YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 31 December 2018

Yarra Ex-20 Australian Equities Fund

Gross returns as at 31 December 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	-13.72	-3.34	-18.40	-9.25	3.22	4.26	6.75
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	-10.67	-1.51	-11.35	NA	NA	NA	NA
Excess return (before fees)‡	-3.06	-1.84	-7.05	NA	NA	NA	NA

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 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	-14.15	-3.42	-18.59	-10.25	1.95	2.95	5.41
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	-10.67	-1.51	-11.35	NA	NA	NA	NA
Excess return (after fees)‡	-3.48	-1.91	-7.25	NA	NA	NA	NA

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.

^ **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 fell alongside global equities in the final quarter of 2018 as macroeconomic factors dominated returns.

The S&P/ASX 300 ex S&P/ASX 20 Accumulation Index declined 11.3% in the quarter, taking its total 12 month return to -6.5%. 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.

REITs (-1.7%) and gold miners (+18.9%) were the best performers 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 (-23.0%) 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%).

Communication Services (-20.9%) also fell heavily as the telco industry faced pressure following the ACCC expressing 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

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.

Lend Lease (LLC, underweight) – the property developer underperformed during the quarter after announcing a $350mn after-tax provision to its Engineering & Services business. The provision was driven by lower productivity in the NorthConnex project in Sydney, excessive wet weather, access issues and remedial work from defective design in other projects. We remain underweight the company for a number of reasons: further write-downs on other troubled contracts are likely, the balance sheet appears stretched in the short term (with gearing at the top of the 10-20% range) and FY19 consensus earnings expectations look overly optimistic, relying on a heavy transactional period in 2H19.

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.

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.

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.

James Hardie (JHX, overweight) – the building materials company underperformed after delivering a worse-than-expected 1H19 result. As part of the result, management downgraded FY19 net profit to $280-320mn (-6.3% at the mid-point) as a result of a weaker US volume and margin outlook. While FY19 guidance is underwhelming, we remain confident about JHX's market share outlook over the medium to long-term; we expect primary demand growth to accelerate as the company wins business following resolution of US supply and manufacturing issues. Secondly, JHX should be able to offset margin pressure through product re-pricing (which it does annually). Lastly, JHX now trades at a more supportive 15.1 times forward earnings, an attractive discount to the ASX Industrials sector.

Key purchases

Sydney Airport (SYD) – we established a position in the airport owner and operator during the quarter. In our view SYD is set to benefit from a supportive demand backdrop – the airport captures approximately 40% of Australia's inbound air passengers – and with strong barriers to entry as Sydney's only international airport. Higher prices and robust passenger numbers support strong revenue growth which, when combined with its high operating leverage, enables SYD to grow its dividend by approximately 10% per annum on a five-year compound annual growth rate.

WorleyParsons (WOR) – we increased 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.

Bluescope Steel (BSL) – we increased our position in the steel producer during the quarter. Our positive outlook is premised on BSL's high-quality assets (domestically and internationally), its strong balance sheet, capital management initiatives (with a $250mn buy-back recently announced) and 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.

Key sales

Clydesdale (CYB) – we exited our position in the UK bank in the quarter following the release of its FY18 result. 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 uncertainty from Brexit, we do not find the stock attractive despite appearing cheap at 0.8 times tangible book value and 8 times forward earnings.

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.

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.

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 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.

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.

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.

Key active underweights

Goodman Group (GMG) – our underweight position reflects our more cautious outlook for development earnings and GMG's premium share price valuation of 20.3 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.

Newcrest (NCM) – our underweight position is predicated on the gold miner's concentrated assets in Cadia and Lihir, premium valuation and an increasing capex profile. Both capex and M&A are likely to increase as the company seeks to gain exposure to five tier-one assets by 2020. The stock trades at an EV/EBITDA multiple of 7.1 times on a 12-month forward basis, which in our view does not reflect significant risks (seismicity and PNG sovereign risk) and is unappealing relative to peers with more attractive organic growth, including OceanaGold (OGC) and Saracen Minerals (SAR).

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 multiple of 15.6 times, however, we do not believe the market fully accounts for risks in ALL's legacy business (outright gaming machine sales),

which is a volatile segment that to a large extent relies on new casino openings, and we question the sustainability of the Digital division's earnings growth following the acquisition of Big Fish Games in January 2018. As a result, we see better relative opportunities elsewhere.

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 earnings and cash flow expectations. We are overweight the Communication Services, Industrials and Consumer Discretionary sectors, but are underweight Real Estate, Financials and Consumer Staples.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	15.98	3.08	12.90
Consumer Discretionary	14.86	9.43	5.43
Consumer Staples	0.00	5.63	-5.63
Energy	10.99	8.18	2.81
Financials	6.06	12.00	-5.94
Health Care	8.26	7.82	0.44
Industrials	21.84	11.65	10.19
Information Technology	0.00	5.16	-5.16
Materials	17.34	17.72	-0.37
Real Estate	0.00	14.69	-14.69
Utilities	0.00	4.65	-4.65

Top 5 holdings

	Portfolio %	Benchmark %	Active %
James Hardie Industries	6.51	1.01	5.49
Atlas Arteria	6.50	0.62	5.87
Star Entertainment Group	6.42	0.57	5.85
TPG Telecom	6.26	0.33	5.92
Seek	6.02	0.90	5.12

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
TPG Telecom	6.26	0.33	5.92
Atlas Arteria	6.50	0.62	5.87
Star Entertainment Group	6.42	0.57	5.85
Underweights			
Goodman Group	0.00	2.58	-2.58
Newcrest Mining	0.00	2.52	-2.52
Aristocrat Leisure	0.00	2.10	-2.10

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.	Since inception % p.a.
Growth return	-12.34	-1.00	0.04	2.48
Distribution return	2.08	2.95	2.91	2.93

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.

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$22.85 mn as at 31 December 2018	
APIR code	JBW0052AU	
Estimated management cost	0.95% p.a	
Buy/sell spread	+/- 0.15%	
Platform availability	Asgard BT Wrap BT Panorama Macquarie Wrap Consolidator	Macquarie Wrap Accumulator 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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