YARRA
CAPITAL MANAGEMENT

Investment Commentary
Quarter to 30 September 2018

Yarra Leaders 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 Leaders Fund^	-1.46	1.51	12.87	10.87	6.51	7.56	9.68
S&P/ASX 100 Accumulation Index	-1.30	1.55	13.32	11.67	8.08	7.91	9.73
Excess return‡	-0.17	-0.03	-0.45	-0.80	-1.57	-0.36	-0.05

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 Leaders Fund: October 1998
^ This Fund is no longer available for new investment. The Reinvestment of distributions is still allowed where an existing Reinvestment instruction is in place.
‡ Excess return: The difference between the Fund's return and the benchmark return (S&P/ASX 100 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 100 Accumulation Index rose 1.5% in the three months to 30 September 2018, taking its 12-month return to 13.3%. 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 Banking and Metals & Mining – which account for 40% of the Index – underperformed during the quarter. The former declined 0.5% as gains from Commonwealth Bank (CBA, +1.1%) and National Australia Bank (NAB, +1.5%) were outweighed by Westpac's (WBC) 4.7% fall. The latter rose 1.4% as BHP (BHP, +5.0%) partially offset weakness from the Gold sector (-8.6%) and Rio Tinto (RIO, -3.5%).

Instead Communication Services (+21.8%), Health Care (+4.3%), and Information Technology (+9.0%) 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 Computershare (CPU, +9.4%), Link Administration (LNK, +8.0%) and Xero (XRO, +8.9%) also supported the Index.

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 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.

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

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.

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.

Key purchases

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).

Alumina (AWC) – we increased our position size during the quarter. We are overweight AWC based on our 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 a 9.1 times forward P/E when considering the strategic appeal of its assets.

Key sales

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.

Macquarie Group (MQG) – we reduced our position size during the quarter 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 15.3 times forward earnings and 2.4 times book value, which is not too demanding given the group generates more than 15% return on equity.

Crown Resorts (CWN) – we trimmed the position size following recent outperformance as our investment thesis plays out. We believe CWN is emerging as a simpler, more focused and more disciplined company. We remain attracted to the stock based on its core Melbourne and Perth businesses – two defensive monopoly assets that support a high dividend payout ratio. Furthermore, VIP gaming activity is rebounding globally, with Australia a clear beneficiary.

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.

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.

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 Industrials, Communication Services and Banking sectors, but are underweight Real Estate, Metals & Mining and Consumer Staples.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	8.35	3.18	5.17
Consumer Discretionary	7.29	3.18	4.11
Consumer Staples	0.00	7.76	-7.76
Energy	7.98	5.70	2.28
Financials	37.82	34.88	2.93
Health Care	6.36	8.83	-2.47
Industrials	13.34	7.73	5.61
Information Technology	1.60	1.27	0.33
Materials	15.50	18.02	-2.53
Real Estate	0.00	7.39	-7.39
Utilities	0.00	2.05	-2.05

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Commonwealth Bank of Australia	11.09	8.24	2.85
Westpac Banking	8.92	6.29	2.63
ANZ Banking	8.65	5.35	3.30
Atlas Arteria	5.17	0.30	4.86
Seek	4.38	0.48	3.90

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	5.17	0.30	4.86
TPG Telecom	4.15	0.19	3.96
Seek	4.38	0.48	3.90
Underweights			
CSL	0.00	5.97	-5.97
National Australia Bank	0.00	4.98	-4.98
BHP Billiton	2.84	7.29	-4.44

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	1.62	1.50	-3.81	-2.57
Distribution return	11.25	9.37	10.32	10.13

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 by investing in larger companies listed on the Australian Securities Exchange, and in doing so outperform the S&P/ASX 100 Accumulation Index over rolling 3-year periods.
Recommended investment time frame	5 - 7 + years
Fund inception	October 1988
Fund size	A$60.64 mn as at 30 September 2018
APIR codes	JBW0011AU
Estimated management cost	1.80% p.a.
Buy/sell spread	+/- 0.15%

Applications and contacts

The Yarra Leaders Fund 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

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

Disclaimers

Yarra Funds Management Limited (ABN 63 005 885 567, AFSL 230 251) ('YFM') is the issuer and responsible entity of a range of registered managed investment schemes, which includes those named in this document ('Funds'). YFM is not licensed to provide personal financial product advice to retail clients. The information provided contains general financial product advice only. The advice has been prepared without taking into account your personal objectives, financial situation or particular needs. Therefore, before acting on any advice, you should consider the appropriateness of the advice in light of your own or your client's objectives, financial situation or needs. Prior to investing in any of the Funds, you should obtain and consider the product disclosure statement ('PDS') for the relevant Fund by contacting our Investor Services team on 1800 034 494 or from our website at www.yarracm.com/pdsupdates/. The information set out has been prepared in good faith and while Yarra Funds Management Limited and its related bodies corporate (together, the "Yarra Capital Management Group") reasonably believe the information and opinions to be current, accurate, or reasonably held at the time of publication, to the maximum extent permitted by law, the Yarra Capital Management Group: (a) makes no warranty as to the content's accuracy or reliability; and (b) accepts no liability for any direct or indirect loss or damage arising from any errors, omissions, or information that is not up to date.

YFM manages each of the Funds and will receive fees as set out in each PDS. To the extent that any content set out in this document discusses market activity, macroeconomic views, industry or sector trends, such statements should be construed as general advice only. Any references to specific securities are not intended to be a recommendation to buy, sell, or hold such securities. Past performance is not an indication of, and does not guarantee, future performance. Information about the Funds, including the relevant PDSs, should not be construed as an offer to any jurisdiction other than in Australia. With the exception of some Funds that may be offered in New Zealand from time to time (as disclosed in the relevant PDS), we will not accept applications from any person who is not resident in Australia or New Zealand. The Funds are not intended to be sold to any US Persons as defined in Regulation S of the US federal securities laws and have not been registered under the U.S. Securities Act of 1933, as amended.

References to indices, benchmarks or other measures of relative market performance over a specified period of time are provided for your information only and do not imply that the portfolio will achieve similar results. Holdings may change by the time you receive this report. Future portfolio holdings may not be profitable. The information should not be deemed representative of future characteristics for the strategy. There can be no assurance that any targets stated in this document can be achieved. Please be advised that any targets shown are subject to change at any time and are current as of the date of this document only. Targets are objectives and should not be construed as providing any assurance or guarantee as to the results that may be realized in the future from investments in any asset or asset class described herein. If any of the assumptions used do not prove to be true, results may vary substantially. These targets are being shown for informational purposes only.

© Yarra Capital Management, 2018.