YARRA
CAPITAL MANAGEMENT

Investment Commentary
Month to 31 January 2019

Yarra Australian Real Assets Securities Fund

Gross returns as at 31 January 2019

	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	10.60	5.14	7.75	12.38	9.92	9.74	10.97	8.65
S&P/ASX Custom Infrastructure, Utilities and A-REITs Index*	9.71	4.91	7.15	9.58	9.19	NA	NA	NA
Excess Return†	0.89	0.22	0.60	2.80	0.74	NA	NA	NA
Growth Return‡	NA	NA	NA	-15.44	-5.93	-1.73	3.06	1.40
Distribution Return‡	NA	NA	NA	27.82	15.85	11.47	7.91	7.25

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 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 January 2019

	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	9.67	5.06	7.52	11.43	9.00	8.81	10.04	7.74
S&P/ASX Custom Infrastructure, Utilities and A-REITs Index*	9.71	4.91	7.15	9.58	9.19	NA	NA	NA
Excess Return†	-0.04	0.15	0.37	1.85	-0.19	NA	NA	NA
Growth Return‡	NA	NA	NA	-16.39	-6.86	-2.65	2.13	0.48
Distribution Return‡	NA	NA	NA	27.82	15.85	11.47	7.91	7.25

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 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 in value for the third consecutive month in January, with broad-based gains across REITs and Infrastructure stocks.

The S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Accumulation Index returned 4.9% for the month, outperforming the broader market by 1.0%. Globally, equities recovered from a weak December after the US Federal Reserve stated it would be patient in raising interest rates and China signalled more stimulus measures in response to an economic slowdown.

REITs (+6.0%) supported the benchmark during the month. Industrial, Office and Diversified REITs outweighed relative weakness from Retail REITs. Shopping mall owners underperformed as an increased number of direct market transactions occurred at prices below prevailing book values, suggesting future valuation risk for the sector. Nevertheless, the top performer for the month was shopping mall owner Unibail-Rodamco-Westfield (URW, +15.1%), which partially retraced significant share price falls in prior periods following the takeover of Westfield (WFD). Diversified REIT Abacus Property (ABP, +12.5%) was the second strongest performer despite no material news in the month.

Meanwhile, Infrastructure & Utilities stocks also generated solid returns, up +3.7% during the month. Electricity utility company Spark Infrastructure (SKI, +9.0%) was the top performer without any material company-specific news. Gas pipeline company APA Group (APA, +8.0%) was the second highest performer following media reports that Australian infrastructure investor IFM is forming a consortium with Global Infrastructure Partners and Canada's OMERS to bid for the company.

Portfolio review

Key contributors

GPT Group (GPT, overweight) – the diversified REIT outperformed in January, during which it announced it was seeking a buyer for its 50% share of MLC Centre in Sydney (co-owned with Dexus (DXS)). We expect strong demand for this asset given the attractive fundamentals of the Sydney office market, and the prime location of the asset. The sale would reduce GPT's Sydney office exposure from its current overweight position of 65% of office funds employed. We remain overweight GPT because we regard the current stock valuation as favourable – with the security trading at around 1.1 times NTA – and regard its prospective dividend yield of around 4.6% 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.

Vicinity Centres (VCX, underweight) – the shopping mall owner underperformed after announcing lower valuations for its assets, particularly in regional and sub-regional areas. VCX reported that 38 out of 62 retail properties were revalued down by $37mn (-0.2%) over the six months to 31 December 2018, with cap rates overall flat at 5.3%. The update supported our thesis that the outlook for second-tier malls – which still represent a large part of VCX's asset base – is worsening. We remain underweight the stock based on our negative view of shopping mall fundamentals.

Dexus Property (DXS, overweight) – the REIT outperformed without any material news during the month. We remain overweight due to DXS's attractive exposure to Sydney and Melbourne offices. 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 last stated NTA (around 20%), 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 detractors

Unibail-Rodamco-Westfield (URW, underweight) – the shopping mall owner partially retraced sharp share price falls from earlier months without any material company-specific news. We remain underweight the stock based on our 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 in our view is high, putting pressure on URW to dispose of secondary assets in a weakening sales environment, placing further stress on earnings and distributions.

Hotel Property Investments (HPI, overweight) – the REIT underperformed without any material company-specific news during the month. We remain attracted to HPI as the owner of large scale hotel venues with attractive leases (long lease tenure) and 100% occupancy. Furthermore, rental leases are largely fixed and increase 4.0% annually with an average lease duration of more than seven years.

Goodman Group (GMG, underweight) – the industrial REIT outperformed without any material news during the month. We remain more cautious than consensus for GMG's development earnings, which account for approximately 40% of total EBITDA and which we expect will moderate over time as the cap rate cyclic normalises. GMG operates in attractive markets for industrial demand and has done a credible job improving the quality of its portfolio in prior periods. However, with the company trading at 22.1 times forward earnings – which includes above mid-cycle development and funds managements earnings – we see better opportunities elsewhere at this time.

Key purchases

Australian Unity Office Fund (AOF) – we increased our position in the Office REIT during the month. We believe AOF has a solid net tangible asset (NTA) growth outlook (5%-plus), driven by its underlying Sydney exposures, in particular Parramatta which comprises 25% of the group's NTA. The Parramatta office market has attractive supply and demand fundamentals, with high population growth and significant new infrastructure (e.g. new light rail). More broadly, we expect the Sydney office market will generate rental growth in the next 12 to 18 months and experience low vacancy rates. With these tailwinds we see AOF's valuation as attractive at an NTA 1.0 times and with a 12-month forward dividend yield of 6.3%.

Key sales

Stockland (SGP) – we reduced our overweight position in the REIT during the month due to a more cautious outlook for its residential business. Nevertheless, while we are underweight Residential REITs at the portfolio level, we continue to 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 captured in its valuation. SGP trades at 0.9 times NTA and with a forecast dividend yield of 7.4%, significantly higher than the wider REIT Index.

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 1.1 times NTA – and regard its prospective dividend yield of around 4.6% 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 20%), 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 in part reflects the complicated ownership structures of its assets. Securityholders approved the management internalisation of ALX in May 2018, a change we believe is a significant step towards ultimately simplifying the ownership structures of the company'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.

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 0.8 times NTA and with a 5.7% 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 represents 15-20% of earnings. Finally, we expect earnings will be negatively impacted as its low-cost gas contracts roll off.

Mirvac (MGR) – we are underweight MGR because we believe its valuation (at 0.9 times NTA with a 5.0% dividend yield on a forecast basis) already captures strong earnings growth. We also regard its cash flow outlook over the next two years as being overly optimistic: it assumes elevated apartment and commercial property development profits, but doesn't fully factor in the slowdown in residential earnings from peak levels. Furthermore, we see headwinds on the horizon as passive property valuations approach the top of the cycle.

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 5.3%, an appealing 3.0% 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	**36.59**	**30.67**	**5.93**
Airport Services	4.80	7.08	-2.27
Highways & Railtracks	23.47	16.82	6.65
Communication Services	0.00	0.86	-0.86
Railroads	6.00	4.08	1.93
Marine Ports & Services	0.00	1.83	-1.83
Information Technology	2.32	0.00	2.32
Utilities	**7.45**	**15.16**	**-7.71**
Electric Utilities	0.00	3.35	-3.35
Gas Utilities	6.00	5.04	0.95
Independent Power and Renewable Electricity Producers	0.00	0.20	-0.20
Multi-Utilities	1.45	6.56	-5.11
Real Estate Investment Trusts (REITs)	**47.83**	**54.17**	**-6.35**
Specialized REITs	5.44	1.87	3.58
Diversified REITs	15.17	16.49	-1.31
Industrial REITs	4.93	9.30	-4.37
Office REITs	15.73	6.83	8.90
Retail REITs	6.56	19.08	-12.51
Other	0.00	0.62	-0.62
Cash and receivables	**8.13**	**0.00**	**8.13**

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Transurban	16.45	14.78	1.67
Dexus	10.49	5.40	5.09
GPT	10.21	4.85	5.37
Atlas Arteria	7.02	2.04	4.98
Aurizon	6.00	4.08	1.93

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	10.21	4.85	5.37
Dexus	10.49	5.40	5.09
Atlas Arteria	7.02	2.04	4.98
Underweights			
Scentre	4.62	9.84	-5.22
AGL Energy	1.45	6.56	-5.11
Vicinity Centres	0.00	4.14	-4.14

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$34.74 mn as at 31 January 2019	
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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