YARRA
CAPITAL MANAGEMENT

Investment Commentary
Month to 31 August 2018

Yarra Australian Real Assets Securities Fund

Total returns as at 31 August 2018

	From 17 December 2015	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception^ % p.a.
Yarra Australian Real Assets Securities Fund	9.64	1.68	4.06	7.78	7.83	9.02	7.56	7.67
S&P/ASX Custom Infrastructure, Utilities and A-REITs Index*	10.66	1.90	4.93	9.75	NA	NA	NA	NA
Excess Return†	-1.02	-0.22	-0.87	-1.97	NA	NA	NA	NA
Growth Return‡	NA	NA	NA	-19.12	-8.37	-2.46	-0.34	0.32
Distribution Return‡	NA	NA	NA	26.91	16.20	11.48	7.90	7.35

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 of Yarra Australian Real Assets Securities Fund: December 2005.
* The Fund's benchmark is a market cap weighted index of infrastructure, utilities and REIT securities included in the S&P/ASX300
† Excess return: The excess return figures shown represent the difference between the portfolio's return and the benchmark return.
‡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 distribution amounts deemed as capital distributions.

Market review

Australian Real Assets outperformed the wider market in August as REITs supported the benchmark amid a relatively benign reporting season.

The S&P/ASX 300 Custom Infrastructure, Utilities and A-REIT Accumulation Index rose 1.9% in the month, taking its total return to 9.7% for the 12 months to 31 August 2018. In comparison, the S&P/ASX 200 returned 1.4% in the month and 15.4% for the year.

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].

Infrastructure & Utilities stocks returned 1.0% for the month. Telecommunications provider SpeedCast International (SDA) was the Index's largest detractor after downgrading FY18 earnings guidance in its 1H18 result due to a protracted recovery in its Energy division. Elsewhere, rail freight operator Aurizon Holdings (AZJ) detracted after also announcing disappointing earnings guidance, with above rail earnings 5% below consensus. Conversely, Transurban (TCL) contributed the most to the Index's return after the Australian Consumer and Competition Commission (ACCC) approved its acquisition of the WestConnex motorway in Sydney for $9.3bn.

Meanwhile, REITs returned 2.6% in the month. At a subsector level, Industrial and Office REITs outperformed while Retail REITs underperformed as the sector experienced the largest negative earnings revisions for FY19. At a stock level, Goodman Group (GMG) and Dexus (DXS) were the top contributors to the Index's return. The former delivered strong FY18 results and FY19 earnings guidance that highlighted the supportive demand environment from tenants leveraged to online shopping. The latter also released its FY18 results, with earnings in line with expectations for the year and strong FY19 DPS guidance for 5% growth, supported by the strong Office market.

Portfolio review

Key contributors

Speedcast International (SDA, underweight) – the satellite-based network communications provider underperformed after reporting 1H18 results that missed expectations and downgrading earnings guidance for the full year. Management now expects FY18 EBITDA of $135mn to $145mn, 10% below prior guidance, as its Energy division continues to drag on earnings. SDA also purchased Globecomm for $US135mn in the period. While the acquisition is accretive, it raises pro-forma gearing to 3.3 times. We remain underweight the stock as we believe its current valuation (12-month forward PE of 12.0 times) doesn't reflect significant risks which include integrating recent acquisitions and renewing key contracts which, if not executed well, would significantly pressure SDA's already stretched balance sheet.

AGL Energy (AGL, underweight) – the energy company underperformed following its FY18 result. While earnings were modestly ahead of expectations, with net profit rising 28% to $1,023mn for the period, investors were instead focused on management's negative outlook for FY19. AGL guided to net profit of $970-1,070mn – 4% below consensus forecasts – due to headwinds around wholesale electricity prices, retail

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

competition, affordability initiatives and gas supply prices. We believe these headwinds will persist for AGL, making it difficult for the business to grow earnings in the short to medium term. AGL also faces the closure of Liddell in 2021, which represents a 15-20% earnings hole. As a result, we remain underweight the stock.

Dexus (DXS, overweight) – the Office REIT outperformed after delivering a better-than-expected FY18 result. Funds from operations (FFO) rose 6% to $653mn for FY18, and management guided to 5% FFO and DPS growth for FY19 – highlighting the strong free cash flow generation of DXS's portfolio. We believe this guidance is achievable when considering the portfolio's high office occupancy rate (+95%) and the 8-10% rent growth expected in FY19 for both Sydney and Melbourne. We remain overweight the stock given its exposure to ongoing strength in these core office markets which have strong supply and demand fundamentals. We see DXS's valuation (at 1.08 times NTA with a 4.7% forecast dividend yield) as attractive when considering these tailwinds.

Key detractors

Goodman Group (GMG, underweight) – the Industrial REIT outperformed as a better-than-expected FY18 result and FY19 guidance highlighted a supportive demand environment from industrial and warehouse space tenants. For FY18, EPS grew 8.3% to $0.467 and DPS lifted 8.1% to $0.28, in line with market forecasts. For FY19 GMG guided to 7% growth in EPS and DPS, which in our view is supported by development EBIT rising 2% and AUM increasing 15% year-on-year. We remain underweight GMG, as we believe the market over-estimates the sustainability of these metrics on a one-to-three year view. We believe that any reversion in cap rates (which compressed another 40 bps to 5.5% in FY18) represents downside risk given GMG's leverage and the resultant impact on Funds Management and Development EBIT.

Mirvac Group (MGR, underweight) – the REIT outperformed following its FY18 result. With FY18 earnings pre-announced (at 8% FFO growth), investors focused on FY19. Management guided to FFO growth of 2-4% and DPS growth of 5% – in line with expectations – as strength in its Office portfolio looks to offset weakness in Residential. While consensus anticipates falling Residential earnings in FY19, it expects a rebound in FY20 driven by record apartment settlements. We remain sceptical; we believe residential earnings have peaked in FY18 and will moderate over time as house price growth weakens. Furthermore, we believe passive property valuations are approaching the top of the cycle.

Aurizon Holdings (AZJ, overweight) – the rail freight operator underperformed after issuing disappointing FY19 earnings guidance, with above rail earnings 5% below consensus at the mid-point (2.5% at the group level) due to bulk contract losses and one-off costs. We expect FY19 to be a transitional year for AZJ as regulatory uncertainty clears in regards to the UT5 decision and the ACCC's proceedings. For UT5, we believe the potential outcome is likely to be more positive for AZJ than the original draft decision. AZJ trades at an attractive EV/EBITDA of 8.4 times and a 12-month forward dividend yield of 5.4%, which factors in the draft decision's negative impact.

Key purchases

APA Group (APA) – we reduced our underweight to the gas pipeline company in response to the stock trading at a more significant discount to CKI's takeover bid (at $11 per security). While the bid remained subject to a number of hurdles including ACCC and Foreign Investment Review Board (FIRB) approval, we believe the discount does not appropriately reflect the high probability of approval. Subsequent to month-end the ACCC approved the deal on the condition CKI sells a package of APA's West Australian gas assets.

Folkestone Education Trust (FET) – we increased our position in the childcare centre property owner during the month. We believe the stock's valuation is attractive (at 0.95 times NTA with a 5.9% forward dividend yield) when considering its exposure to a diverse set of childcare centres across Australia and the favourable demand backdrop, with childcare centres growing and a well-supported industry in Australia (private and government funded). FET owns more than 400 centres across Australia that have attractive yields of 6% when considering rental growth outlook of 3%, high occupancy of more than 99% and long lease terms at 9.1 years.

Key sales

Aurizon Holdings (AZJ) – we reduced our overweight position in the company in the month in favour of more compelling opportunities elsewhere, but remain positive towards the stock. We expect FY19 to be a transitional year for AZJ as regulatory uncertainty clears in regards to the UT5 decision and the ACCC's proceedings. For UT5, we believe the potential outcome is likely to be more positive for AZJ than the original draft decision. AZJ trades at an attractive EV/EBITDA of 8.4 times and 12-month forward dividend yield of 5.4%, which factors in the negative impact from the draft decision.

AGL Energy (AGL) – we increased our underweight to AGL as the company's FY18 results highlighted the significant headwinds facing earnings for the foreseeable future. Firstly, we believe wholesale electricity prices are set to retreat from all-time highs. Secondly, AGL's retail margins are under pressure from increased competition and regulatory scrutiny, particularly for customers not receiving a discount. We also believe AGL's transition away from being a fully integrated electricity generator is likely to create material earnings pressure over time. Finally, we expect earnings to be negatively impacted as its low cost gas contracts roll off.

Unibail-Rodamco Westfield (URW) – we increased our underweight to the shopping mall owner during the month. Retail mall fundamentals are weakening, with distribution trending away from traditional bricks and mortar and towards online shopping. Specifically to URW, we see downside risk to operating metrics in future periods as rental growth becomes more challenged. Additionally, balance sheet gearing is high in our view, putting pressure on URW to dispose of secondary assets in a weak sales environment, creating downward pressure on earnings and distributions.

Key active overweights

GPT Group (GPT) – we believe GPT offers investors exposure to a high-quality, diversified commercial real estate portfolio. We view GPT's financial guidance as being less aggressive than some peers, with minimal reliance on asset transactions to meet guidance. We see the current valuation as favourable – a factor which is not reflected in the market's valuation at around 0.94 times NTA – and view its prospective dividend yield of 5.0% as attractive in the current environment. GPT's balance sheet is also stronger than many of its peers (due to low gearing of approximately 25%) which provides flexibility for selective strategic acquisitions.

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, creating a pathway to fully reflect their intrinsic value. We believe ALX now has a credible strategy for achieving this goal over the next 12 months which will result in significant upside.

Transurban (TCL) – we are overweight TCL due to its strong growth outlook (with a number of new project and expansion plans), asset diversification and attractive risk adjusted total return. If inflation returns, its compounding effect will provide a meaningful offset to higher discount rates (on a net present value basis), given the majority of TCL's revenue growth is linked to CPI.

Key active underweights

Goodman Group (GMG) – our underweight position reflects our more cautious outlook for development earnings and GMG's premium share price valuation of 21.0 times earnings and at 2.2 times net tangible assets. We see the outlook for development earnings – which account for approximately 40% of total EBITDA – moderating with commencements beginning to fall. As a result, we are sceptical that development work in progress (WIP) can be maintained at current elevated levels ($3.5-3.6bn in FY18) over the medium-term. Lastly, we believe the tailwind from Amazon's entry into the Australian market (i.e. generating more demand for warehousing space) is overblown in the context of GMG's Australian business.

Scentre Group (SCG) – we are underweight the shopping mall owner based on our negative view of Retail REIT fundamentals. SCG faces significant headwinds as changing consumer preferences direct an increasing proportion of retail sales away from malls to online. Implications include higher capex requirements and a more challenging leasing and transaction backdrop (particularly for its second-tier assets). We do not believe SCG's valuation – at 0.87 times NTA and with a 5.4% forward dividend yield – properly accounts for these headwinds.

AGL Energy (AGL) – we are underweight AGL because we believe the business faces significant earnings headwinds in future years. Firstly, we believe wholesale electricity prices are set to retreat from all-time highs. Secondly, AGL's retail margins are under pressure from increased competition and regulatory scrutiny, particularly for customers not receiving a discount. We also believe AGL's transition away from being a fully integrated electricity generator is likely to create material earnings pressure over time. Finally, we expect earnings to be negatively impacted as its low cost gas contracts roll off.

Market outlook

Our conviction in the Real Assets sector is underpinned by solid fundamentals and attractive underlying valuation support. The S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Accumulation Index offers an attractive forecast dividend yield of 5.2%, an appealing 2.7% premium above the 10-year Australian bond rate.

Within Infrastructure, we believe strong fundamentals and attractive growth opportunities should continue to support the likes of Transurban (TCL) and Atlas Arteria (ALX). We remain cautious towards infrastructure providers with exposure to cyclical end markets such as AGL Energy (AGL). In particular, AGL trades on a relatively high valuation when considering the headwinds around wholesale electricity prices, declining retail margins and the 15-20% earnings hole from the closure of Liddell in 2021.

With A-REITs now trading at average premiums of approximately 20% to last stated tangible book values, at this point in the cycle we continue to prefer exposure to high-quality asset owners at more attractive valuations such as GPT Group. We believe structural headwinds for shopping mall owners are likely to persist – with changing consumer preferences directing an increasing proportion of retail sales away from malls to online – and we maintain our highly selective approach across the sector, steering away from owners of malls lacking strong barriers to competition. We expect growth in sector earnings and distributions in coming periods, albeit at slower rates than past years as interest expense reduction tailwinds fade. Robust balance sheets (average gearing levels below 30% net debt / total assets) and strong in-place occupancy levels suggest future returns in-line with those of the underlying real estate.

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
GPT	9.39	4.30	5.09
Atlas Arteria	7.19	2.10	5.09
Transurban	17.25	12.39	4.86
Underweights			
Goodman	2.79	7.94	-5.15
Scentre	5.06	10.13	-5.07
AGL Energy	1.49	6.33	-4.84

Sector allocation

	Portfolio %	Benchmark %	Active %
Infrastructure	39.81	28.82	10.99
Airport Services	5.18	7.70	-2.53
Highways & Railtracks	24.43	14.49	9.95
Telecommunication Services	1.60	1.02	0.58
Railroads	6.06	3.87	2.19
Marine Ports & Services	0.00	1.74	-1.74
Information Technology	2.54	0.00	2.54
Utilities	8.24	15.40	-7.16
Electric Utilities	1.79	3.33	-1.54
Gas Utilities	4.96	5.46	-0.50
Independent Power and Renewable Electricity Producers	0.00	0.28	-0.28
Multi-Utilities	1.49	6.33	-4.84
Real Estate Investment Trusts (REITs)	49.45	55.78	-6.33
Specialized REITs	4.74	1.74	3.00
Diversified REITs	16.93	15.94	0.99
Industrial REITs	2.79	8.51	-5.72
Office REITs	13.97	7.56	6.42
Retail REITs	11.02	21.48	-10.46
Other	0.00	0.56	-0.56
Cash and receivables	2.50	0.00	2.50

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.

Features

Investment objective	To achieve a balance of income and medium-to-long term capital growth by investing primarily in Australian listed infrastructure, utilities and REIT securities. In doing so, we aim to outperform the S&P/ASX 300 Custom Infrastructure, Utilities and A-REITS Index over rolling three year periods.	
Recommended investment time frame	5 - 7 + years	
Fund inception	December 2005	
Fund size	A$37.83 mn as at 31 August 2018	
APIR code	JBW0030AU	
Estimated management cost	0.85% p.a.	
Buy/sell spread	+/- 0.15%	
Platform availability	Asgard BT Wrap BT Panorama Colonial FirstWrap IOOF Pursuit Select Macquarie Wrap Consolidator	PowerWrap SmartWrap OneVue Hub24

Applications and contacts

Investment into the Yarra Australian Real Assets Securities Fund can be made by Australian resident investors only.

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