YARRA
CAPITAL MANAGEMENT

Investment Commentary
Month to 30 November 2018

Yarra Australian Real Assets Securities Fund

Gross returns as at 30 November 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	8.62	0.41	-2.73	-0.15	6.30	8.61	9.83	8.18
S&P/ASX Custom Infrastructure, Utilities and A-REITs Index*	7.80	0.14	-5.09	-2.03	NA	NA	NA	NA
Excess Return†	0.82	0.28	2.36	1.89	NA	NA	NA	NA
Growth Return‡	NA	NA	NA	-24.87	-9.54	-2.73	1.83	1.00
Distribution Return‡	NA	NA	NA	24.72	15.84	11.34	8.00	7.18

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 gross of all fees, meaning they do not reflect the deduction of any investment management fees which would reduce returns and assume reinvestment of all distributions. Investment in the fund is not available on a fee free basis and this should be factored into any analysis of past performance.

Net returns as at 30 November 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	7.71	0.34	-2.93	-0.99	5.41	7.69	8.90	7.27
S&P/ASX Custom Infrastructure, Utilities and A-REITs Index*	7.80	0.14	-5.09	-2.03	NA	NA	NA	NA
Excess Return†	-0.09	0.21	2.16	1.04	NA	NA	NA	NA
Growth Return‡	NA	NA	NA	-25.70	-10.43	-3.64	0.90	0.08
Distribution Return‡	NA	NA	NA	24.72	15.84	11.34	8.00	7.18

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 rose modestly in November, outperforming a falling market as investors increased their allocation to defensive equities.

The S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Accumulation Index rose 0.1% in the month. In aggregate, constituents held their value even as the wider ASX 300 declined 2.2% in the period.

Within Infrastructure & Utilities (+0.6%), logistics company Qube (QUB, +9.0%) was the top performer in the month after announcing at its AGM that first quarter results were ahead of expectations, driven by higher volumes at its Patrick Terminals business. Sydney Airport (SYD, +5.6%) was the second best performer as traffic data showed international passenger growth of +6% y/y for October and robust domestic passenger growth of +1.6% y/y.

Meanwhile, REITs declined 0.3%. At a subsector level, Office and Diversified REITs outperformed Retail and Industrial REITs. At a stock level the top performers included Charter Hall Retail REIT (CQR, +6.4%), which divested two assets for $76.1mn (representing a 1% discount to book value) and reiterated FY19 guidance, and Shopping Centres Australasia Property Group (SCP, +2.7%), which held its AGM and also reaffirmed FY19 guidance.

Portfolio review

Key contributors

Unibail-Rodamco Westfield (URW, underweight) – the shopping mall owner declined in value over weakening sentiment towards European REITs and ongoing softness in the US. In the previous month, management commented that retailers face significant challenges and that lease terms are generally taking longer to negotiate. We remain underweight the stock based on the view that retail mall fundamentals are weakening, with distribution trending away from traditional bricks and mortar and increasingly towards online shopping. Specifically to URW, we see downside risks 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 weakening sales environment, placing further stress on earnings and distributions.

NEXTDC (NXT, overweight) – the data centre operator outperformed in the month after announcing that contracted commitments for its S2 data centre have increased by 30% to 47% of total planned capacity. S2 is expected to open in 1H18 and has a nameplate capacity of 30 megawatts, almost double that of S1 which opened in September 2013. The update supported our investment thesis that NXT is structurally set to benefit from the increasing adoption of cloud technology and is accelerating its expansion to meet the demands of its clients. Its three new data centres, including S2, will support significant medium to longer term earnings growth. The outlook for NXT appears attractive given the company's growth profile, infrastructure-like characteristics at maturity and supportive valuation.

GPT (GPT, overweight) – the REIT outperformed during the month without any material company-specific news. We continue to 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 1.0 times NTA – and regard 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.

Key detractors

AGL Energy (AGL, underweight) – the energy company outperformed in November, partially retracing underperformance in prior periods. During the month AGL responded to government pressure to decrease electricity prices by extending its loyalty program. The move has a smaller impact on earnings than the market was fearing (at around $9mn after tax). We remain underweight AGL as we see the business facing significant earnings headwinds in future years, including wholesale electricity prices declining with increasing renewable penetration, lower retail margins from more intense competition and ongoing regulatory scrutiny.

Qube Logistics (QUB, underweight) – the logistics company outperformed after announcing at its AGM that first-quarter results were ahead of expectations, driven by 6% container volume growth at Patrick Terminals as the business takes share from key competitor DP World. Notwithstanding the strong start to the year, QUB maintained its guidance for a 'solid' increase in NPATA for FY19. We remain underweight the company despite several earnings tailwinds, which we believe are more than captured in the stock's valuation at 11.7 times EV/EBITDA once adjusting for Moorebank valuation.

Atlas Arteria (ALX, overweight) – the toll road operator declined modestly in value in the month without any material company-specific news. 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 reflects the complicated ownership structures of its assets.

Key purchases

APA Group (APA) – we increased our holdings in the gas pipeline company during the month, moving our active position to overweight from modestly underweight. We took the federal government's announcement – that it intended to block CK Group's proposed acquisition at $11 per share – as a buying opportunity. We see APA's valuation (at an EV/EBITDA of 12.1 times with a 5.4% dividend yield) as attractive when considering its exposure to increasingly important gas markets and strong competitive position, with dominant market share.

Sydney Airport (SYD) – we increased our position size in the airport owner and operator during the month, taking advantage of the recent sell-off. In our view SYD is set to benefit from a continued supportive demand backdrop (the airport captures approximately 40% of Australia's inbound air passengers) with robust passenger growth supporting strong revenue growth which, when combined with high incremental margins will enable SYD to continue grow its dividend in the mid to high single digits.

Key sales

Ausnet (AST) – we exited our position in the electric utilities company to accommodate a larger position in APA whose valuation was discounted post the proposed takeover by CK Group being blocked. While view AST as trading around fair value on a 6.1% dividend yield, the risks around RAB growth have materially increased given regulatory scrutiny.

Vocus (VOC) – we exited the position in the telco following recent outperformance. Since initiating a position in VOC the company has moved away from being a telecommunications infrastructure provider to more of a service provider and as such a position is no longer warranted.

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, due to less reliance on asset transactions to meet guidance. We see the current valuation as favourable – with the security trading at around 1.0 times NTA – and regard 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 the Sydney and Melbourne office markets. These two 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 (modest at around 10%), 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 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 0.84 times NTA and with a 5.7% forward dividend yield – appropriately factors in these headwinds.

AGL Energy (AGL) – we are underweight AGL because we believe the company faces significant earnings headwinds in future years. Firstly, we believe wholesale electricity prices are set to retreat from elevated levels. Secondly, AGL's retail margins are under pressure from increased competition and regulatory scrutiny, particularly in relation to customer discounts. 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 station in 2021 which currently comprise 15-20% of earnings. Finally, we expect earnings to be negatively impacted as its low cost gas contracts roll off.

Vicinity Centres (VCX) – our underweight position in the shopping mall owner is based on our negative view of Retail REIT fundamentals. VCX faces significant headwinds as changing consumer preferences direct an increasing proportion of retail sales to online. We believe the outlook for second-tier malls – which still comprises a large part of VCX's value – is worsening. Though VCX is lifting the quality of its portfolio by focusing on the development of its best assets and divesting its lower-quality centres, we do not believe this will offset the continued decline in value from its second-tier assets.

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 5.5%, an appealing 2.9% 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 wholesale electricity prices, sustainability of retail margins given regulatory risks and the 15-20% earnings hole from the closure of the Liddell power station in 2021.

Within A-REITs, we prefer exposure to high quality asset owners at more attractive valuations such as Dexus Property (DXS). We believe structural headwinds for shopping mall owners are likely to persist – changing consumer preferences are 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	10.43	4.51	5.92
Atlas Arteria	7.44	2.11	5.33
Dexus	9.75	5.04	4.71
Underweights			
Scentre	5.10	9.91	-4.81
AGL Energy	1.43	5.91	-4.47
Vicinity Centres	0.00	4.10	-4.10

Sector allocation

	Portfolio %	Benchmark %	Active %
Infrastructure	39.27	30.57	8.70
Airport Services	5.60	7.50	-1.90
Highways & Railtracks	24.75	16.29	8.46
Communication Services	0.01	0.92	-0.91
Railroads	6.46	4.00	2.46
Marine Ports & Services	0.00	1.86	-1.86
Information Technology	2.45	0.00	2.45
Utilities	7.90	14.39	-6.49
Electric Utilities	0.00	3.32	-3.32
Gas Utilities	6.47	4.96	1.51
Independent Power and Renewable Electricity Producers	0.00	0.21	-0.21
Multi-Utilities	1.43	5.91	-4.47
Real Estate Investment Trusts (REITs)	51.81	55.04	-3.23
Specialized REITs	5.82	1.83	3.99
Diversified REITs	16.82	15.47	1.35
Industrial REITs	4.87	8.44	-3.57
Office REITs	14.92	7.75	7.17
Retail REITs	9.38	20.96	-11.57
Other	0.00	0.60	-0.60
Cash and receivables	1.02	0.00	1.02

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$35.24 mn as at 30 November 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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