YARRA CAPITAL MANAGEMENT

Investment Commentary
Month to 28 February 2019

Yarra Australian Real Assets Securities Fund

Gross returns as at 28 February 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	11.53	3.50	11.07	19.30	10.05	9.72	12.75	8.88
S&P/ASX Custom Infrastructure, Utilities and A-REITs Index*	10.55	3.19	10.42	16.36	9.32	NA	NA	NA
Excess Return†	0.98	0.31	0.65	2.93	0.73	NA	NA	NA
Growth Return‡	NA	NA	NA	-10.24	-5.83	-1.74	4.72	1.65
Distribution Return‡	NA	NA	NA	29.54	15.88	11.46	8.03	7.23

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 28 February 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	10.59	3.43	10.84	18.29	9.13	8.79	11.80	7.97
S&P/ASX Custom Infrastructure, Utilities and A-REITs Index*	10.55	3.19	10.42	16.36	9.32	NA	NA	NA
Excess Return†	0.04	0.24	0.42	1.93	-0.20	NA	NA	NA
Growth Return‡	NA	NA	NA	-11.25	-6.76	-2.67	3.77	0.74
Distribution Return‡	NA	NA	NA	29.54	15.88	11.46	8.03	7.23

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 for the fourth consecutive month in February, but underperformed the wider market as companies delivered results that were slightly better than feared.

The S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Accumulation Index rose 3.2% in the month, taking its 2019 return to 8.3%. In comparison, the ASX 300 returned 6.0% for the month and 10.1% this calendar year. In aggregate February reporting season was largely in line with subdued expectations, though upward revisions from Resources offset downgrades elsewhere.

In infrastructure (+4.8%), Speedcast International (SDA, +33.3%) was the top performer after providing FY19 EBITDA guidance ahead of the market's expectations. A larger expected contribution to earnings from its Energy division – where SDA provides remote communication services to offshore oil producers – was chiefly responsible for the upgrade. Elsewhere, Sydney Airport (SYD, +9.8%) contributed more materially to the Index's return following a solid FY18 result, with FY19 distribution guidance for 4% growth and upbeat commentary about international passenger growth.

Within REITs (+1.8%), Subsector performance correlated with earnings revisions; Industrials (+9.3%) and Office (+4.5%) REITs outperformed while Retail REITs (-2.2%) and Diversified REITs (+1.0%) underperformed. At a stock level, the best performer during the month was Goodman Group (GMG, +9.8%). The industrial warehouse provider outperformed after upgrading FY19 EPS guidance by 2.5% and providing commentary of more bullish earnings into FY20, ahead of current consensus estimates. Conversely, shopping mall owner Unibail-Rodamco-Westfield (URW, -8.6%) delivered a FY18 result below expectations, with FY19 EPS guidance 8% below FY18 and 13% below consensus. Furthermore, URW no

longer expects its Westfield acquisition to be earnings accretive in FY19.

Portfolio review

Key contributors

Vicinity Centres (VCX, underweight) – the shopping mall owner underperformed following its 1H19 result. While management maintained Funds From Operations (FFO) guidance at 18.0-18.2 cents per share, this was only achievable due to the benefit from the recent buy-back and fewer asset sales than expected; management stated they are no longer pursuing a number of sales due to weak market conditions. Meanwhile, comparable FFO growth guidance fell from 3.4-4.6% to 2.3-3.4%. 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.

Unibail-Rodamco-Westfield (URW, underweight) – the shopping mall owner underperformed after its FY18 result fell short of expectations, with FY19 EPS guidance 8% below FY18 and 13% below consensus. Furthermore, URW no longer expects its Westfield acquisition to be accretive in FY19. 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, URW's balance sheet gearing in our view is high, adding pressure on the company to dispose of secondary assets in a weakening sales environment and placing further stress on earnings and distributions.

Atlas Arteria (ALX, overweight) – the toll road operator outperformed during the month as it released its FY18 result largely in line with expectations. The second-half distribution from APRR was slightly higher than expected and FY19 distribution guidance was maintained at 30 cents per share. While the outlook for traffic growth in 1Q19 is mixed as a result of the US government shutdown and the yellow vest protests in France, underlying trends appear robust. We remain overweight the toll road operator on the grounds that simplifying the ownership structure of its key asset will unlock the vehicle's intrinsic value. We believe ALX now has a credible strategy for achieving this goal which will result in significant upside.

Key detractors

NEXTDC (NXT, overweight) – the data centre operator underperformed following its 1H19 result. Management downgraded FY19 revenue guidance from $183-188mn to $180-184mn, however this was entirely due to its acquisition of Asia Pacific Data Centre (APDC), which removed distribution income from APDC and lowered interest income from a lower cash balance. Otherwise the result was in line with expectations, with EBITDA guidance reiterated at $83-87mn. We continue to believe the business is structurally set to benefit from the increasing adoption of cloud technology and is accelerating its expansion to meet the demands of its clients. To this end, the company is currently building three new data centres which 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.

Goodman Group (GMG, underweight) – the industrial warehouse provider outperformed after upgrading FY19 EPS guidance by 2.5% and providing commentary of more bullish earnings into FY20, ahead of current consensus estimates. Management issued new guidance for FY20 DPS, implying EPS in the range of 54.5 to 60 cents per share, a 6% upgrade at the midpoint. While the result was strong and highlighted the high demand for GMG's industrial assets, we believe this rate of growth is unsustainable over the long term. We expect moderating growth to reveal valuation risk with the stock, which currently trades at 23.1 times forward earnings including above mid-cycle development and funds management earnings.

Mirvac Group (MGR, underweight) – the diversified REIT outperformed after its 1H19 result beat expectations. Strong performances from its office and industrial segments drove 1H19 FFO 10% ahead of consensus forecasts. Further, management tightened FY19 FFO guidance from 2-4% to 3-4%. Its residential division delivered a solid result, with 83% of FY19 EBIT secured and EBIT up 71% y/y. That being said, management cautioned that residential conditions continue to deteriorate. We continue to believe the market 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.

Key purchases

Transurban (TCL) – we increased our overweight position in the toll road operator during the month, taking advantage of recent share price weakness. In our view TCL has a strong growth outlook (with a number of new project and expansion plans), 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.

Viva Energy REIT (VVR) – we took part in the REIT's equity placement during the month. We saw the issue price of $2.32 as attractive, with VVR offering a forecast dividend yield of 6.3% and FY19 EPS growth of 3.0-3.75%. We see further upside potential from development opportunities with its sole tenant Viva Energy (VEA), particularly following VEA's newly announced 10-year alliance with Coles (COL), as well as from accretive acquisitions. Its valuation – at a 5% premium to last-stated NTA – is below small cap REIT peers and, in our view, factors in the known risks (such as the long-term structural headwinds for petrol volumes).

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 long-term 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

GPT Group (GPT) – we reduced our position following recent outperformance. However, GPT remains a high conviction overweight due to its 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.

Charter Hall Education Trust (CQE) – we reduced our position in the REIT following recent outperformance but remain overweight the stock. CQE's net operating income (NOI) outlook remains supportive, with 2.5% underlying growth set for an upgrade once negotiations with a key large tenant – which operates around 200 of CQE's 450 childcare assets – complete. That being said, we expect flat FY19 EPS as development activity slows, with DPS growth of 6% driven by a higher payout ratio. Additionally, direct market transactions in the industry have slowed, with cap rates expanding 0-25 basis points, indicating lower future NTA growth.

Dexus Property (DXS) – we reduced our position following recent outperformance. However, DXS remains a high conviction overweight in the portfolio due to its exposure to the Sydney and Melbourne office markets. We believe they have 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.

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. We believe the approval by securityholders to internalise management in May 2018 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 has a credible strategy for achieving this goal which will result in significant upside.

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.

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 around 4.5% 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.

Key active underweights

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.

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 0.9 times NTA and with a 5.8% forward dividend yield – fails to appropriately factor in these headwinds.

Mirvac (MGR) – we are underweight MGR because we believe its valuation (at 1.1 times NTA with a 4.5% 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 5.1%, 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.

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Transurban	18.80	14.78	4.02
Dexus	10.29	5.51	4.77
GPT	9.38	4.77	4.61
Atlas Arteria	7.56	2.13	5.42
APA	6.72	5.37	1.35

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 %
Atlas Arteria	7.56	2.13	5.42
Dexus	10.29	5.51	4.77
GPT	9.38	4.77	4.61
Underweights			
AGL Energy	1.48	6.34	-4.86
Scentre	4.63	9.37	-4.74
Mirvac	0.00	4.33	-4.33

Sector allocation

	Portfolio %	Benchmark %	Active %
Infrastructure	**40.46**	**31.40**	**9.06**
Airport Services	5.59	7.57	-1.98
Highways & Railtracks	26.36	16.92	9.44
Communication Services	0.00	0.98	-0.98
Railroads	6.34	4.09	2.25
Marine Ports & Services	0.00	1.84	-1.84
Information Technology	2.17	0.00	2.17
Utilities	**8.20**	**15.22**	**-7.03**
Electric Utilities	0.00	3.30	-3.30
Gas Utilities	6.72	5.37	1.35
Independent Power and Renewable Electricity Producers	0.00	0.22	-0.22
Multi-Utilities	1.48	6.34	-4.86
Real Estate Investment Trusts (REITs)	**48.98**	**53.37**	**-4.39**
Specialized REITs	6.13	1.87	4.26
Diversified REITs	14.10	16.30	-2.20
Industrial REITs	5.56	9.70	-4.14
Office REITs	16.48	6.96	9.52
Retail REITs	6.71	17.95	-11.24
Other	0.00	0.59	-0.59
Cash and receivables	**2.36**	**0.00**	**2.36**

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$33.88 mn as at 28 February 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.

Website www.yarracm.com

Investor Services Team 1800 034 494 (Australia) +61 3 9002 1980 (Overseas) IST@yarracm.com