YARRA
CAPITAL MANAGEMENT

Yarra Investment Fund

Total returns as at 30 September 2018

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Investment Fund^	-1.06	2.65	14.43	11.53	6.98	7.67	10.45
S&P/ASX 200 Accumulation Index†	-1.26	1.53	13.97	12.10	8.19	7.74	NA
Excess return‡	0.20	1.12	0.46	-0.57	-1.21	-0.08	NA

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.
Due to differences in business dates at month end, Fund performance returns are provided as at 27 September 2018, and benchmark performance returns are provided as at 30 September 2018. The monthly, quarterly and annual performance returns have been impacted.
* Inception date Yarra Investment Fund: December 1984.
^ This Fund is no longer available for new investment. The Reinvestment of distributions is still allowed where an existing Reinvestment instruction is in place.
† Since April 2008 the benchmark for the Yarra Investment Fund is the S&P/ASX 200 Accumulation Index
‡ Excess return: The difference between the Fund's return and the benchmark return (S&P/ASX 200 Accumulation Index).

Market review

The Australian share market rose in the September quarter as a relatively benign reporting season overshadowed divergent trends among stocks and sectors.

The S&P/ASX 200 Accumulation Index rose 1.5% in the three months to 30 September 2018, taking its 12-month return to 14.0%. The index underperformed global indices in the quarter but outperformed in the year, with the MSCI World Index returning 5.4% and 12.9% respectively.

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].

Banking and Metals & Mining – which comprise 38% of the market –declined 0.5% and 0.3% respectively. These sectors, which trade at forecast P/E multiples of 12 and 13 times respectively, usually determine the direction of the local market. In the former, gains from Commonwealth Bank (CBA, +1.1%) and National Australia Bank (NAB, +1.5%) were outweighed by Westpac's (WBC) 4.7% fall. In the latter, BHP (BHP, +5.0%) partially offset weakness from the Gold sector (-11.6%) and Rio Tinto (RIO, -3.5%).

Instead Communication Services (+17.5%), Health Care (+4.2%), and Information Technology (+13.6%) supported the market. The telco sector re-rated following the proposed "merger of equals" between TPG Telecom (TPM, +65.2%) and Vodafone, while CSL (CSL, +15.6%) was largely responsible for Health Care's contribution. IT stocks also enjoyed widespread gains, led by Afterpay (APT, +92.0%), Computershare (CPU, +9.4%) and Xero (XRO, +8.9%).

On a 12-month basis Resources contributed the most to the index's return, with Metals & Mining up +27.1% and Energy up 37.1% as the iron ore price rose 9.0% $US68 per tonne and the oil price surged 46.8% to $US83 per barrel. Conversely, the banks declined 2.6% in response to regulatory uncertainty from the Financial Services Royal Commission.

Elsewhere, Health Care (+40.4%) and Information Technology (+50.1%) generated the highest returns. In the former, CSL (CSL, +52.0%) and ResMed (RMD, +65.4%) were largely responsible. In the latter, all but two constituents rose in the period. Top performers included Altium (ALU, +155.8%), Afterpay (APT, +329.4%), Appen (APX, +169.6%) and Wisetech Global (WTC, +154.4%).

Portfolio review

Key contributors

TPG Telecom (TPM, overweight) – the company outperformed during the quarter after announcing a proposed merger of equals with Vodafone, with TPM to own 49.9% of the combined entity 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 merged entity (to be called TPG Telecom) becoming a strong challenger to incumbents Telstra (TLS) and Optus. TPG Telecom will have an enterprise value of $15bn, comprising debt of $4.1bn (2.2 times 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. Management delivered FY18 EBITDA in line with expectations and guided to FY19 EBITDA of $350-370mn, 5% below forecasts at the

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

midpoint, though cash conversion for the period increased from 68% to 110%. The improvement alleviated concerns that VOC would need to raise capital to avoid breaching its debt covenants. We remain positive towards the stock based 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 18.2 times forward earnings) currently capitalises only limited future growth.

Atlas Arteria (ALX, overweight) – the toll road operator outperformed during the quarter despite releasing FY19 dividend guidance below market expectations at its 1H18 result. While little changed operationally, ALX provided maiden guidance of $0.30 for the full year, below forecasts for $0.35. We believe FY19 dividend guidance is conservative as ALX negotiates the internalisation of MAF, the vehicle through which ALX owns its core asset APRR. More broadly, we continue to see significant upside based on the continued strong operational performance of its attractive, long-dated assets (group revenue growing at 5.7% p.a.) and its discounted valuation of 11 times EV/EBITDA, which is in part due to its complicated ownership structure.

Santos (STO, overweight) – the oil & gas producer outperformed after announcing the acquisition of Quadrant Energy for $2.15bn during the quarter. The purchase was made at an attractive price (4.4 times trailing EBITDAX), did not require a capital raising and will be highly EBITDAX accretive. The acquisition also diversifies STO's portfolio across Australia (reducing its reliance on East Coast gas), with the company consolidating its position in the Western Australian gas market at around a 36% combined market share. With our original investment thesis intact we remain overweight the stock: STO is significantly cash flow positive at current levels and the balance sheet should rapidly deleverage to less than 25% by 2021 (assuming an oil price of $US65 per barrel).

ResMed (RMD, overweight) – the sleep apnea device maker outperformed following its FY18 result. While 4Q18 earnings largely matched consensus forecasts as strong mask sales offset weaker rest-of-world (ROW) equipment sales, FY19 guidance was stronger than expected. Management expects a gross margin of 58%, which was above consensus expectations for 57.5% and equates to a 2% increase to net profit. We remain positive towards RMD: while the market is beginning to capture the company's appealing growth characteristics, we see further upside as earnings growth rates accelerate over the next one to two years, with benefits accruing from a positive product cycle in the flow generator and mask segments.

Key detractors

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 11.4 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.

Telstra (TLS, underweight) – the telco outperformed in response to its FY18 result and TPG Telecom (TPM) announcing a "merger of equals" with Vodafone, consolidating the industry from four main players to three. Though core underlying EBITDA declined by 11.3% in FY18 – with 2H18 accelerating to 14.2% – the market reacted positively to TLS maintaining its dividend and increasing post-paid Mobile subscriber numbers (reversing Optus's dominance from prior quarters). We continue to believe TLS faces earnings headwinds across all divisions in the medium term as the merged TPM/Vodafone entity, which operates at a lower cost base, increases pressure on TLS's market share and margins across its Mobile and fixed line businesses. 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 16.0 times provides appropriate valuation support.

James Hardie (JHX, overweight) – the building materials company underperformed after delivering maiden FY19 earnings guidance below market expectations in its 1Q19 results. Management guided to FY19 net profit of $US300-340mn, 4% below consensus forecasts at the midpoint. Around half of the downgrade came from partially one-off drivers, including higher US input costs and the refurbishment of the Fermacell plant, however the other half was due to reduced conviction in the growth outlook for its US-based business. Nevertheless, we remain confident about the market share outlook in the medium term, with primary demand growth to accelerate as JHX wins business following resolution of US supply and manufacturing issues. Furthermore, JHX now trades at a more supportive 18.8 times forward earnings, a 10% discount to its Industrial peers.

CSR (CSR, overweight) – the building materials company underperformed in response to concerns of a housing construction slowdown. In our view these concerns are overdone in regards to CSR, since the moderation is largely confined to the high-rise category; CSR's exposure is mostly to the single family home market which continues to enjoy strong underlying demand fundamentals. We remain overweight the stock based on three factors: a more positive outlook on the

Building Products division than consensus as a result of an improved competitive landscape and market structure in bricks, management's strong operational expertise across all divisions (including Aluminium where earnings are being optimised through proactive hedging strategies and efficiency measures) and CSR's strong balance sheet – it is effectively debt free – which leave it well placed to pursue selective bolt-on acquisitions or capital management initiatives.

Seek (SEK, overweight) – the online recruitment company underperformed in the quarter following its FY18 results. While the pre-announced FY18 result was in line with consensus expectations, FY19 EBITDA guidance was below analyst forecasts by 5%, with the Latin America, Education and Early State businesses expected to weigh on earnings. Management also indicated a greater willingness to pursue M&A, particularly in Education despite the weaker track record than in Employment. Nevertheless, we remain overweight the stock. 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.

Key purchases

oOH! Media (OML) – we increased our position size in the outdoor media company during the quarter. We support the recent acquisition of Adshel, given its mid-single digit earnings accretion and strong strategic rationale, with clear revenue and cost synergies. More broadly we hold an 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.

Atlas Arteria (ALX) – we increased our position size in the toll road operator in the quarter. We believe FY19 dividend guidance is conservative as ALX negotiates the internalisation of MAF, the vehicle through which ALX owns its core asset APRR. More broadly, we continue to see significant upside based on the continued strong operational performance of its attractive, long-dated assets (group revenue growing at 5.7% p.a.) and its discounted valuation of 11 times EV/EBITDA, which is in part due to its complicated ownership structure.

Clydesdale (CYB) – we increased our position size during the quarter after establishing a position in June in response to the UK bank's £1.7bn takeover of Virgin Money. 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 standalone 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 as the company moves to advanced accreditation (a regulatory certification that reduces the amount of capital required to be held against its assets).

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. With such a strong offer from the French suitor and implementation expected before the end of CY2018, we believe a competing bid is unlikely. However, we remain positive towards the outdoor media industry, and subsequently increased our position in peer oOH! Media (OML).

CSR (CSR) – we reduced our overweight position due to our view of the available upside from current levels, but we remain positive towards the company. In our view concerns over a housing construction slowdown are overdone in regards to CSR, since the moderation is largely confined to the high-rise category; CSR's exposure is mostly to the single family home market which continues to enjoy strong underlying demand fundamentals. We remain overweight the stock based on three factors: a more positive outlook on the Building Products division than consensus as a result of an improved competitive landscape and market structure in bricks, management's strong operational expertise across all divisions (including Aluminium where earnings are being optimised through proactive hedging strategies and efficiency measures) and CSR's strong balance sheet – it is effectively debt free – which leave it well placed to pursue selective bolt-on acquisitions or capital management initiatives.

Downer EDI (DOW) – we reduced our position during the quarter 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.

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.

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.

James Hardie (JHX) – we hold a positive view of both JHX's domestic (approximately 20% of earnings) and US operations (approximately 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 to the top-end of the 20-25% target range in FY19 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 2017 quarter, given its market leading position (75% category share of fibre gypsum market) and options for growth

Vocus Group (VOC) – our positive view of the telecommunications company is 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 18.2 times forward earnings) currently capitalises only limited future growth.

Key active underweights

CSL (CSL) – we remain underweight CSL based on its forward valuation (32.5 times P/E and 22.8 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 together 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 11.4 times forward earnings and 1.4 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.

Wesfarmers (WES) – outside the domestic Bunnings business, we maintain a negative view towards each of the conglomerate's divisions. In the short term, WES's decision to demerge Coles signals the supermarket's outlook remains challenged despite price investment. Following the demerger (expected to complete in FY19) WES becomes more skewed to Bunnings (50% of EBIT), its structurally challenged department stores and Officeworks (29% of EBIT). Officeworks and the department store industry (including discount department stores Target and Kmart) face increasing competition (e.g. Amazon) and excess physical store capacity. WES is also more exposed to its Industrials segment, which comprises cyclical, lower quality businesses.

Telstra (TLS) – we are underweight the telco because we believe it faces earnings headwinds across all divisions in the medium term as the merged TPM/Vodafone entity, which operates at a lower cost base, increases pressure on TLS's market share and margins across its Mobile and fixed line businesses. 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 16.0 times provides appropriate valuation support.

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 4.6% on a 12-month forward basis (before franking) versus 2.7% 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 Communication Services sectors, but are underweight Real Estate, Metals & Mining and Consumer Staples.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	10.91	3.77	7.14
Consumer Discretionary	9.22	4.18	5.04
Consumer Staples	0.00	7.88	-7.88
Energy	8.81	5.98	2.83
Financials	34.38	32.43	1.95
Health Care	5.71	8.56	-2.84
Industrials	12.38	7.64	4.74
Information Technology	2.55	2.14	0.41
Materials	14.68	18.00	-3.32
Real Estate	0.00	7.50	-7.50
Utilities	0.00	1.90	-1.90

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Commonwealth Bank of Australia	10.04	7.52	2.51
Westpac Banking	8.05	5.74	2.31
ANZ Banking	7.79	4.88	2.91
Atlas Arteria	4.69	0.28	4.41
Seek	3.97	0.44	3.53

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	4.69	0.28	4.41
TPG Telecom	3.75	0.17	3.57
Seek	3.97	0.44	3.53
Underweights			
CSL	0.00	5.45	-5.45
National Australia Bank	0.00	4.54	-4.54
BHP Billiton	2.56	6.65	-4.09

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	2.84	1.82	-3.24	-1.89
Distribution return	11.59	9.70	10.21	9.56

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 outperform the S&P/ASX 200 Accumulation Index over rolling 3-year periods.
Recommended investment time frame	5 + years
Fund inception	December 1984
Fund size	A$9.6 mn as at 30 September 2018
APIR codes	JBW0005AU
Estimated management cost	1.65% p.a.
Buy/sell spread	+/- 0.15%

Applications and contacts

The Yarra Investment 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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