**Investment Commentary**
Quarter to 30 September 2018

# Yarra Australian Real Assets Securities Fund

## Total returns as at 30 September 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 | 8.71 | -1.62 | 0.58 | 8.06 | 8.04 | 7.89 | 7.87 | 7.48 |
| S&P/ASX Custom Infrastructure, Utilities and A-REITs Index* | 9.38 | -2.40 | -0.28 | 8.11 | NA | NA | NA | NA |
| Excess Return† | -0.67 | 0.78 | 0.86 | -0.05 | NA | NA | NA | NA |
| Growth Return‡ | NA | NA | NA | -18.92 | -8.20 | -3.47 | -0.06 | 0.19 |
| Distribution Return‡ | NA | NA | NA | 26.97 | 16.24 | 11.36 | 7.93 | 7.29 |

**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 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 declined modestly in the September quarter as a benign reporting season overshadowed divergent trends among stocks and sectors.

The S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Accumulation Index declined 0.3% for the three months to 30 September 2018, taking its 12-month return to 8.1%. In comparison, the S&P/ASX 300 returned 1.5% for the quarter and 14.0% 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 declined 3% in the period as the three largest stocks, Transurban (TCL, -4.8%), Sydney Airport (SYD, -3.8%) and AGL Energy (AGL, -10.6%) weighed on the Index. TCL announced the WestConnex acquisition and an associated capital raising, while SYD and AGL faced higher regulatory uncertainty in their respective industries. In contrast, toll road operator Atlas Arteria (ALX, +10.5%) outperformed as it negotiates the internalisation of MAF, the vehicle through which it owns its core French based toll road asset APRR.

REITs rose 2% in the quarter as strength from Diversified, (+5.6%), Industrial (+7.7%) and Office REITs (+6.7%) offset weakness from Retail REITs (-4.1%). M&A activity intensified in the sector: Investa Office Fund (IOF, +5.5%) received a competing bid from Oxford Property at $3.4bn (surpassing Blackstone's offer) and Industrial group Propertylink (PLG) received a $693mn bid from ESG Real Estate. At a stock level, the largest index contributors were Mirvac Group (MGR, +11.1%) and Goodman Group (GMG, +7.7%), both of which delivered better-than-expected FY18 results.

## Portfolio review

### Key contributors

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.

AGL Energy (AGL, underweight) – the energy company underperformed following its FY18 result and further regulatory uncertainty, with the spectre of regulated retail tariffs a real possibility that looms large over the sector. 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

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

forecasts – due to headwinds around wholesale electricity prices, retail 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.

Scentre Group (SCG, underweight) – the shopping mall owner underperformed after announcing it purchased a 50% stake in Eastgardens (mall located in Sydney) on a tight cap rate of 4.25% for $720mn and in response to its 1H18 results. Eastgardens marks SCG's first major direct asset acquisition since 2012, and was surprising given expectations SCG may try to sell assets to fund its announced $700mn buy-back. Meanwhile, SCG's results highlighted that fundamentals remain under increasing pressure, with specialty rents now growing at 5 times moving-annual-turnover (MAT) sales (4.5% versus 0.9%), a level we do not believe is sustainable. We remain underweight SCG as recent transactional data highlights the structural pressures impacting mall valuations, with further evidence of net mall sellers (such as from peer Vicinity Centres (VCX)). SCG trades at 0.84 times NTA with a 5.6% forward dividend yield, which appears supportive but doesn't yet factor in the ongoing headwinds facing the company, including higher capex requirements and a narrower pool of specialty tenants capable of paying high rents with fixed annual rent increases.

**Key detractors**

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 offsets weakness in Residential. While consensus anticipates Residential earnings to fall 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.

Goodman Group (GMG, underweight) – the Industrial REIT outperformed as a better-than-expected FY18 result and FY19 guidance highlighted the 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 (up on 6% growth guidance of prior years) which in our view is supported by development EBIT rising 2% and AUM increasing over 10% year-on-year. We remain underweight GMG, as we believe the market is over-confident on the sustainability of these metrics on a three-year view. We believe that any reversion to 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.

NEXTDC (NXT, overweight) – the data centre company underperformed in the quarter following the release of its FY18 result. FY18 results beat forecasts, with EBITDA of $64mn versus consensus at $60.8mn, and FY19 guidance was solid with EBITDA guidance of $75-80mn. However, management didn't announce any material contract wins – something the market had been anticipating from the result – which negatively impacted performance in the quarter. 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 appears remains attractive given the company's growth profile, infrastructure-like characteristics at maturity, and supportive valuation.

**Key purchases**

Dexus Property (DXS) – we increased our position in the office REIT during the quarter. DXS provides a high quality exposure to Sydney and Melbourne offices, markets which have the most attractive supply and demand fundamentals with both expected to generate 8-10% rent growth in FY19. While the stock now trades at a premium to NTA (5%+), the Sydney office market outlook remains supportive (DXS is 10% under-rented) while the trading profit outlook has been materially de-risked on a three-year view.

Goodman Group (GMG) – we reduced our underweight in the Industrial REIT during the quarter. We remain negative towards the stock as we believe the market is overconfident on the sustainability of development EBIT over a three-year view. However, have less conviction heading into FY20 as GMG continues to benefit from the shift away from traditional retail towards online shopping. We believe that any reversion to cap rates (which compressed another 40 bps to 5.5% in FY18) represents downside risk given GMG's operating leverage and the resultant impact on Funds Management and Development EBIT.

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 FIRB approval, we saw the discount as not appropriately reflecting the probability of approval. Subsequent to our purchase the ACCC approved the deal on the condition CKI sells a package of APA's Western Australian gas assets.

**Key sales**

Viva Energy REIT (VVR) – we exited our position in the petrol station REIT prior to its 1H18 result. VVR now trades at 0.95 times NTA following outperformance in recent months, which we no longer find appealing when considering the outlook for the petrol station asset class of increased supply and structurally low demand risk from alternate fuelled vehicles.

BWP Trust (BWP) – we reduced our overweight position following strong outperformance from the REIT. BWP now trades at 1.13 times forward NTA with a 5.2% dividend yield, which is less compelling but remains attractive when considering its low finance risk. BWP remains a high quality business given its tenant quality (Bunnings), long term alternative property uses (mixed use and residential conversion valuation uplift) and strong balance sheet position. We continue to believe the leasing risk associated with BWP's main tenant, Bunnings, is being overstated. In our view, lease exits will reduce from the current abnormal levels caused by the Masters closure, while alternative acquisition demand exists for the majority of sites where Bunnings will not renew.

Ausnet (AST) – we reduced our position in the electric utilities company following a negative regulatory development. The Australian Energy Regulator (AER) announced draft rate of return guidelines which determine revenues for the five year period from 2020. If implemented, this change will lower the weighted average cost of capital (WACC) by 45 basis points, effectively removing $2bn of revenue from the sector over the period and making it more difficult for AST to achieve dividend growth given regulated revenues make up 85% of its revenues.

**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.

Dexus Property (DXS) – our overweight position is premised on the REIT's high quality exposure to Sydney and Melbourne offices. The markets have the most attractive supply and demand fundamentals, with both expected to generate 8-10% rent growth in FY19. While the stock now trades at a premium to NTA (5%+), the Sydney office market outlook remains supportive (DXS is 10% under-rented) while the trading profit outlook has been materially de-risked on a three-year view.

**Key active underweights**

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 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 including the closure of the Liddell power plant in 2021 which currently contribute 15-20% of earnings. Finally, we expect earnings to be negatively impacted as its low cost gas contracts roll off.

Mirvac (MGR) – we are underweight MGR based on our belief that its valuation (at 1.0 times NTA with a 4.9% dividend yield on a forecast basis) is capturing strong earnings growth and an optimistic cash flow outlook over the next two years, driven by elevated apartment and commercial property development profits. However, in our view residential earnings are at peak levels and will moderate over time, which is at odds with optimistic consensus forecasts. Furthermore, in our view passive property valuations are approaching the top of the cycle.

## 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 5.3%, an appealing 2.6% 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 to the wholesale electricity prices, 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 | 9.98 | 4.36 | 5.62 |
| Atlas Arteria | 7.50 | 2.15 | 5.35 |
| Dexus | 9.52 | 4.97 | 4.55 |
| **Underweights** | | | |
| Scentre | 5.03 | 9.85 | -4.83 |
| AGL Energy | 1.44 | 5.98 | -4.54 |
| Mirvac | 0.00 | 4.16 | -4.16 |

## Sector allocation

| | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| Infrastructure | 38.17 | 29.89 | 8.28 |
| Airport Services | 5.08 | 7.42 | -2.34 |
| Highways & Railtracks | 23.99 | 15.78 | 8.21 |
| Telecommunication Services | 0.60 | 1.01 | -0.41 |
| Railroads | 6.10 | 3.81 | 2.29 |
| Marine Ports & Services | 0.00 | 1.86 | -1.86 |
| Information Technology | 2.39 | 0.00 | 2.39 |
| Utilities | 8.34 | 14.95 | -6.61 |
| Electric Utilities | 1.82 | 3.22 | -1.40 |
| Gas Utilities | 5.09 | 5.49 | -0.40 |
| Independent Power and Renewable Electricity Producers | 0.00 | 0.26 | -0.26 |
| Multi-Utilities | 1.44 | 5.98 | -4.54 |
| Real Estate Investment Trusts (REITs) | 50.80 | 55.17 | -4.37 |
| Specialized REITs | 5.46 | 1.78 | 3.68 |
| Diversified REITs | 17.02 | 16.07 | 0.94 |
| Industrial REITs | 4.76 | 8.31 | -3.55 |
| Office REITs | 14.30 | 7.48 | 6.82 |
| Retail REITs | 9.26 | 20.94 | -11.68 |
| Other | 0.00 | 0.57 | -0.57 |
| Cash and receivables | 2.69 | 0.00 | 2.69 |

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$36.66 mn as at 30 September 2018 | |
| APIR code | JBW0030AU | |
| Estimated management cost | 0.85% p.a. | |
| Buy/sell spread | +/- 0.15% | |
| Platform availability | Asgard<br>BT Wrap<br>BT Panorama<br>Colonial FirstWrap<br>IOOF Pursuit Select<br>Macquarie Wrap<br>Consolidator | PowerWrap<br>SmartWrap<br>OneVue<br>Hub24 |

**Applications and contacts**

Investment into the Yarra Australian Real Assets Securities 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