YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 31 December 2018

Yarra Emerging Leaders Fund

Gross returns as at 31 December 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	-2.92	-12.38	-4.01	3.57	9.55	12.10	11.11
Emerging Leaders Combined Benchmark†	-2.94	-13.40	-7.98	8.76	8.28	8.54	6.57
Excess return (before fees)‡	0.02	1.02	3.97	-5.19	1.27	3.56	4.54

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

	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	-3.02	-12.65	-5.20	2.29	8.20	10.72	9.82
Emerging Leaders Combined Benchmark†	-2.94	-13.40	-7.98	8.76	8.28	8.54	6.57
Excess return (after fees)‡	-0.08	0.75	2.79	-6.48	-0.09	2.18	3.25

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 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

Australian small and mid caps fell alongside global equity markets in the final quarter of 2018 as macroeconomic factors dominated returns.

The Emerging Leaders Benchmark declined 13.4% in the three months to 31 December 2018, taking its total return for the year to -8.0%. In comparison, the S&P/ASX 200 Accumulation Index declined 8.2% and the MSCI World Index dropped by 13.0% for 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% 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 for 3.5% growth.

REITs (+3.8%) and gold miners (+24.8%) were the only notable sectors to generate positive returns in the benchmark during the quarter. In the former, top performers included Shopping Centres Australasia Property Group (SCP, +9.2%), Charter Hall Retail REIT (CQR, +8.9%) and BWP Trust (BWP, +8.3%). In the latter Saracen Minerals (SAR, +57.1%), Evolution Mining (EVN, +39.2%), St. Barbara (SBM, +34.7%) and Regis Resources (RRL, +29.8%) outperformed as the gold price climbed 7.5% to $US1,282 per ounce.

Conversely, Energy (-27.3%) declined the most in the quarter as Brent Crude fell 34.0% to $US54 per barrel. The largest falls came from Sundance Energy (SEA, -55.6%), WorleyParsons (WOR, -41.1%) and Senex Energy (SXY, -45.0%).

Industrials (-17.5%) and Communication Services (-20.9%) also fell heavily. In the former, RCR Tomlinson (RCR, -100%) went into administration due to cost blowouts at one of its solar farm projects in Queensland. Other poor performers included Seven Group (SVW, -37.3%) and Emeco (EHL, -41.2%). The latter underperformed after the ACCC expressed concerns about the proposed merger between TPG Telecom (TPM, -24.4%) and Vodafone and as weakness in the Australian advertising market impacted the Media (-30.5%) industry.

Portfolio review

Key contributors

Saracen Minerals (SAR, overweight) – the gold producer outperformed during the quarter in response to the higher gold price, which rose 7.5% to $US1,282 per ounce amid the equity market sell-off. We remain overweight the stock, as we continue to prefer SAR amongst its peers when considering its

organic production growth, increasing mine life, declining cost profile and net cash balance sheet position.

TradeMe (TME, overweight) – the NZ online auction and classifieds company outperformed after receiving takeover offers from private equity firms Apax Partners and Hellman & Friedman. Apax made the first preliminary, non-binding and indicative bid in November at NZ$6.40 per share, a 25% premium to the previous day's trading price. In response TME granted due diligence to the firm until mid-December to facilitate a binding offer. After a competing bid emerged from Hellman & Friedman in early December at $6.45 per share, Apax matched it with a binding bid (following due diligence) that the TME board unanimously backed. Hellman & Friedman subsequently informed TME it would not return with a superior bid.

Scottish Pacific (SCO, overweight) – while shares in the debtor finance company were flat during the quarter pending the proposed takeover by Affinity Equity Partners, they still outperformed the declining share market. We exited the position in early December, prior to the deal being finalised and SCO's suspension from quotation.

ResMed (RMD, overweight) – the sleep apnea device maker outperformed during the quarter after delivering a solid 1Q19 result and announcing a series of bolt-on acquisitions. EPS was 4% ahead of consensus for the period, driven by strong revenue growth (+13%) as the company took market share in Masks in the Americas and Devices in the rest of the world. The acquisitions, which included MatrixCare for $US750mn and Propeller Health for $US225mn, build out RMD's offering in connected health care solutions alongside Brightree. The result provides us with confidence that RMD is well placed to beat FY19 earnings expectations. While the market is beginning to capture the company's appealing growth characteristics, we see further upside as earnings growth rates accelerate over the next one to two years, with benefits accruing from a positive product cycle in the flow generator and mask segments.

MYOB (MYO, overweight) – the accounting software company outperformed after receiving a takeover proposal from private equity group KKR during the quarter at $3.70 per share, which was later revised up to $3.77 per share before being reduced to $3.40 per share following due diligence and the equity market sell-off. MYO agreed to the revised offer in the absence of a superior proposal, subject to an independent expert's report recommending the transaction. KKR made the initial offer after acquiring a 19.9% stake in MYO, with 17.6% purchased from Bain Capital Abacus Holdings at $3.15 per share. While we reduced our overweight position following the initial bid, we continue to hold a small position in the stock given the potential for a competing bid, with MYO able to solicit competing proposals until February 2019, and the stock now trading at a material discount to the offer.

Key detractors

WorleyParsons (WOR, overweight) – the engineering services company underperformed in response to the Brent Crude oil price declining 34.0% to $US54 per barrel and due to a shortfall in the retail component of its equity raising to part fund its $US3.3bn acquisition of Jacobs ECR. Retail shareholders took up only 51% of their entitlements with the shortfall taken up by sub-underwriters. We remain overweight the stock based on our positive view of the Jacobs acquisition and WOR's existing hydrocarbons business, where we see the potential for significant upside. 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.

oOH! Media (OML, overweight) – the outdoor media company underperformed during the quarter 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 quarter OML clarified the Brisbane City Council had voted to approve the contract, with binding documentation executed at the end of November. 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.

TPG Telecom (TPM, overweight) – the telco underperformed after the ACCC raised concerns about its proposed merger with Vodafone. The regulator laid out a statement of issues, including that it would substantially lessen competition by removing TPM as an aggressive competitor in Mobile and that Vodafone may become an effective fixed broadband reseller. While the update is disappointing, we believe the issues can be addressed and that the merger ultimately will be delayed, not blocked. 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.

Evolution Mining (EVN, underweight) – the gold miner outperformed as the gold price rose 7.5% to $US1,282 during the quarter. We remain modestly underweight the sector, with our preferred exposures Saracen Minerals (SAR) and, to a lesser extent, diversified miner Independence Group (IGO). We find SAR appealing versus its peers when considering its organic production growth, increasing mine life, declining cost profile and net cash balance sheet position. IGO has 30% exposure to gold through its Tropicana mine, which we view as a world-class reserve.

Northern Star Resources (NST, underweight) – the gold miner outperformed as the gold price rose 7.5% to $US1,282 during the quarter. We remain modestly underweight the sector, with our preferred exposures Saracen Minerals (SAR) and, to a lesser extent, diversified miner Independence Group (IGO). We

find SAR appealing versus its peers when considering its organic production growth, increasing mine life, declining cost profile and net cash balance sheet position. IGO has 30% exposure to gold through its Tropicana mine, which we view as a world-class reserve.

Key purchases

Bluescope Steel (BSL) – we established a position in the steel producer during the quarter. 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.

WorleyParsons (WOR) – we participated in the discounted capital raising to build our position during the quarter. We expect WOR will 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, we expect the company's strong operating leverage – driven by management's focus on controlling overhead costs and maintaining high staff utilisation – will drive earnings above consensus expectations. We also hold a positive view of WOR's recent Jacobs' ECR acquisition, which makes sense strategically and is expected to be 20% EPS accretive on an FY18 pro-forma basis. While WOR trades at a premium to peers based on consensus expectations (14.3 times forward earnings), this premium falls to a discount when adjusted for WOR's strong growth potential.

Elders (ELD) – we increased our position in the agribusiness business during the quarter as the company underperformed following its FY18 result. Despite beating expectations and reafffirming guidance, the market focused on 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 11.7 times.

Key sales

Scottish Pacific (SCO) – we exited the position during the quarter as the stock traded in line with the proposed takeover of $4.40 per share from private equity firm Affinity Equity Partners. With shareholders voting in favour of the deal at SCO's AGM at the end of November, SCO shares were suspended from quotation on December 7.

CSR (CSR) – we exited our position early in the quarter in response to higher risks of the company missing FY19 earnings expectations. Activity lead indicators in CSR's building products division (70% of value) recently turned negative, with major builder display-suite volumes down 10%. Additionally, CSR's aluminium division (10% of value) faces increased downside risk from higher alumina prices. Subsequent to us exiting the position, CSR released its 1H19 results, reporting EBIT 5-10% below consensus expectations. While FY19 guidance was in line with consensus, we believe it will be challenging to achieve since it relies on a higher earnings contribution from its building products division.

MYOB (MYO) – we exited our position in the company following the initial proposed takeover by KKR of $3.70 per share. Subsequent to us exiting the position, KKR revised its bid down to $3.40 per share following due diligence. MYO agreed to the revised offer in the absence of a superior proposal, subject to an independent expert's report recommending the transaction.

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 is in part due to the complicated ownership structures of its assets. Securityholders approved the management internalisation of ALX 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.

WorleyParsons (WOR) – we expect WOR to benefit from its exposure to oil and gas (primarily through its hydrocarbons business), which we believe stands to benefit from increased capital expenditure across the industry. As activity levels increase, strong operating leverage – driven by management's focus on controlling 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 (14.3 times forward earnings), this premium falls to a discount when adjusted for WOR's strong growth potential.

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. While the ACCC's concerns about the proposed merger have caused uncertainty, we believe the issues can be addressed and that the deal will ultimately be delayed, not blocked.

Star Entertainment (SGR) – we are overweight the casino operator because we believe the market underestimates SGR's ability to enhance asset performance through operational improvements and capital expenditure 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. Further, we believe SGR's valuation is attractive, with the stock trading at 14.9 times versus peer Crown Resorts (CWN) at 18.5 times.

Kathmandu (KMD) – our investment thesis is premised 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 10.3 times). Furthermore, we hold a positive view of the recent OBOZ acquisition, which accelerates KMD's expansion into footwear and the US wholesale market.

Key active underweights

Tabcorp (TAH) – we are underweight the gambling services provider because we believe earnings expectations are too optimistic and that the market's valuation, at 20.1 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 26.6 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.

Northern Star (NST) – we are modestly underweight the gold sector, with our preferred exposures Saracen Minerals (SAR) and, to a lesser extent, diversified miner Independence Group (IGO). We find SAR appealing versus its peers when considering its organic production growth, increasing mine life, declining cost profile and net cash balance sheet position. IGO has 30% exposure to gold through its Tropicana mine, which we view as a world-class reserve.

Boral (BLD) – our underweight position is premised on the company's exposure to moderating domestic construction material markets, including new housing demand in Australia where we believe activity is likely to soften in the medium term. We also believe BLD paid a full price for the recent acquisition of US asset Headwaters and question the earnings sustainability of the US business and BLD's ability to extricate synergies to meet stated targets. While BLD's valuation of around 10.6 times forward earnings appears undemanding relative to historic valuations, we do not believe it fully factors in these risks at present.

Evolution Mining (EVN) –we are modestly underweight the gold sector, with our preferred exposures Saracen Minerals (SAR) and, to a lesser extent, diversified miner Independence Group (IGO). We find SAR appealing versus its peers when considering its organic production growth, increasing mine life, declining cost profile and net cash balance sheet position. IGO has 30% exposure to gold through its Tropicana mine, which we view as a world-class reserve.

Market outlook

We believe fundamentals including employment, population and GDP growth point to a robust Australian economy. The outlook for company earnings appears strong, supported by Resources and select Industrials.

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 2.3% from the Australian 10-year government bond yield.

Macroeconomic risks persist, however, and require careful monitoring. 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, Financials and Real Estate.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	13.37	5.67	7.69
Consumer Discretionary	20.08	13.56	6.53
Consumer Staples	5.98	7.52	-1.54
Energy	5.11	4.82	0.29
Financials	4.83	10.80	-5.98
Health Care	12.06	6.68	5.38
Industrials	14.18	11.66	2.52
Information Technology	3.51	7.34	-3.83
Materials	15.31	22.03	-6.72
Real Estate	2.16	8.05	-5.89
Utilities	0.00	1.86	-1.86

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Atlas Arteria	6.26	1.06	5.20
WorleyParsons	5.11	0.91	4.20
Star Entertainment Group	4.57	0.96	3.61
TPG Telecom	4.57	0.56	4.01
Seek	4.56	1.52	3.04

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	6.26	1.06	5.20
WorleyParsons	5.11	0.91	4.20
TPG Telecom	4.57	0.56	4.01
Underweights			
Tabcorp Holdings	0.00	2.21	-2.21
a2 Milk Company	0.00	1.92	-1.92
Northern Star Resources	0.00	1.51	-1.51

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	-6.86	0.42	6.13	7.97
Distribution return	1.66	1.87	2.06	2.75

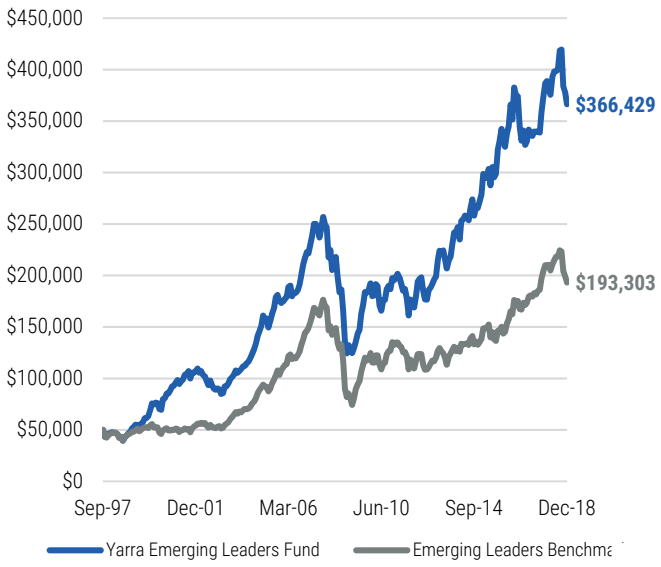
The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders 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$144.43 mn as at 31 December 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 December 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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