YARRA CAPITAL MANAGEMENT

Investment Commentary
Month to 28 February 2019

Yarra Emerging Leaders Fund

Gross returns as at 28 February 2019

	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	3.83	5.48	5.55	8.26	10.83	13.68	11.45
Emerging Leaders Combined Benchmark†	5.91	7.97	2.23	13.94	9.97	11.20	7.04
Excess return (before fees)‡	-2.08	-2.49	3.32	-5.68	0.85	2.48	4.40

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

	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	3.73	5.15	4.24	6.92	9.45	12.28	10.16
Emerging Leaders Combined Benchmark†	5.91	7.97	2.23	13.94	9.97	11.20	7.04
Excess return (after fees)‡	-2.18	-2.82	2.02	-7.02	-0.52	1.08	3.11

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 generated their best monthly return in one-and-a-half years during February as companies delivered results that were better than feared.

The Emerging Leaders benchmark returned 5.9% for the month, taking its 2019 return to 11.2%. In comparison, the S&P/ASX 200 returned 6.0% for the month, taking its return to 10.1% this year.

In aggregate February reporting season was largely in line with subdued expectations, though upward revisions from Resources offset downgrades elsewhere. The market's strong return came from earnings multiple expansion, with the benchmark forward P/E rising from 15.5 to 16.5 times. Globally, equities rose in response to more dovish outlooks from central banks.

All sectors rose in value during the month, with the strong returns coming from Information Technology (+10.5%), Energy (+9.5%) and Financials (+9.2%). In IT, the strongest performers were Altium (ALU, +32.3%), Appen (APX, +46.9%) and Infomedia (IFM, +24.8%). Energy stocks rose in response to the higher oil price, with Brent Crude up 9% to $US66 per barrel. Financials outperformed as equity markets stabilised and the Financial Services Royal Commission released its Final Report, which made recommendations that weren't as severe as expected.

Conversely, traditionally defensive sectors REITs (+0.5%), Utilities (+1.5%) and Consumer Staples (+2.2%) underperformed during the period. Across the three sectors the largest falls came from shopping mall owner Unibail-Rodamco-Westfield (URW, -8.6%), vitamins maker Blackmores (BKL, -27.7%) and poultry provider Inghams (ING, -12.2%).

Portfolio review

Key contributors

Nanosonics (NAN, overweight) – the disinfection medical device maker outperformed in response to a strong 1H19 result. Sales rose 36% to $US40.7mn as the company grew its installed base of devices to 19,310 units (up 9%). Management reiterated its AGM guidance for installed growth for the full year to be similar to FY18, with improved consumable margins once the new distribution agreement with GE Healthcare takes effect from 1 July. We continue to believe NAN offers an attractive growth profile, with the sale of consumables for its devices generating a high-quality, annuity-style revenue stream. Lastly, NAN has a strong balance sheet – it is in a net cash position – to fund future growth and support further product innovation.

Evolution Mining (EVN, underweight) – the gold miner underperformed despite releasing a 1H19 result largely in line with expectations, partially retracing outperformance from prior periods. During the month the gold price declined 0.6% to $US1,313 per ounce. We remain underweight the stock, with our preferred exposures Saracen Minerals (SAR) and, to a lesser extent, diversified miner Independence Group (IGO).

Alumina (AWC, overweight) – the company outperformed following a strong FY18 result in which underlying earnings and the dividend (equating to a full-year yield of 12%) were ahead of expectations. FY19 guidance was also positive due to higher alumina production and lower sustaining capex and unit costs. We continue to hold a positive view of the commodity and AWC's high-quality assets, with earnings, cash flow and capital management upside versus consensus expectations. The aluminium market remains very tight, with the approaching Chinese winter closures again having the potential to be even more restrictive. We believe that AWC is undervalued at a forward P/E of 10.2 times when considering the strategic appeal of its assets.

Key detractors

Saracen Minerals (SAR, overweight) – shares in the gold miner declined following a softer-than-expected 1H19 result, partially retracing strong outperformance from prior periods. NPAT for the first half fell 7% to 43mn y/y, missing consensus forecasts largely due to higher-than-expected costs for purchasing and processing third party ore. During the month SAR also announced exploration results, with resource increases and upgrades across its operations. While SAR remains our favoured gold exposure, its positive outlook appears increasingly captured by the market with the stock trading at an EV/EBITDA of 6.5 times (versus the wider industry at 5.9 times). This view caused us to further reduce our holdings in the month.

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.

TPG Telecom (TPM, overweight) – the telco underperformed during the month, following comments from competitor Telstra (TLS) in its 1H19 result that margins for its Fixed business will reduce to zero unless NBN wholesale prices are changed, causing concerns about TPM's margins. We remain overweight the stock based on our positive view of the company's proposed merger with Vodafone. We expect the combined entity will unlock significant synergies and harness its infrastructure, scale and balance sheet to disrupt incumbents TLS and Optus through a 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 are addressable and that, while delayed, the deal will not be blocked.

Key purchases

Incitec Pivot (IPL) – we established a position in the explosives and fertiliser producer during the month. We believe IPL trades at an attractive valuation when considering its long-term outlook. While disruptions to operations from severe weather will impact earnings in FY19, lead indicators suggest demand is improving for its key commodities, urea and diammonium phosphate. Further, its explosives business is experiencing more stable pricing as mining demand normalises. At 15.3 times forward earnings, IPL trades well below the wider Industrial sector and at an historically wide discount to key competitor Orica (ORI), which trades at 17.7 times.

Bapcor (BAP) – we increased our holdings in the automotive parts retailer after establishing the small position in January. We believe BAP is well positioned to maintain defensive low-teens earnings growth into the medium to long term, which is currently not reflected in the share price (with the company now trading on 16.5 times forward earnings). After several years of undertaking acquisitions, BAP is now in a strong position to optimise its business structure by rolling out new stores, enhancing existing stores (shifting to corporate owned stores provides more control) and implementing cost reduction initiatives.

Nine Entertainment (NEC) – we established a position in the media and entertainment company following its poorly received result. Notwithstanding weak advertising markets and lack of visibility, we believe the profitability of NEC's television division has stabilised as it continues to take share from Ten Network Holdings. Furthermore, we believe potential downside is more than factored in with the stock trading at 11.4 times forward earnings. Meanwhile, the embedded value of Stan and Domain – two high quality assets that are generating strong growth – is trading at a significant discount.

Key sales

TradeMe (TME) – we reduced our position following the proposed takeover from Apax Partners. We continue to hold a position in the company, given it trades at a small discount to the $NZ6.45 per share offer price and because a higher bid could emerge. However, we acknowledge this is less likely after the TME board unanimously backed Apax's offer and the competing suitor, Hellman & Friedman, exited the bidding process.

Saracen Minerals (SAR) – we further reduced the position in the gold miner following recent strong outperformance. 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. However, with the stock trading at an EV/EBITDA of 6.5 times – versus the Small Ords Gold sector at 5.9 times – its positive outlook appears to be largely captured by the market at this time.

Iluka Resources (ILU) – we reduced our holdings in the mineral sands producer during the month, but still retain a small overweight position. We continue to believe ILU's valuation (at a 12-month forward P/E of 9.9 times) is attractive when considering the outlook for robust earnings from its high-quality assets and dominant position in the zircon and titanium dioxide feedstock markets. However, we believe mineral sands prices are close to peak levels, which is at odds with optimistic consensus forecasts for further price increases.

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 now has a credible strategy for achieving this goal in the near term, which will result in significant upside.

WorleyParsons (WOR) – we expect WOR will benefit from its exposure to oil and gas (primarily through its hydrocarbons business), which we believe will see gains 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 on a pro-forma basis before cost synergies. While WOR trades at a premium to peers based on consensus expectations (18.3 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 company's 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, while delayed, the deal will not be blocked.

Key active underweights

A2 Milk (A2M) – we believe the stock's valuation – trading at a forecast P/E of 31.1 times – fully captures the company's growth opportunity at this time but doesn't factor in potential distribution risks. A2M's earnings in recent years have been underpinned by Chinese infant formula sales, which have grown significantly. However, the market's expectations for future growth rely on A2M sustaining its current market share growth and the brand maintaining its appeal to the Chinese consumer, which may become increasingly challenged as competitors launch comparable products.

Tabcorp (TAH) – we are underweight the gambling services provider because we believe earnings expectations are too optimistic and regard the market's valuation, at 22.3 times 12-month forward P/E, as 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.

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 a 30% exposure to gold through its Tropicana mine, which we view as a world-class reserve.

Market outlook

We believe fundamentals including employment and population growth point to a robust Australian economy, tempered by moderating growth, falling house prices and soft consumer confidence. Nevertheless, the outlook for company earnings appears solid, supported by select Resources and 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 4.7% on a 12-month forward basis (before franking) versus 2.1% from the Australian 10-year government bond yield.

Global macroeconomic risks persist, though, and require careful monitoring. We remain alert to economic and geopolitical risks, including rising interest rates in the US, slowing global economic growth, 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 Financials, Real Estate and Information Technology.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	14.73	5.76	8.97
Consumer Discretionary	17.72	13.42	4.30
Consumer Staples	5.55	7.20	-1.64
Energy	6.22	5.43	0.79
Financials	2.33	10.45	-8.13
Health Care	13.98	6.48	7.50
Industrials	14.62	12.18	2.44
Information Technology	3.34	8.08	-4.74
Materials	18.16	21.53	-3.36
Real Estate	2.27	7.63	-5.36
Utilities	0.00	1.85	-1.85

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Atlas Arteria	6.35	1.10	5.24
WorleyParsons	6.22	1.09	5.13
Star Entertainment Group	4.69	0.86	3.84
Seek	4.63	1.52	3.11
TPG Telecom	4.40	0.53	3.87

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	6.35	1.10	5.24
WorleyParsons	6.22	1.09	5.13
TPG Telecom	4.40	0.53	3.87
Underweights			
a2 Milk Company	0.00	2.35	-2.35
Tabcorp Holdings	0.00	2.23	-2.23
Northern Star Resources	0.00	1.39	-1.39

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	2.42	4.97	7.36	9.50
Distribution return	1.83	1.95	2.09	2.79

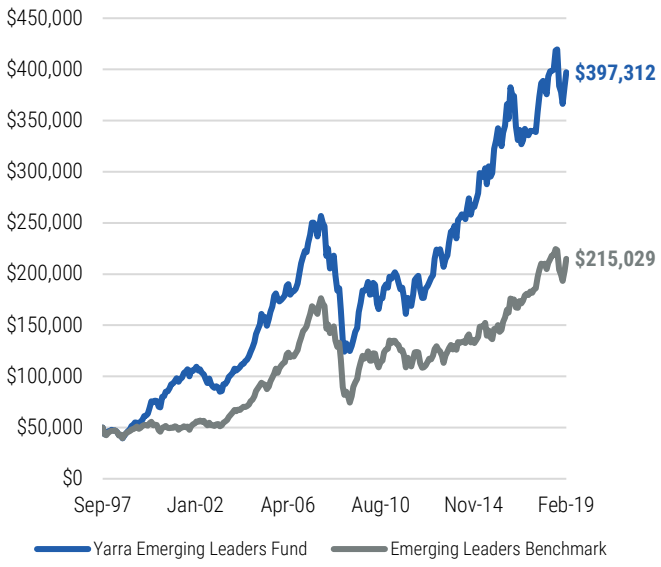
The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders 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$155.08 mn as at 28 February 2019
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 February 2019.



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.

Website www.yarracm.com

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