YARRA
CAPITAL MANAGEMENT

Investment Commentary
Quarter to 31 March 2019

Yarra Leaders Fund

Gross returns as at 31 March 2019

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Leaders Fund^	-0.97	9.36	5.12	9.33	5.95	10.28	NA
S&P/ASX 100 Accumulation Index	0.84	10.72	12.50	11.41	7.32	10.42	9.64
Excess return (before fees)‡	-1.81	-1.36	-7.38	-2.08	-1.37	-0.14	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 March 2019

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Leaders Fund^	-1.12	8.88	3.26	7.39	4.07	8.33	9.35
S&P/ASX 100 Accumulation Index	0.84	10.72	12.50	11.41	7.32	10.42	9.64
Excess return (after fees)‡	-1.96	-1.84	-9.24	-4.02	-3.25	-2.09	-0.29

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 Leaders Fund: October 1998
^ This Fund is no longer available for new investment. The Reinvestment of distributions is still allowed where an existing Reinvestment instruction is in place.
‡ Excess return: The difference between the Fund's return and the benchmark return (S&P/ASX 100 Accumulation Index).

Market review

Australian equities generated their best return since the wake of the GFC in the March quarter, with all sectors rising in the period.

The S&P/ASX 100 Accumulation Index rose 10.7% in the three months to 31 March 2019, taking its 12-month return to 12.5%. The local index underperformed global indices during the quarter, with the MSCI World Index and S&P500 returning 12.8% and 13.6% respectively.

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 mostly came from earnings multiple expansion, with the S&P/ASX 100's 12-month forward P/E rising from 14.1 to 15.4 times. Globally, equities rose in response to more dovish outlooks from central banks as global growth slowed.

Resources outperformed during the quarter as major commodities surged. In Metals & Mining (+22.0%), Rio Tinto (RIO, +32.8%), Fortescue Metals Group (FMG, +78.1%) and BHP Billiton (BHP, +19.8%) rose in concert with the iron ore price, which increased 19.9% to $US87 per tonne due to expectations of disruption to supply from Vale's Brazil operations following a mining disaster in late January. Meanwhile, Energy (+14.1%) rallied in response to higher oil prices, with Brent Crude rising 23.8% to $US68 per barrel following OPEC cuts and US sanctions against Venezuela.

Communication Services (+17.7%) also performed strongly during the quarter. Telstra (TLS) rallied +19.5% in response to its 1H19 result, which was not as bad as feared, and the lower bond yield environment with the Australian 10-year bond yield declining 55 bps to 1.8%. Other strong performers were Nine Entertainment (NEC, +27.5%) and Carsales.com (CAR, +16.9%).

Elsewhere, the Banking sector (+3.0%) underperformed despite the recommendations from the Financial Services Royal Commission final report not being as severe as expected. Further, Commonwealth Bank's (CBA, +0.3%) 1H19 result and quarterly updates from the other major banks were generally in line with expectations.

Consumer Staples (+6.8%) also underperformed as supermarket groups Woolworths (WOW, +5.0%) and Coles (COL, +0.9%) weighed on the index. Their 1H19 results revealed higher cost pressures and increased capex required in stores, systems and distribution centres.

Portfolio review

Key contributors

Santos (STO, overweight) – the oil and gas producer outperformed in response to the higher oil price, with Brent Crude rising 23.8% to $US68 per barrel following OPEC cuts and US sanctions against Venezuela, as well as a solid FY18 result. STO reported NPAT up 12% to $727mn – 19% ahead of consensus expectations – and better unit cost guidance for 2019. We remain overweight the stock based on a positive view of its 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 delever to less than 30% by the end of 2019.

Atlas Arteria (ALX, overweight) – the toll road operator outperformed during the quarter 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.

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 for $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 16.4 times forward earnings, an attractive discount to the ASX Industrials sector.

Key detractors

Star Entertainment (SGR, overweight) – the casino operator underperformed due to concerns of a slowdown in VIP revenue and weaker consumer sentiment amid falling house prices. The company's 1H19 results released in February validated concerns regarding VIP, with the Sydney segment (10% of group earnings) causing EBITDA to miss expectations by 5% as its revenue fell 49% (y/y). However, the core domestic gaming business showed strong and resilient growth despite the challenging consumer environment, with revenue growth at 5.7% and management indicating that the positive trends have continued into the second half. We continue to believe the market underestimates SGR's ability to enhance asset performance through operational improvements and capex programs. In our view the company's brownfield developments – the expansion in Sydney, the redevelopment on the Gold Coast and the Queen's Wharf in Brisbane – provide meaningful upside opportunities in the medium to longer term.

Rio Tinto (RIO, underweight) – the iron ore miner outperformed during the quarter after a Brazilian dam disaster caused supply disruptions in the iron ore market, causing the commodity to rise 19.9% to $US87 per tonne during the quarter. While the Vale failure has only a small impact on the global seaborne market (less than 1% of supply), it creates uncertainty about Vale's other Brazilian operations and puts into question around 5% of global supply. RIO remains a higher quality iron ore operator with robust free cash flows, but we remain underweight the company as new supply comes onto the market from elsewhere and China's demand wanes from strong, stimulus-induced levels.

Commonwealth Bank (CBA, overweight) – the bank underperformed during the quarter despite delivering an in-line 1H19 result and the release of recommendations from the Financial Services Royal Commission final report which were not as severe as expected. However, the result showed revenue fell 2% (y/y) on a continuing operations basis, largely driven by the Retail division where net interest margins declined 11 bps. Notwithstanding a challenging revenue environment, we believe CBA appears well positioned for cost reductions and capital returns, which should result in modest pre-provision profit growth and better EPS growth. In our view the Financial Services Royal Commission's final report clears the uncertainty pervading the industry and should alleviate pressure, enabling CBA to take advantage of banking fundamentals, delivering stable net interest margins (CBA's rate rise in early September alleviates this pressure), low to mid-single digit credit growth and ongoing cost reductions.

Key purchases

WorleyParsons (WOR) – we established a position in the company during the quarter. We expect WOR will benefit from its exposure to oil and 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 (16.8 times forward

earnings), this premium falls to a discount when adjusted for WOR's strong growth potential.

APA Group (APA) – we established a position in the gas pipeline company during the quarter. At an EV/EBITDA of 12.9 times and with a 4.9% dividend yield, we regard APA's valuation as attractive when considering its exposure to increasingly important gas markets and strong competitive position, with dominant market share. Its growth outlook into FY20 is supported by a range of projects approaching commissioning, which should alone contribute 6% to revenue growth. Further, we believe the risk around potential regulation of pipeline networks via an arbitration framework appears to have passed.

Incitec Pivot (IPL) – we established a position in the explosives and fertiliser producer during the quarter. 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 14.1 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.

Key sales

ResMed (RMD) – we reduced our overweight position early in the quarter, prior to RMD's disappointing second quarter FY19 result. While the result missed consensus forecasts, it demonstrated that RMD's core US business (55% of group sales) continues to perform well. We continue to 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.

Crown Resorts (CWN) – we exited our position during the quarter. While we believe CWN is emerging as a simpler, more focused and more disciplined company and remain attracted to the stock based on its core Melbourne and Perth businesses, we believe this is fully factored into the share price at 19.4 times 12-month forward earnings. Our preferred overweight in the industry is Star Entertainment (SGR), which trades at a more appealing 14.4 times 12-month forward earnings.

Challenger (CGF) – we exited our position early in the quarter due to our view that business pressures were mounting from the Financial Services Royal Commission, investment market weakness and margin compression. Following our decision to exit, CGF downgraded FY19 normalised EBIT by 8% at the midpoint, which it attributed to lower cash distributions in its Life segment and lower funds management performance fees. While CGF now appears cheap at 13.5 times forward earnings, we see risks to consensus expectations and the potential for the new chief executive to abandon the company's 18% pre-tax ROE target, which would cause the stock to de-rate further

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 – which comes into effect on 1 April 2019 – 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.

Origin Energy (ORG) – we are overweight the company on the basis that its 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.

ANZ Bank (ANZ) – we believe ANZ has made substantial progress in controlling its costs relative to peers and consequently is well placed to continue to return capital to shareholders, particularly following the sale of its life insurance business. In our view the Financial Services Royal Commission's final report clears the uncertainty pervading the industry and should alleviate pressure, enabling ANZ to capitalise on its ability to generate credit growth through its mortgage market share. Further, we expect the company will benefit from an ongoing rebound in small-to-medium enterprise lending. We view the company's discount to peers as attractive, at a P/E multiple of 11.1 times and a price to book multiple of 1.2 times.

Key active underweights

National Australia Bank (NAB) – we do not hold a position in the bank, with our preferred banking exposures being Commonwealth Bank (CBA), Westpac (WBC) and ANZ Bank (ANZ). NAB's domestic business is a clear underperformer relative to peers, with pre-provision earnings stagnant over a number of years and significant catch-up investment required as evident by its move to accelerate costs and investment in FY18 together with a large ($755mn) restructuring charge. After a large 5-8% step-up in costs in FY18, NAB has guided to flat cost growth in FY19 and FY20, which we believe is unsustainable. We do not regard NAB's valuation – at 10.8 times forward earnings and 1.3 times book value – as being appealing in light of these headwinds.

CSL (CSL) – we remain underweight CSL based on its forward valuation (30.1 times P/E and 21.0 times EV/EBITDA on a 12-month forward basis), which we believe appropriately captures the current earnings outlook at this time. The growth outlook for CSL's key plasma products remains robust, with the company continuing to strengthen its relative market position

through long-term investment in capacity, product innovation and collection centres.

BHP Billiton (BHP) – our underweight position reflects our cautious medium to longer term view towards BHP's commodity exposures, particularly iron ore and coal. Notwithstanding recent supply disruptions, we believe fundamentals point to lower prices as new supply comes onto the market and China's demand wanes from strong, stimulus-induced levels. We continue to monitor BHP's ability to support earnings through lower costs – cost inflation is building and capex will need to increase to more historic levels.

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 4.6% on a 12-month forward basis (before franking) versus 1.8% 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, Consumer Staples and Health Care.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	6.98	3.42	3.56
Consumer Discretionary	4.17	5.32	-1.15
Consumer Staples	0.00	5.23	-5.23
Energy	10.50	5.65	4.86
Financials	32.50	33.64	-1.13
Health Care	5.68	8.67	-2.99
Industrials	19.29	8.31	10.98
Information Technology	0.00	1.18	-1.18
Materials	16.01	18.92	-2.91
Real Estate	0.00	7.46	-7.46
Utilities	2.35	2.20	0.15

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Commonwealth Bank of Australia	10.83	8.30	2.53
Westpac Banking	9.44	5.94	3.49
ANZ Banking	8.53	5.03	3.50
Atlas Arteria	5.19	0.32	4.87
Transurban	4.81	2.30	2.51

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	5.19	0.32	4.87
Origin Energy	4.46	0.84	3.61
ANZ Banking	8.53	5.03	3.50
Underweights			
National Australia Bank	0.00	4.60	-4.60
CSL	1.53	5.89	-4.36
BHP Billiton	4.41	7.56	-3.16

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	-7.34	-1.57	-6.17	-1.86
Distribution return	10.60	8.95	10.24	10.19

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 by investing in larger companies listed on the Australian Securities Exchange, and in doing so outperform the S&P/ASX 100 Accumulation Index over rolling 3-year periods.
Recommended investment time frame	5 - 7 + years
Fund inception	October 1988
Fund size	A$56.19 mn as at 31 March 2019
APIR code	JBW0011AU
ARSN code	090 047 662
Estimated management cost	1.80% p.a.
Buy/sell spread	+/- 0.15%

Applications and contacts

The Yarra Leaders Fund is no longer available for new investment. The reinvestment of distributions is still allowed where an existing reinvestment instruction is in place.

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