YARRA CAPITAL MANAGEMENT

**Investment Commentary**
Month to 30 November 2018

# Yarra Emerging Leaders Fund

## Gross returns as at 30 November 2018

| | 1 month % | 3 months % | 1 year % | 3 years % p.a. | 5 years % p.a. | 10 years % p.a. | Since inception* % p.a. |
|---|---|---|---|---|---|---|---|
| Yarra Emerging Leaders Fund | -1.44 | -9.44 | 2.54 | 5.86 | 10.64 | 13.15 | 11.31 |
| Emerging Leaders Combined Benchmark† | -2.49 | -11.27 | -2.40 | 10.91 | 9.50 | 9.30 | 6.74 |
| Excess return (before fees)‡ | 1.04 | 1.83 | 4.94 | -5.05 | 1.14 | 3.85 | 4.57 |

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

| | 1 month % | 3 months % | 1 year % | 3 years % p.a. | 5 years % p.a. | 10 years % p.a. | Since inception* % p.a. |
|---|---|---|---|---|---|---|---|
| Yarra Emerging Leaders Fund | -1.55 | -9.72 | 1.28 | 4.55 | 9.27 | 11.75 | 10.02 |
| Emerging Leaders Combined Benchmark† | -2.49 | -11.27 | -2.40 | 10.91 | 9.50 | 9.30 | 6.74 |
| Excess return (after fees)‡ | 0.94 | 1.55 | 3.67 | -6.36 | -0.23 | 2.46 | 3.28 |

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* Inception date Yarra Emerging Leaders Fund: September 1997
† Comprising 50% S&P/ASX Midcap 50 Accumulation Index and 50% S&P/ASX Small Ordinaries Accumulation Index
‡ Excess return: The difference between the Fund's return and the benchmark return.

### Market review

Weaker commodity prices and a stronger Australian dollar sent Australian small and midcaps lower in November, with the local index underperforming global markets.

The Emerging Leaders Benchmark declined 2.5% in November, underperforming the S&P/ASX 200 Accumulation Index which fell 2.2% in the month. In comparison, the MSCI World Index and the S&P500 lifted by 1.2% and 2.0% respectively.

While eight out of 11 sectors fell in the month, the worst detractors from the benchmark's return were Energy (-11.9%) and Metals & Mining (-4.3%). All Energy stocks fell in value in response to Brent crude dropping 21% to $US59 per barrel during the month, with the worst performers including Beach Energy (BPT, -13.4%), FAR (FAR, -44.8%), Washington H. Sol Pattinson (SOL, -8.2%) and WorleyParsons (WOR, -9.5%). In Metals & Mining, the worst performers included Bluescope Steel (BSL, -21.9%) and Alumina (AWC, -12.5%).

Elsewhere, mining services and construction firms weighed on Industrials (-4.2%). RCR Tomlinson (RCR, -100%) went into administration due to cost blowouts at one of its solar farm projects in Queensland, only three months after completing a $100mn capital raise. Other poor performers included CIMIC Group (CIM, -14.1%), Seven Group (SVW, -10.3%) and Downer EDI (DOW, -9.4%).

Conversely, Information Technology rallied 5.0% in the month, supporting the index. Top performers included high P/E stocks Afterpay (APT, +15.5%), Appen (APX, +30.6%), Wisetech Global (WTC, +16.5%), TechnologyOne (TNE, +16.0%) and NEXTDC (NXT, +9.7%).

### Portfolio review

**Key contributors**

TradeMe (TME, overweight) – the NZ online auction and classifieds company outperformed after receiving a takeover bid from private equity firm Apax Partners. The preliminary, non-binding and indicative bid was priced at NZ$6.40 per share, a 25% premium to the previous day's trading price. In response TME has granted due diligence to the firm until mid-December to facilitate a binding offer. We remain overweight the stock – which trades at a 4% discount to the offer – given Apax Partners is a credible suitor (with $US51bn of funds raised) that has previously executed a number of deals in the online classified space. Subsequent to month-end a competing bid emerged from private equity firm Hellman & Friedman at $6.45 per share.

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 before

the end of the year 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.

Collins Foods (CKF, overweight) – the quick-service restaurant company outperformed after delivering a strong 1H19 result. Underlying EBITDA grew 23.5% to $56.1mn – in line with consensus forecasts – as accelerating like-for-like sales from the core KFC Australia business (+3.1%) offset a 2.5% decline from KFC Europe (due to an unusually hot summer). While CKF didn't provide FY19 earnings guidance, the outlook for sales growth appears promising, with six additional KFC Australia stores and four more KFC Europe stores set to open in the second half. Meanwhile, the new Taco Bell format stores are trading materially ahead of expectations, with management expecting to add another two in CY18 and 10 in CY19.

**Key detractors**

WorleyParsons (WOR, overweight) – the engineering services company underperformed in November in response to the Brent Crude oil price declining 21% to $US59 per barrel and due to a shortfall in the retail component of its equity raising to part fund the $US3.3bn acquisition of Jacobs ECR. Retail shareholders took up only 51% of their entitlements, reflecting a negative view of the acquisition, with the shortfall taken up by sub-underwriters. We remain overweight the stock based on a positive view of the Jacobs acquisition and upside from WOR's existing hydrocarbons business. In our view the acquisition is strategically sound, with 20% EPS accretion in FY18 on a pro-forma basis before cost synergies. In hydrocarbons, which comprise 39% of the combined business following the transaction, the recovery remains on track with activity levels robust and client behaviour unchanged.

Alumina (AWC, overweight) – the stock underperformed without any material company-specific news during the month. We remain 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 7.9 times forward P/E when considering the strategic appeal of its assets.

oOH! Media (OML, overweight) – the outdoor media company underperformed in the month due to concerns around slower consumer spending and that its recently acquired Adshel business would lose a key street furniture contract with the Brisbane City Council. Later in the month OML clarified that the Brisbane City Council has voted to approve the contract, and binding documentation was executed at the end of the month. We continue to support the Adshel acquisition, 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.

**Key purchases**

Bluescope Steel (BSL) – we established a position in the steel producer during the month. Our positive outlook is premised on BSL's high-quality assets both domestically and internationally, its strong balance sheet, capital management initiatives (with a $250mn buy-back recently announced) and a supportive valuation at 6.4 times forward earnings. While BSL's earnings remain subject to volatile commodity prices, its recent cost-reduction programs and shifting business mix provides confidence its earnings are more resilient than in previous cycles, which we believe is underappreciated by the market. In the long-term, we expect BSL to remain soundly profitable and cash-flow positive, even when the cycle troughs.

Kathmandu (KMD) – we increased our position as the outdoor adventure retailer provided another strong trading update during the month which further supports our investment thesis. Our positive view is based on KMD's attractive category exposure, market share opportunities both in Australia and internationally, margin expansion opportunities and attractive valuation (12-month forward P/E of 10.0 times). Furthermore we hold a positive view of the recent OBOZ acquisition, which accelerates KMD's expansion into footwear and the US wholesale market.

Elders (ELD) – we increased our position in the agribusiness during the month as the company underperformed following its FY18 result. Despite beating expectations, the market focused on expectations for a weaker 1H19 result amid weaker summer cropping and livestock activity levels. We continue to expect high single-digit to low double-digit earnings growth, driven by organic growth and potential accretive acquisitions. Furthermore, we recognise the potential corporate appeal of the company given its attractive business segments, its simplified capital structure relative to prior years and modest valuation. A strong management team and ELD's diversified business across agriculture commodities support the stock continuing to re-rate from its 12-month forward P/E multiple of 11.3 times.

**Key sales**

Clydesdale (CYB) – we exited our position in the UK bank following its FY18 result in the month. While FY18 earnings were only modestly below expectations, disappointing FY19 guidance invalidated our investment thesis. CYB guided to net interest margins (NIMs) of 160-170 bps, well below consensus of 179 bps, due to a contraction in the recently acquired Virgin Money portfolio. The main driver was customers rolling off Virgin Money's higher margin back book to the lower margin

front book, which we expect will cause ongoing pressure. In the context of deteriorating fundamentals, a weaker industry structure than we had perceived and ongoing Brexit uncertainty, we don't find the stock attractive despite appearing cheap at 0.8 times tangible book value and 8 times forward earnings.

Crown Resorts (CWN) – we exited the position 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. However, at 18.5 times 12-month forward earnings we believe this is more than factored into the share price. Our preferred overweight in the industry is Star Entertainment (SGR), which trades at a more appealing 14.2 times 12-month forward earnings.

Scottish Pacific (SCO) – we reduced the position size in November as the stock traded in line with the proposed takeover of $4.40 per share in cash from private equity firm Affinity Equity Partners. With shareholders voting in favour of the deal at SCO's AGM at the end of the month, SCO shares are expected to be suspended from quotation on December 7 (pending court approval). Subsequent to month end we exited our position in the stock.

**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 in part reflects 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. We believe ALX now has a credible strategy for achieving this goal in the near term which 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 will 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 expect the combined entity will now be able to acquire 5G spectrum at lower cost in the upcoming auction.

WorleyParsons (WOR) – we expect WOR to benefit from its exposure to oil & gas (primarily through its Hydrocarbons business), which we believe stands to benefit from increased capex across the industry. As activity levels increase, strong operating leverage – driven by management's focus on controlling overhead costs and maintaining high staff utilisation – should drive earnings above consensus expectations. We also hold a positive view of WOR's recent Jacobs' ECR acquisition, which makes sense strategically and is 20% EPS accretive in FY18. While WOR trades at a premium to peers based on consensus expectations (17.2 times forward earnings), this premium falls to a discount when adjusted for WOR's strong growth potential.

**Key active underweights**

Tabcorp (TAH) – we are underweight the gambling services provider because we believe earnings expectations are too optimistic and the market's valuation, at 20.2 times 12-month forward P/E, is stretched. Our key concern is the outlook for the conventional wagering business, which operates in a low growth industry and with high levels of competition, placing intense pressure on its traditional retail distribution strategy. The merger of TAH and Tatts Group in December 2017 doesn't alter our view of the structural headwinds in wagering, with the lofty acquisition price and high gearing more than offsetting targeted cost synergies in our view.

A2 Milk (A2M) – we believe the stock's valuation – trading at a forecast P/E of 26.1 times – fully captures the company's growth opportunity at this time but doesn't factor in potential distribution risks. A2M's earnings over recent years have been underpinned by Chinese infant formula sales which have grown significantly. However, the market's expectations for future growth relies on the sustainability of current distribution channels (in particular via daigous), competitors failing to gain traction and the A2M brand maintaining its appeal to the Chinese consumer.

Incitec Pivot (IPL) – we are underweight the stock based on a negative outlook for IPL's key commodities, urea and diammonium phosphate (DAP). IPL's other business, explosives, enjoys a strong competitive position across most markets, but moderate risks have now emerged following West Australian contract losses announced in FY18, with other key contracts coming up for renewal in the near term.

## Market outlook

We believe fundamentals point to a solid earnings cycle for the Australian equity market. Consensus sees Resources driving mid-single-digit earnings growth, moderated by lower earnings growth from Industrials and Financials.

Australian equities are priced in line with long-term averages based on forward earnings estimates, though valuations remain attractive relative to alternatives such as fixed interest. The S&P/ASX 200 Index yields 5.1% on a 12-month forward basis (before franking) versus 2.6% from the Australian 10-year government bond yield.

We remain alert to economic and geopolitical risks, including lower house prices domestically, rising interest rates in the US, the impact of tariffs and China's real rate of growth.

We see significant value in certain sectors but believe others to be overvalued based on our earnings and cash flow expectations. We are overweight the Communication Services, Consumer Discretionary and Health Care sectors, but are underweight Materials, Real Estate and Information Technology.

## Sector allocation

| | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| Communication Services | 14.72 | 6.14 | 8.58 |
| Consumer Discretionary | 19.92 | 13.58 | 6.34 |
| Consumer Staples | 4.06 | 7.37 | -3.31 |
| Energy | 5.03 | 4.85 | 0.18 |
| Financials | 10.22 | 11.30 | -1.08 |
| Health Care | 11.95 | 6.69 | 5.26 |
| Industrials | 14.02 | 11.96 | 2.06 |
| Information Technology | 3.75 | 7.31 | -3.56 |
| Materials | 11.88 | 21.70 | -9.81 |
| Real Estate | 2.02 | 7.17 | -5.15 |
| Utilities | 0.00 | 1.92 | -1.92 |

## Top 5 holdings

| | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| Atlas Arteria | 6.47 | 1.14 | 5.34 |
| WorleyParsons | 5.03 | 1.18 | 3.85 |
| TPG Telecom | 4.93 | 0.63 | 4.30 |
| Seek | 4.66 | 1.67 | 2.99 |
| ResMed | 4.33 | 1.96 | 2.37 |

## Key active positions

| Overweights | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| Atlas Arteria | 6.47 | 1.14 | 5.34 |
| TPG Telecom | 4.93 | 0.63 | 4.30 |
| WorleyParsons | 5.03 | 1.18 | 3.85 |
| **Underweights** | | | |
| Tabcorp Holdings | 0.00 | 2.22 | -2.22 |
| a2 Milk Company | 0.00 | 1.83 | -1.83 |
| Incitec Pivot | 0.00 | 1.62 | -1.62 |

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 | -0.56 | 2.63 | 7.12 | 8.85 |
| Distribution return | 1.83 | 1.92 | 2.15 | 2.90 |

The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), 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 through exposure to small and medium sized Australian companies that are considered to possess strong capital growth potential. In doing so, the aim is to outperform the benchmark over rolling 3-year periods. |
| Recommended investment time frame | 5 - 7 + years |
| Fund inception | September 1997 |
| Fund size | Pooled Fund A$149.52 mn as at 30 November 2018 |
| APIR codes | JBW0010AU |
| Estimated management cost | 1.25% p.a. |
| Buy/sell spread | +/- 0.20% |
| Platform availability | Asgard, BT Wrap, Macquarie Wrap, Consolidator, Hub24 |

## Investment performance comparison of $50,000

After fees, since inception of the Yarra Emerging Leaders Fund, September 1997 to November 2018.

For illustrative purposes only. Past performance does not guarantee future results, which may vary. The total net fund returns shown are prepared on an exit to exit basis (i.e. they include all ongoing fees and expenses and assume reinvestment of all distributions). They do not take personal taxation into account. The comparison with the benchmark (comprising 50% S&P/ASX Midcap 50 Accumulation Index and 50% S&P/ASX Small Ordinaries Accumulation Index) is for comparative purposes only. Index returns do not allow for transactional, management, operational or tax costs. An index is not managed and investors cannot invest directly in an index.

## Applications and contacts

Investment into the Yarra Emerging Leaders Fund can be made by Australian resident investors only.

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**Disclaimers**

The Yarra Emerging Leaders Fund is substantially invested in the Yarra Emerging Leaders Pooled Fund ('Pooled Fund'). References in this document to the underlying assets or investments of the Fund generally relate to the assets held in the Pooled Fund. The Fund's benchmark comprises 50% S&P/ASX Midcap 50 Accumulation Index and 50% S&P/ASX Small Ordinaries Accumulation Index.

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