YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 31 December 2018

Yarra Australian Real Assets Securities Fund

Gross returns as at 31 December 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	9.10	2.07	0.85	2.67	8.32	8.79	9.67	8.29
S&P/ASX Custom Infrastructure, Utilities and A-REITs Index*	8.27	1.99	-0.82	0.73	7.65	NA	NA	NA
Excess Return†	0.83	0.07	1.67	1.94	0.67	NA	NA	NA
Growth Return‡	NA	NA	NA	-22.75	-7.30	-2.58	1.86	1.01
Distribution Return‡	NA	NA	NA	25.42	15.62	11.37	7.81	7.28

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 31 December 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	8.18	1.99	0.64	1.81	7.41	7.87	8.75	7.38
S&P/ASX Custom Infrastructure, Utilities and A-REITs Index*	8.27	1.99	-0.82	0.73	7.65	NA	NA	NA
Excess Return†	-0.09	0.00	1.45	1.08	-0.24	NA	NA	NA
Growth Return‡	NA	NA	NA	-23.61	-8.21	-3.49	0.94	0.10
Distribution Return‡	NA	NA	NA	25.42	15.62	11.37	7.81	7.28

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 held their value in the December quarter, 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 declined 0.8% in the quarter, substantially better than the broader S&P/ASX 300 Index which declined 8.4%. Australian shares outperformed global indices, with the MSCI World Index and the S&P 500 dropping by 13.0% and 13.5% respectively in the quarter.

The VIX "fear index" more than doubled during the quarter to 25.4 points as concerns rose that higher interest rates, trade tariffs and growing cost inflation were harming global economic growth. The US Federal Reserve nevertheless raised interest rates by 0.25% to a target range of 2.25-2.5% in December and gave a less dovish outlook than expected. In Australia, third-quarter GDP was below expectations, rising 2.8% y/y versus the RBA's forecast of 3.5% growth.

Infrastructure stocks provided the most support, rising 0.2% in the period. At a stock level, the best performers were Aurizon Holdings (AZJ, +4.1%), Transurban (TCL, +6.4%) and AGL Energy (AGL, +5.6%). The largest underperformers included Atlas Arteria (ALX, -10.3%) and Qube Holdings (QUB, -7.0%).

Within REITs (-1.7%), Industrial (+3.9%) and Office (+2.0%) outperformed while Retail (-4.9%) weighed on the sector. Top performers included Shopping Centres Australasia Property Group (SCP, +9.2%), Charter Hall Retail REIT (CQR, +8.9%) and BWP Trust (BWP, +8.3%). Conversely, Unibail-Rodamco-Westfield (URW) fell 24% in response to the deteriorating outlook for shopping malls globally and due to balance sheet concerns.

Portfolio review

Key contributors

Unibail-Rodamco Westfield (URW, underweight) – the shopping mall owner declined in value over weakening sentiment towards European REITs, ongoing softness in the US and growing concerns about its balance sheet and dividend sustainability. During the quarter management commented that bricks and mortar retailers are facing 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, as distribution trends increasingly towards online shopping. Specifically to URW, we see downside risks to operating metrics in future periods as rental growth becomes increasingly 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.

GPT (GPT, overweight) – the REIT outperformed during the quarter after announcing a $448mn revaluation gain across its portfolio, translating to a 4.7% rise in its June 2018 NTA of $5.31 per share. Valuations lifted across both its office and retail assets. 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 yet to be 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.

Transurban (TCL, overweight) – the toll road operator outperformed after releasing September quarter traffic data and as investors increased allocations to defensive equities. The update confirmed that average daily traffic grew 3.3% across its portfolio, supported by Melbourne's CityLink which grew 5.5% as all lanes opened following the completion of the Citylink Tulla Widening project. In our view TCL has a strong growth outlook (with a number of new project and expansion plans), provides asset diversification and offers an attractive risk-adjusted total return. If inflation returns, its compounding effect will provide a meaningful offset to higher discount rates (on a net present value basis), given the majority of TCL's revenue growth is linked to CPI.

Key detractors

Atlas Arteria (ALX, overweight) – the toll road operator underperformed during the quarter in response to traffic impacts from riots in France, with sections of its APRR toll road blocked, some toll gates held open and fewer people choosing to travel. While the protests present a short-term negative for ALX's key asset, we continue to see upside over the next 12 months due to other potential catalysts. One is the internalisation of MAF Group, the vehicle through which ALX owns APRR. In the longer term 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.

AGL Energy (AGL, underweight) – the energy company outperformed in the quarter, partially retracing underperformance in prior periods. During the quarter 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 believe the business faces 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.

Stockland (SGP, overweight) – the diversified REIT underperformed after releasing a worse-than-anticipated 1Q19 update. In particular, SGP revealed residential net deposits fell to 1,293 for the quarter – falling short of management expectations for 1,300-1,500. SGP also reported only 1,030 settlements for the period, raising concerns it may not meet its target for more than 6,000 lot settlements in FY19. Nevertheless, we remain overweight the stock. While we are underweight residential REITs at the portfolio level, we believe SGP will outperform its peers because its more affordable housing land lots will remain in higher demand. We consider the recent weakness (from elevated activity levels) to be more than captured in its valuation. SGP trades at 0.8 times NTA and with a forecast dividend yield of more than 7.5%, significantly higher than the wider REIT Index.

Key purchases

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

Dexus Property (DXS) – we increased our position in the office REIT during the quarter. DXS offers a high quality exposure to Sydney and Melbourne offices, two markets which have the most attractive supply and demand fundamentals with both expected to generate 5-8% 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.

GDI Property (GDI) – we increased our position size during the quarter. We believe GDI's property portfolio is in an attractive sub-sector (office) and is well placed geographically; the company is overweight properties in Perth, a market which has passed through the bottom of the cycle and is recovering slowly. GDI is internally managed and has a management

team which is strongly aligned with its shareholders. Furthermore, GDI trades at an attractive valuation of 1.1 times its last tangible book value and with a forecast dividend yield of approximately 6.0%.

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.

Unibail-Rodamco-Westfield (URW) – we exited our underweight position during the quarter. 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, pressuring URW to dispose of secondary assets in a weakening sales environment, placing further stress on earnings and distributions.

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.

Dexus Property (DXS) – our overweight position is premised on the A-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 5-8% rent growth in FY19. While the stock now trades at a modest premium to NTA (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.

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. We believe the 2018 internalisation of ALX's management 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.

Key active underweights

Scentre Group (SCG) – we are underweight the shopping mall owner based on our negative view of shopping mall 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 believe that SCG's valuation – at 0.83 times NTA and with a 5.8% forward dividend yield – fails to appropriately factor 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 via the Liddell power station closure in 2021 which currently comprises 15-20% of earnings. Finally, we expect earnings will 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 shopping mall 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 represent 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 3.2% 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 continue to maintain a 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.

Sector allocation

	Portfolio %	Benchmark %	Active %
Infrastructure	**38.89**	**31.34**	**7.55**
Airport Services	5.45	7.60	-2.16
Highways & Railtracks	24.71	16.86	7.85
Communication Services	0.00	0.91	-0.91
Railroads	6.45	4.16	2.29
Marine Ports & Services	0.00	1.81	-1.81
Information Technology	2.29	0.00	2.29
Utilities	**7.68**	**15.02**	**-7.33**
Electric Utilities	0.00	3.28	-3.28
Gas Utilities	6.14	4.90	1.24
Independent Power and Renewable Electricity Producers	0.00	0.22	-0.22
Multi-Utilities	1.54	6.62	-5.08
Real Estate Investment Trusts (REITs)	**50.27**	**53.64**	**-3.37**
Specialized REITs	5.81	1.92	3.89
Diversified REITs	16.46	16.03	0.43
Industrial REITs	4.96	8.94	-3.98
Office REITs	15.95	6.68	9.27
Retail REITs	7.10	19.47	-12.37
Other	0.00	0.61	-0.61
Cash and receivables	**3.15**	**0.00**	**3.15**

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Transurban	17.40	14.84	2.56
Dexus	10.72	5.24	5.48
GPT	10.39	4.68	5.71
Atlas Arteria	7.31	2.02	5.29
Aurizon	6.45	4.16	2.29

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.

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
GPT	10.39	4.68	5.71
Dexus	10.72	5.24	5.48
Atlas Arteria	7.31	2.02	5.29
Underweights			
Scentre	5.02	10.15	-5.13
AGL Energy	1.54	6.62	-5.08
Vicinity Centres	0.00	4.08	-4.08

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$35.41 mn as at 31 December 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.

Website www.yarracm.com

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