YARRA
CAPITAL MANAGEMENT

**Investment Commentary**
Month to 31 August 2018

# Yarra Ex-20 Australian Equities Fund

## Total returns as at 31 August 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 | 6.08 | 5.70 | 10.21 | 22.21 | 12.96 | 9.09 | 8.43 |
| S&P/ASX 300 ex S&P/ASX 20 Accumulation Index# | 2.25 | 2.04 | NA | NA | NA | NA | NA |
| Excess return‡ | 3.83 | 3.66 | 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 share market rose in August as a relatively benign reporting season overshadowed divergent trends among stocks and sectors.

The S&P/ASX 300 ex S&P/ASX 20 Accumulation Index returned 2.0% in the month, taking its total return for 12 months to 17.6%. In comparison, the wider S&P/ASX 300 Index returned 1.4% for the month and 15.5% 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].

Momentum dominated returns in the month, with the top P/E quintile outperforming the ASX 200 by 6.2% and the bottom quintile underperforming by 3.3%. Banking and Resources – which comprise almost half of the market –declined 1.2% and 4.4%. These sectors, which trade at forecast P/E's of 12 and 13 times respectively, usually determine the direction of the local market.

Instead Health Care (+10.7%), Telecommunication Services (+13.1%) and Information Technology (+12.9%) supported the market. CSL (CSL, +15.6%) was largely responsible for Health Care's contribution, while the telco sector re-rated following the proposed "merger of equals" between TPG Telecom (TPM, +50.0%) and Vodafone. IT stocks also enjoyed widespread gains, led by Xero (XRO, +19.3%), Altium (ALU, +37.4%), Wisetech Global (WTC, +40.1%), Computershare (CPU, +6.8%), Afterpay (APT, +27.9%) and Appen (APX, +41.2%).).

## Portfolio review

### Key contributors

TPG Telecom (TPM, overweight) – the company outperformed during the month after announcing a proposed merger of equals with Vodafone, with TPM to own 49.9% 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 combined entity (to be called TPG Telecom) becoming a strong challenger to incumbents Telstra (TLS) and Optus. The entity will have an enterprise value of $15bn, comprising debt of $4.1bn (2.2x 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.

Star Entertainment (SGR, overweight) – the casino operator outperformed after announcing FY18 earnings ahead of analyst forecasts in its full-year result and making positive outlook comments for FY19. EBITDA grew 14% – ahead of consensus by 2.7% – driven by 55% growth in VIP turnover and cost control in Sydney. Management expects all properties and products to return to growth in FY19, with table hold rates rebounding to above long-term trend levels. We remain overweight the stock, as we continue to 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.

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

Vocus Group (VOC, overweight) – the telco outperformed after delivering a better-than-expected FY18 result. Though management delivered FY18 EBITDA in line with expectations and guided to FY19 EBITDA of $350-370mn, 5% below forecasts at the midpoint, cash conversion for the period increased from 68% to 110%. The improvement alleviated concerns in the market that VOC would need to raise capital to avoid breaching its debt covenants. We remain positive towards the stock 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 16.0 times forward earnings) currently capitalises only limited future growth.

**Key detractors**

Ansell (ANN, overweight) – the protective clothing manufacturer underperformed following an underwhelming FY19 outlook. While management reported solid FY18 results, with EPS of $US1.02 in the middle of guidance, ANN guided to FY19 EPS of $US1.06 (at the midpoint) – short of consensus at $US1.10. Reasons included a higher effective tax rate, higher raw materials costs and uncertainty surrounding the potential introduction of new tariffs. We believe guidance is conservative, since it ignores any benefit from the ongoing share buy-back, M&A or additional price increases to recover rising input costs and tariffs.

Iluka Resources (ILU, overweight) – the mineral sands producer underperformed after announcing 1H18 net profit 5-7% below analyst forecasts and guiding to higher costs for FY18. ILU expects operating costs to increase by 11% and increased its capital expenditure for Sierra Rutile – a project which it purchased in late 2016 – by 50%. On the other hand, ILU also increased its zircon price by 12% for the next six months, lifted zircon production for the next three years, guided to lower capex at its flagship Jacinth-Ambrosia mine and deferred the Balranald project. We continue to hold an overweight position in ILU, which remains a relative safe haven in Metals & Mining given its visibility over commodity pricing for the foreseeable future.

Eclipx Group (ECX, overweight) – the sales financing group declined in value following a disappointing FY18 trading update. Management downgraded FY18 NPATA by 11% versus earlier guidance and market expectations. The Graysonline and Right2Drive businesses were responsible, with the core Australian and New Zealand Commercial businesses (70% of group earnings) generating earnings growth of 5%. We continue to hold a positive view towards ECX's core business: the company should continue to take market share (with high single-digit volume growth and stable pricing) and where there is a large cost-out opportunity from upgrading existing systems. Additionally, ECX is well positioned to capitalise on the major banks pulling back from lending in this industry. Subsequent to the downgrade the company received a takeover offer from fleet peer, SGFleet. The logic for industry consolidation is compelling with significant synergies available to the merged entity. With the stock trading at a P/E of 10.4 times on a 12-month forward basis – a material discount to its peers (13 to 17 times) will continue to hold the position.

**Key purchases**

Eclipx (ECX) – we took a period of underperformance after a disappointing FY18 trading update as an opportunity to increase our position size in the sales financing group. We continue to hold a positive view towards ECX's core business: the company should continue to take market share (with high single-digit volume growth and stable pricing) and there is a large cost-out opportunity from upgrading existing systems. Additionally, ECX is well positioned to capitalise on the major banks pulling back from lending in this industry. Subsequent to increasing the position size, the company received a takeover offer from fleet peer, SGFleet. The logic for industry consolidation is compelling with significant synergies available to the merged entity. The stock is trading on a P/E of 10.4 times on a 12-month forward basis – a material discount to its peers which trade in a range of 13 to 17 times.

James Hardie (JHX) – we increased our position in the building materials company following its 1Q19 result. While JHX's maiden guidance for FY19 was underwhelming, 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 19.2 times forward earnings, an 11% discount to the ASX Industrials.

JB Hi-Fi (JBH) – we increased our position in the electronics retailer during the month as the FY18 result increased our conviction in our investment thesis. While The Good Guys has a more conservative outlook amid heightened price competition, we believe the business is better equipped to deal with these issues through its new sales commission system and that significant synergy, sales and margin opportunities remain. Our medium-term investment thesis remains in place, being that concerns regarding Amazon's entry into the Australian market are overplayed 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.

**Key sales**

Downer EDI (DOW) – we reduced our position in the month 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.

CSR (CSR) – we reduced our overweight position due to our view of the 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.

Ansell (ANN) – we modestly reduced our position size following ANN's FY18 result, but remain positive towards the stock. We believe FY19 guidance is conservative, since it ignores any benefit from the ongoing share buy-back, M&A or additional price increases to recover rising input costs and tariffs. More broadly, we continue to believe ANN can further improve operating leverage and increase market share, growing earnings above consensus expectations. Drivers include internal programs to increase operational efficiency, improved margins from new distributor agreements and a shift to higher-value products. ANN's relative valuation remains attractive, trading on a 12-month forward P/E of 17.1 times – a significant discount to its domestic peer group.

**Key active overweights**

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.

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 increase towards 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.

Star Entertainment (SGR) – we are overweight the stock 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. SGR trades on 17.6 times forward earnings, a significant discount versus peer Crown Resorts (CWN) at 22.2 times despite having a superior growth outlook.

**Key active underweights**

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 to derive more revenue from its annuity-style leasing of electronic gaming machines. At a forward P/E of 23.2 times, however, we do not believe the market fully accounts for risks in the ALL's legacy business (outright sales), which is a volatile segment that to a large extent relies on new casino openings, and question the sustainability of the Digital division's earnings growth following the acquisition of Big Fish Games in January 2018. As a result, we believe there are better relative opportunities elsewhere.

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 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 local business.

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 18.5 times forward EV/EBITDA and is sensitive to higher interest rates, which we remain wary of at this point of the cycle.

## 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 300 ex S&P/ASX 20 Accumulation Index yields 3.6% on a 12-month forward basis (before

franking) versus 2.5% 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 are overweight the Telecommunication Services, Industrials and Consumer Discretionary sectors, but are underweight Real Estate, Consumer Staples and Utilities.

## Sector allocation

| | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| Consumer Discretionary | 17.91 | 11.77 | 6.14 |
| Consumer Staples | 0.00 | 5.82 | -5.82 |
| Energy | 8.32 | 6.46 | 1.86 |
| Financials | 9.69 | 12.70 | -3.01 |
| Health Care | 8.02 | 7.91 | 0.11 |
| Industrials | 14.93 | 11.58 | 3.34 |
| Information Technology | 6.87 | 6.28 | 0.59 |
| Materials | 20.22 | 16.89 | 3.32 |
| Real Estate | 0.00 | 15.07 | -15.07 |
| Telecommunication Services | 11.32 | 1.07 | 10.25 |
| Utilities | 0.00 | 4.43 | -4.43 |

## Top 5 holdings

| | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| TPG Telecom | 8.07 | 0.39 | 7.67 |
| James Hardie Industries | 6.78 | 1.25 | 5.53 |
| Seek | 6.09 | 1.05 | 5.05 |
| Star Entertainment Group | 5.81 | 0.59 | 5.22 |
| Santos | 5.48 | 1.59 | 3.89 |

## Income and growth

| | 1 year % | 3 years % p.a. | 5 years % p.a. | Since inception % p.a. |
|---|---|---|---|---|
| Growth return | 18.68 | 9.62 | 6.15 | 5.53 |
| Distribution return | 3.53 | 3.34 | 2.93 | 2.91 |

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.

## Key active positions

| Overweights | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| TPG Telecom | 8.07 | 0.39 | 7.67 |
| James Hardie Industries | 6.78 | 1.25 | 5.53 |
| Seek | 5.81 | 0.59 | 5.22 |
| **Underweights** | | | |
| Aristocrat Leisure | 0.00 | 2.68 | -2.68 |
| Goodman Group | 0.00 | 2.29 | -2.29 |
| Sydney Airport | 0.00 | 2.16 | -2.16 |

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 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$30.23 mn as at 31 August 2018 | |
| APIR code | JBW0052AU | |
| Estimated management cost | 0.95% p.a | |
| Buy/sell spread | +/- 0.15% | |
| Platform availability | Asgard<br>BT Wrap<br>BT Panorama<br>Macquarie Wrap Consolidator | Macquarie Wrap Accumulator<br>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

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