ASX 300 Accumulation Index.
‡ Excess return: The difference between the Fund's return and the benchmark return.

Market review

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

The S&P/ASX 300 Accumulation Index returned 8.4% in the three months to 30 June 2018, taking its 12 month return to 13.2%. 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 low 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 (+14.5%) 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 (+19.8%) was the top performer with all but one constituent – 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 (+15.9%) generated strong returns almost entirely due to 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 (-13.3%). 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[1]

Key contributors

NextDC (NXT, overweight) – the data centre company outperformed after announcing early in the quarter a capital raising to fund a major expansion. The $280mn capital raising is designed to support growth in the longer term by bringing forward development of its new data centres, with existing capacity expected to be absorbed in the next two to three years. The capital raising supported our thesis that NXT 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.

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

[1] Commentary contained in this section largely relates to the period during which the Fund's previous strategy was in operation.

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.

APN Outdoor (APO, overweight) – the outdoor advertising company outperformed during the quarter after accepting an improved takeover offer from French suitor JCDecaux in June. Following an initial offer of $6.52 per share in cash, JCDecaux subsequently increased it to $6.70 per share – a 15% premium to the stock's price prior to the announcement. We support the $1.2bn acquisition, which equates to an EV/EBITDA multiple of 13.0x – 30% higher than the ASX 200 Industrials at 10.0x and at a premium to other transactions in the industry (peer oOH! Media (OML) purchased Adshel for 11.6x during the quarter). We continue to hold an overweight position, with APO trading at a 6% discount to the bid. In our view the likelihood that the ACCC blocks the deal is low when the combined entity would only account for 34% of total outdoor advertising industry revenues.

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.

JB Hi-Fi (JBH, overweight) – the electronics retailer underperformed following a negative trading update, with FY18 net profit downgraded by 4.2% to $230mn. Management attributed the downgrade to lower gross margins from The Good Guys as a result of aggressive pricing from Harvey Norman (HVN). We remain overweight JBH despite the more conservative growth outlook for The Good Guys, as we still believe synergy, sales and margin opportunities exist following the acquisition of the company in November 2016. Our medium- term investment thesis remains in place, being that concerns regarding Amazon's recent entry into the Australian market are overdone 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.

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 and sales

Given the Fund's investment strategy changed effective 25 June 2018, information relating to key purchases and sales is not considered to be relevant for this period.

Key active overweights[2]

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.

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.

Star Entertainment (SGR) – we are overweight SGR because 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.

[2] Active overweights and underweights relate to the Fund's new investment strategy which came into effect on 25 June 2018.

Key active underweights[2]

Aristocrat Leisure (ALL) – we are underweight ALL on the grounds that consensus fully captures the company's growth outlook, with the market fully factoring in the opportunity from deriving more revenue from its annuity-style leasing of electronic poker machines. However, at a forward P/E of 22.9 times we do not believe the market accounts for the risk in the company's legacy business (outright sales), which is a volatile segment that to a large extent relies on new casinos opening, as well as questions over the sustainability of the Digital division's earnings growth (recent acquisition). As a result, we believe there are better opportunities elsewhere.

Newcrest (NCM) – our underweight to the gold miner is predicated on its concentrated assets in Cadia and Lihir, a premium valuation and an increasing capex profile. Both capex and M&A is likely to increase as the company seeks to gain exposure to five tier-one assets by 2020. The stock trades at an EV/EBITDA multiple of 6.5 times on a 12-month forward basis, which in our view does not reflect significant risks (seismicity and PNG) and is expensive relative to peers such as OceanaGold (OGC) at 4.4 times and Saracen Minerals (SAR) at 6.3 times.

Sydney Airport (SYD) – while we have a positive view towards the business given the strong barriers to entry and a supportive demand backdrop (SYD captures 40% of inbound air passengers to Australia), we see better opportunities elsewhere. SYD trades at 18.7 times forward EV/EBITDA and is sensitive to higher interest rates, which we are wary about at this point of the cycle.

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 are overweight the Telecommunication Services, Materials and Consumer Discretionary sectors, but are underweight Real Estate, Consumer Staples and Utilities.

Sector allocation

	Portfolio %	Benchmark %	Active %
Consumer Discretionary	16.59	11.52	5.07
Consumer Staples	0.00	5.78	-5.78
Energy	8.11	6.42	1.69
Financials	9.51	12.52	-3.01
Health Care	8.56	7.71	0.85
Industrials	15.89	11.26	4.63
Information Technology	7.80	5.84	1.97
Materials	24.48	18.62	5.86
Real Estate	0.00	14.75	-14.75
Telecommunication Services	8.07	0.93	7.13
Utilities	0.00	4.64	-4.64

Top 5 holdings

	Portfolio %	Benchmark %	Active %
James Hardie Industries	7.29	1.37	5.92
Seek	6.41	1.05	5.37
Star Entertainment Group	5.74	0.55	5.19
Santos	5.51	1.51	4.00
TPG Telecom	5.22	0.24	4.98

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
James Hardie Industries	7.29	1.37	5.92
Seek	6.41	1.05	5.37
Star Entertainment Group	5.74	0.55	5.19
Underweights			
Aristocrat Leisure	0.00	2.69	-2.69
Newcrest Mining	0.00	2.27	-2.27
Sydney Airport	0.00	2.20	-2.20

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.	Since inception % p.a.
Growth return	10.75	4.78	6.06	4.73
Distribution return	3.29	3.19	2.93	2.95

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 through exposure to Australian Securities Exchange listed securities excluding the largest 20 by market capitalisation (as defined by the S&P/ASX 20 Index). In doing so, the aim is to outperform the S&P/ASX 300 ex S&P/ASX 20 Accumulation Index over rolling 3-year periods.	
Recommended investment time frame	5 - 7 + years	
Fund inception	August 2010	
Fund size	Pooled Fund A$32.93 mn as at 30 June 2018	
APIR code	JBW0052AU	
Estimated management cost	0.95% p.a	
Buy/sell spread	+/- 0.15%	
Platform availability	Asgard BT Wrap BT Panorama Macquarie Wrap Consolidator	Macquarie Wrap Accumulator Hub24

Applications and contacts

Investment into the Yarra Ex-20 Australian Equities Fund can be made by Australian resident investors only.

Website www.yarracm.com

Investor Services Team 1800 034 494 (Australia) +61 3 9002 1980 (Overseas) IST@yarracm.com