YARRA CAPITAL MANAGEMENT

Investment Commentary
Month to 28 February 2019

Yarra Ex-20 Australian Equities Fund

Gross returns as at 28 February 2019

	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	-4.60	5.70	6.88	1.27	9.84	5.74	7.88
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	-0.62	5.30	9.58	NA	NA	NA	NA
Excess return (before fees)‡	-3.98	0.40	-2.69	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 28 February 2019

	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	-5.21	5.63	6.63	0.21	8.51	4.43	6.52
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	-0.62	5.30	9.58	NA	NA	NA	NA
Excess return (after fees)‡	-4.59	0.33	-2.94	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

Australian equities continued their strong run in 2019 as February reporting season delivered results slightly better than feared.

The S&P/ASX 300 Ex-20 Accumulation Index returned 5.3% in February, taking its total return for 2019 to 11.3%. 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 15.8 to 16.4 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 Financials (+10.0%), Industrials (+7.2%) and Information Technology (+7.5%). Financials rose following a less severe Financial Services Royal Commission Final Report than expected. Industrials stocks exposed to Resources, such as Monadelphous (MND, +20.6%) and Seven Group (SVW, +22.5%), delivered better-than-expected results.

In IT, the strongest performers were Altium (ALU, +32.3%), Appen (APX, +46.9%) and Infomedia (IFM, +24.8%).

Conversely, traditionally defensive sectors REITs (+2.1%) and Consumer Staples (+1.0%) underperformed during the period. Across the two 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

James Hardie (JHX, overweight) – the building materials company outperformed following a better-than-expected 3Q19 result. While net profit was largely in line with expectations at $US65.9mn, the full-year guidance range was tightened to $US295-310mn, higher at the midpoint than the previous range of $US280-320mn. Furthermore, the new chief executive announced an ambitious $US100mn cost-out target over the next three years. 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 the company does annually). Lastly, JHX now trades at a more supportive 16.1 times forward earnings, an attractive discount to the ASX Industrials sector.

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.

Cochlear (COH, underweight) – the medical device maker declined after its 1H19 result revealed its implant sales (58% of total sales) had stalled following a competitor's new offering, with higher volumes offset by lower prices. Unlike COH's devices, the competitor's implants can be used while a patient is in an MRI machine. We remain underweight COH because we believe its valuation – at 35 times earnings and an EV/EBITDA of 23 times on a 12-month forward basis – fails to account for ongoing market share pressure. We expect to see below-system implant unit growth for the short to medium term, impairing P/E expansion with the stock.

Key detractors

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.

Eclipx (ECX, overweight) – while Eclipx didn't report results during the period, its suitor McMillian Shakespeare (MMS) delivered a weak 1H19 result and said it is still reviewing the merger proposal following Eclipx's disappointing market update in January. We remain overweight the stock given it trades at a discount to the MMS offer and because we hold a positive view of ECX's core business: ECX should take market share (with high single-digit volume growth and stable pricing) and has a large cost-out opportunity from upgrading existing systems.

Carsales.com (CAR, overweight) – the online automotive classifieds company underperformed following a worse-than-expected 1H19 result. NPAT missed consensus forecasts by 7% as the domestic core business slowed to flat growth and finance earnings declined materially, offsetting a strong result from the International division. Management guided to moderate revenue, EBITDA and NPAT growth for the 2H19, causing consensus to downgrade FY19 NPAT forecasts by 4-6%. We believe the earnings miss is largely cyclical and remain overweight the stock. We continue to see CAR's valuation – at a forward P/E of 22.1 times – as supportive when considering the company's outlook for long term earnings growth, its conservative accounting (with low capitalisation of research and development investment) and its undervalued international businesses.

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.

Origin Energy (ORG) – we increased our position in the energy company after establishing it during the prior month. We believe ORG's recent initiatives to simplify the business will unlock value; asset sales have substantially reduced balance sheet leverage and focused attention on its key assets – the Energy Markets business and APLNG project. The implied valuation of both the Energy Markets business and APLNG remains conservative, with an eventual demerger of both businesses or sale of APLNG the critical next step in crystallising this value.

NEXTDC (NXT) – we established a position in the data centre operator during the month, taking advantage of recent share price weakness. We 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.

Key sales

Bluescope Steel (BSL) – we reduced our position during the month but remain positive towards the steel producer. Our 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 8.4 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 will remain soundly profitable and cash-flow positive, even when the cycle troughs.

WorleyParsons (WOR) – we reduced our position but remain positive towards the company. 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, WOR's 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 acquisition of Jacobs' ECR, 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.

Santos (STO) – we reduced our position following recent outperformance but remain positive towards the oil and gas producer. We hold a positive view of STO's recent Quadrant acquisition and the company's strong free cash flow profile. The Quadrant acquisition, which was approved by the ACCC during the previous quarter, was made at an attractive price (4.4 times trailing EBITDAX), did not require a capital raising and will be highly EBITDAX accretive. The acquisition also diversifies STO's portfolio across Australia (reducing its reliance on East Coast gas), consolidating its position in the Western Australian gas market at around a 36% combined market share. STO remains significantly cash flow positive at current oil price levels, with the balance sheet likely to deleverage to less than 30% by the end of 2019.

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.

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.

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 15.2 times 12-month forward earnings compared to peer Crown Resorts (CWN) at 19.2 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 23.6 times earnings and 2.3 times net tangible assets. We see the outlook for development earnings – which account for approximately 40% of total EBITDA – moderating with commencements now 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. Finally, 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, its 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 7.6 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 offering more attractive organic growth.

QBE Insurance (QBE) – we are underweight QBE because we believe its valuation – at 13.5 times forward earnings – captures the current favourable pricing environment for premiums but fails to account for the underlying volatility of its business model. We expect higher earnings volatility following QBE's recently announced reinsurance program, which costs $125mn less but increases the company's exposure to medium-sized events. QBE is also now more reliant on investment income (40% of insurance profit) for growth, where the outlook is less favourable.

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 300 Index ex S&P/ASX 20 Index yields 3.8% 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 most overweight stocks within the Industrials, Communication Services and Energy sectors, but are underweight Real Estate, Financials and Consumer Staples.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	16.69	3.12	13.57
Consumer Discretionary	9.28	9.37	-0.09
Consumer Staples	0.00	5.36	-5.36
Energy	14.29	8.85	5.44
Financials	3.16	11.94	-8.79
Health Care	8.09	7.51	0.58
Industrials	24.14	11.59	12.55
Information Technology	1.32	5.43	-4.11
Materials	20.75	17.74	3.01
Real Estate	0.00	14.49	-14.49
Utilities	0.00	4.58	-4.58

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Atlas Arteria	6.95	0.64	6.30
Sydney Airport	6.88	2.22	4.66
James Hardie Industries	6.51	1.07	5.44
TPG Telecom	6.23	0.31	5.92
Star Entertainment	6.01	0.50	5.51

Income and growth

	1 year %	3 years % p.a.	5 years % p.a.	Since inception % p.a.
Growth return	-2.12	5.37	1.48	3.62
Distribution return	2.32	3.14	2.95	2.90

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.

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	6.95	0.64	6.30
TPG Telecom	6.23	0.31	5.92
Star Entertainment	6.01	0.50	5.51
Underweights			
Goodman Group	0.00	2.81	-2.81
Newcrest Mining	0.00	2.54	-2.54
QBE Insurance	0.00	2.31	-2.31

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.

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$22.31 mn as at 28 February 2019	
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

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