YARRA CAPITAL MANAGEMENT

**Investment Commentary**
Month to 31 August 2020

# Yarra Australian Equities Fund

## Gross returns as at 31 August 2020

| | 1 month % | 3 months % | 1 year % | 3 years % p.a. | 5 years % p.a. | 10 years % p.a. | Since inception* % p.a. |
|---|---|---|---|---|---|---|---|
| Yarra Australian Equities Fund | 4.14 | 7.42 | -8.89 | 3.43 | 6.20 | 7.44 | 10.14 |
| S&P/ASX 200 Accumulation Index† | 2.83 | 6.04 | -5.08 | 6.10 | 7.46 | 7.81 | 8.93 |
| Excess return (before fees)‡ | 1.31 | 1.38 | -3.81 | -2.67 | -1.26 | -0.37 | 1.22 |

**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 August 2020

| | 1 month % | 3 months % | 1 year % | 3 years % p.a. | 5 years % p.a. | 10 years % p.a. | Since inception* % p.a. |
|---|---|---|---|---|---|---|---|
| Yarra Australian Equities Fund | 4.06 | 7.17 | -9.75 | 2.46 | 5.20 | 6.42 | 9.14 |
| S&P/ASX 200 Accumulation Index† | 2.83 | 6.04 | -5.08 | 6.10 | 7.46 | 7.81 | 8.93 |
| Excess return (after fees)‡ | 1.23 | 1.13 | -4.67 | -3.64 | -2.26 | -1.38 | 0.22 |

**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 Australian Equities Fund: July 1996

† The benchmark for the Yarra Australian Equities Fund has been amended since the Fund's inception. Effective 28 February 2008 the benchmark is the S&P/ASX 200 Accumulation Index, replacing the S&P/ASX 200 ex Property Accumulation Index Monthly. Further information on changes to the Fund's benchmark is available upon request.

‡ Excess return: The difference between the portfolio's return and the benchmark return.

### Market review

Australian equities rose during August as reporting season delivered earnings largely in line with downbeat expectations.

The S&P/ASX 200 Accumulation Index increased by 2.8%, taking its 12-month return to -5.1%. The benchmark underperformed global indices, with the MSCI World Index (+6.3%) and the S&P500 (+7.2%) supported by their larger exposure to the Information Technology sector.

FY20 results largely met consensus forecasts, which were cut dramatically from March onwards as the COVID-related disruption became apparent. Earnings for the period declined 15%, led by Financials and Industrials but offset by Resources amid strong commodity prices. The outlook for FY21 remains highly uncertain, with more than a 50% reduction in companies providing guidance.

At a sector level, Consumer Discretionary (+8.7%) and Information Technology (+15.5%) were the top performers. Retailers with a strong online presence – including JB Hi-Fi (JBH, +11.7%), Harvey Norman (HVN, +18.8%) and Super Retail Group (SUL, +20.5%) –and online payment solutions providers such as Afterpay (APT, +33.4%) delivered strong results as they benefited from fiscal stimulus. In addition, IDP Education (IEL, +50.9%) and G8 Education (GEM, +28.0%) delivered better-than-expected results despite challenging market conditions.

Conversely, the only sectors to decline during the period were Consumer Staples (-0.4%), Communication Services (-3.8%) and Utilities (-4.8%). Communication Services was weighed down by Telstra (TLS, -11.4%) following a worse-than-expected FY20 result. In Staples, A2 Milk (A2M, -11.8%) and Treasury Wine Estates (TWE, -14.4%) revealed headwinds from their exposure to China (amid geopolitical tensions), while in Utilities AGL Energy (AGL, -7.9%) and APA Group (APA, -5.2%) also delivered disappointing FY20 results.

### Portfolio review

#### Key contributors

Telstra (TLS, underweight) – the telco underperformed during the period following a disappointing FY20 result. While underlying EBITDA was in line with guidance (at the bottom end of the range), its composition was low quality with core divisions Mobile (47% of EBITDA), Fixed (9% of EBITDA) and Data & IP (17% of EBITDA) seeing declines of -7%, -18% and -57% respectively. Heading into FY21 these divisions remain challenged, with the Data & IP (17% underlying EBITDA) headwinds seemingly worse than management's initial

expectations (due to NBN push into the segment), resulting in the company reducing its FY23 ROIC target of 10% to now be >7%. The result supported our thesis that TLS faces earnings headwinds across all its divisions in the medium term beyond consensus forecasts. Following the completion of its merger, the combined TPG/Vodafone entity operates at a lower cost base and will increase pressure on TLS's market share and pricing. We also believe there are risks of lower future NBN payments and remain sceptical that TLS can fill its EBITDA shortfall when NBN payments conclude and the company faces higher access costs. Consequently, we do not believe its headline forward P/E of 20.7 times provides appropriate valuation support.

Nine Entertainment (NEC, overweight) – the media company outperformed after delivering an FY20 result better than expectations. FY20 EBITDA declined 15% to $397mn, in line with the recently guidance range of $390-410mn. The company was able to offset extremely challenging ad markets with cost out programs, a resilient performance from Domain and strong growth from Stan. While no guidance was given for FY21, management noted ad markets had improved marginally in July. Our thesis remains premised on a supportive valuation, its high-quality digital assets (Stan, 9Now and Domain), and a number of savings initiatives in the short term. We believe the difficult ad markets relating to the COVID-19 crisis are already factored into NEC's valuation, with the stock trading at 18.2 times forward earnings. At these levels, we do not believe sufficient value is attributed to its subsidiaries when considering their long-term growth profile, with double-digit earnings growth expected in FY21. NEC plans to save $266mn by the end of CY2020 through programming content and operational initiatives and by deferring capex and spectrum charges.

Star Entertainment (SGR, overweight) – the casino operator outperformed after beating expectations in its FY20 result. Normalised FY20 EBITDA declined 23% y/y to $430mn, 10% ahead of consensus forecasts. Moreover, July revenues have returned to 80% of the previous year's level despite current restrictions in place. With subdued costs, capex cut and VIP receivables coming through, the business is already generating strong cash flow – enabling management to pay down debt and giving lenders confidence in the outlook. We remain overweight the casino operator on the grounds it has available liquidity and debt headroom to withstand disruption from the COVID-19 crisis. SGR's cost base is extremely flexible, phased in line with revenue and demand and aided by JobKeeper, which is available until 27 September and will cover 65% of total staff costs. In the long term, our overweight position is premised on the belief that the market underestimates SGR's ability to enhance asset performance through operational improvements and capex programs.

**Key detractors**

Afterpay (APT, underweight) – the online payment solutions company outperformed after delivering a better-than-expected FY20 result. While management had already reported key metrics and underlying EBITDA of $44mn, the market reacted positively to the FY21 trading update. Management said online sales in Australia and New Zealand accelerated into July and August and continued at record levels in the US, with strong customer acquisition. Our underweight position is premised on several factors. In the short term, we believe APT's valuation does not reflect the uncertainty associated with COVID-19 despite the company's strong balance sheet position. While APT's loss rates are low so far, it remains extremely early in the bad debt cycle (where APT is exposed as an unsecured consumer lending business). In addition, APT's long-term risks remain, including heightened regulation (e.g. expense verification), increased competition (such as from PayPal) and the sustainability of the company's attractive margins.

APA Group (APA, overweight) – the gas pipeline owner underperformed after delivering a disappointing FY20 result. While FY20 EBITDA of $1,654mn was at the top end of revised guidance, FY21 EBITDA guidance of $1,625-1,655mn was 4% below consensus forecasts. Further, management guided to flat dividends, which is below consensus expectations. We remain overweight the company as we believe the lower earnings guidance in FY21 reflects temporary issues and will normalise in FY22. As a result, we see its valuation (at an EV/EBITDA of 13.0 times and with a 4.8% forecast dividend yield) as attractive when considering its exposure to increasingly important gas markets and dominant market share position. We view APA's balance sheet as very strong with $2bn of liquidity and no refinancing requirements until FY22, particularly when the COVID-19 crisis has had no impact on earnings. The company will actually generate additional cash flows as weakness in oil end-markets reduces capex requirements, further protecting the dividend trajectory. In the medium term, we see dividend upside given the company's conservative balance sheet position.

ResMed (RMD, overweight) – the sleep apnea and respiratory device maker underperformed during the period – partially retracing outperformance from prior periods – despite releasing a stronger-than-expected 4Q20 result. Stronger COVID-related ventilator sales more than offset weakness from its sleep apnea products, with 4Q20 EBITDA growing +24%. However, management's outlook disappointed the market, flagging a sharp fall in ventilator sales, low single-digit revenue growth and gross margin headwinds. That being said, we retain a small overweight position in the company, having materially reduced the position size in recent months. We believe the ventilator outlook appears conservative, as it guides to no COVID-related sales by the March 2021 quarter (implying a swift resolution of the crisis). Moreover, we expect RMD's core sleep apnea division to rebound strongly post-COVID on the grounds that demand for its products has been deferred, not lost. Our long-term investment thesis remains intact, with benefits accruing from a positive product cycle in the flow generator and mask segments. New software and integration with the customer is supporting device sales versus competitors.

**Key purchases**

Reece (REH) – we increased our position in the plumbing and bathroom supplier during the period after establishing a position in the prior month. We see the stock's valuation as

supportive (at 14.5 times forward EV/EBITDA) when considering REH's strong industry position in ANZ – demonstrated by 1% FY20 sales growth despite COVID, well above peer Tradelink at -4% – and the significant growth potential through its US business MORSCO. We expect MORSCO (52% of group sales and 26% of EBIT) to deliver strong sales growth as the number of its stores increase and as profitability closes in to market leader Ferguson. Lastly, REH's rapidly improving balance sheet following the capital raising ($1bn gross cash) puts the business on a sound position for further inorganic growth and increased dividends to shareholders (following the surprise 6 cents per share dividend in FY20).

Link Administration (LNK) – we increased our position in the share registry company during the period. We expect decreased market activity levels will reduce LNK's revenue by around 10% in the short term, while costs will increase across fund administration as activity increases following the government's announcement of early access to superannuation for individuals affected by COVID-19. However, we believe this is more than captured in the share price – LNK trades at 14.0 times FY22 earnings – while the potential earnings acceleration from FY22 onwards is being ignored. In particular, we hold a positive view of LNK's PEXA business, which should see earnings accelerate rapidly as the business is recapitalised and the housing market normalises.

Iluka Resources (ILU) – we increased our position in the mineral sands producer during the period. Our positive view is underpinned by ILU's Mining Area C (MAC) royalty, which entitles the company to receive 1.232% of iron ore revenue generated from BHP Group (BHP)'s Mining Area C mine and, in addition, an annual capacity payment of $1mn for every million tonne increase in exports from the area. In our view the royalty is undervalued at current share price levels. Moreover, in the medium term we expect the demerger of the MAC royalty will unlock significant value, with the entity likely to provide a strong dividend yield. In regards to ILU's mineral sands business, we recognise that the short-term demand outlook for mineral sands remains challenging but regard the industry structure as attractive (consolidated supply), with less pricing volatility compared to previous cycles.

**Key sales**

GPT Group (GPT) – we exited our position during the period as we became more concerned about the outlook for Office and Retail REITs, to which GPT has exposure at 40% and 42% of its asset base respectively. We believe the structural headwinds the two subsectors face will cause a faster and deeper decline in rents and asset values than what is implied in its share price (at 0.7 times NTA). While GPT remains our preferred REIT (given its strong balance sheet and high-quality portfolio), we prefer exposure to large cap infrastructure (TCL, ALX) which does not face such issues.

Ansell (ANN) – we reduced our position during the period following recent outperformance, but remain overweight the stock. In the short term, we continue to believe ANN's Health Care division (55% of EBIT) will support earnings as it provides crucial equipment to combat the COVID-19 virus, more than offsetting likely short-term disruption from its Industrial division (45% of group EBIT). More broadly, we continue to view the business favourably as it undergoes internal programs to increase operational efficiency and improve margins from new distributor agreements, and shifts towards higher-value products. We do not believe this is captured by consensus; the stock trades at 21.8 times, a large discount to the wider Industrials ex-Financials at 28.4 times.

JB Hi-Fi (JBH) – we trimmed our position following recent outperformance but remain overweight the electronics retailer. In the short term JBH is a beneficiary of the shift to remote working and stronger homewares consumer spending. In the longer term we continue to believe the market underestimates JBH's ability to grow across different trading conditions, which is not reflected in its valuation at 18 times FY21 earnings. While subsidiary The Good Guys has a more conservative outlook amidst heightened price competition and a slowing housing environment, we believe the business is better equipped to deal with these issues, with improved supplier support post-acquisition and upside through improved execution.

**Key active overweights**

BHP Group (BHP) – we believe the company's valuation is attractive in the context of firm iron ore prices (above $US110 per tonne) and China returning to production following COVID-19. BHP still trades on a 12-month forward P/E of 16.2 times, an EV/EBITDA of 6.5 times, and generates a free cash flow yield above 10%. Its balance sheet is robust (gearing is approximately 15%), with management carrying out a well-defined capital allocation strategy. More broadly, we view BHP as a relatively defensive Metals & Mining exposure, with a diversified portfolio and clear strategy of capital allocation.

Atlas Arteria (ALX) – we maintain a high-conviction overweight position based on ALX's strong liquidity position, which leaves it well placed to weather the COVID-19 related downturn in revenues for FY20, and a positive long-term view. ALX holds attractive, long-duration assets and trades at a discounted valuation (10.0 times normalised EV/EBITDA), which more than captures the disruption from COVID-19 as travel restrictions and lockdowns reduce traffic volumes in the short term. We continue to believe the intrinsic value of ALX's assets will eventually be realised following the simplification of its ownership structure in the past two years, resulting in significant upside.

Origin Energy (ORG) – our overweight position remains premised on our view that recent initiatives to simplify the business will unlock value (reducing debt, focusing attention on key assets Energy Markets and APLNG). Following its initiatives, ORG is now in a stronger position to withstand lower oil and electricity wholesale prices, which we view as being at unsustainably low levels. The company has >$4bn of liquidity – which can cover all debt maturities in the next 36 months – while APLNG has a lower distribution breakeven of $US27-31 per barrel and $1.2bn in cash (as at 30 June 2020).

**Key active underweights**

CSL (CSL) – we remain underweight CSL based on its forward valuation (42.1 times P/E and 29.0 times EV/EBITDA on a 12-month forward basis), which we believe appropriately captures the 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.

National Australia Bank (NAB) – we remain underweight the bank, reflecting both short-term and long-term concerns. In the short term, we see NAB as being more vulnerable to bad debts due its higher exposure to SMEs relative to peers, businesses that are adversely affected by the COVID-19 crisis. While NAB has strengthened its capital position through a highly dilutive, discounted $3.5bn capital raising and has increased collective provisioning alongside peers, the bank is yet to take an AUSTRAC provision unlike its peers. In the long term, we continue to believe that catch-up investment is required for NAB following years of underinvestment. We do not regard the company's valuation – at 12.7 times forward earnings – as being appealing considering these headwinds.

Wesfarmers (WES) – our underweight position remains premised on the view its divisions, outside Bunnings (57% of EBIT), face significant earnings headwinds. Officeworks (6% of EBIT) and the department store industry (including discount department stores Target and Kmart, 19% of EBIT) face increasing competition (e.g. Amazon) and excess physical store capacity. Furthermore, the company's Industrials segment (18% of EBIT) comprises cyclical, lower quality businesses. As such, we don't find the valuation attractive at 27.4 times forward earnings, roughly in line with the wider Industrial ex-Financials' 28.3 times.

## Market outlook

The Australian economy contracted sharply in the June quarter, confirming the largest recession since the Great Depression, albeit the 7% q/q contraction was in line with forecast and the higher frequency economic data has continued to surprise expectations.

By the end of August, the Australian economy has responded significantly to the 2nd largest fiscal stimulus in the developed world, supplemented by $32bn in voluntary superannuation withdrawals, accommodative financial conditions and strong commodity prices. Although declines in consumption contributed the vast majority of the contraction in economic activity in the June quarter, the declines were heavily concentrated in service sectors impacted by the COVID restrictions, especially tourism, entertainment, restaurants and personal services. In contrast, nominal retail sales in July expanded a dramatic 12%, with sales of recreational goods (+51% y/y), liquor (+37% y/y), electrical goods (+33% y/y), hardware (+28% y/y) and furniture (+26% y/y) leading the expansion.

Despite the strength in retail sales, the household saving rate jumped to 18% in the June quarter – the highest since the early 1970s – suggesting that the consumer has ample capacity to continue to drive the economic recovery in 2020-21. Indeed, more resilient household wealth outcomes and a recovering labour market (with 40% of the 871k jobs lost in April and May returning in June and July) suggests our long held forecast for a small "v-shaped" recovery through 2020-21 was playing out slightly faster than expected.

Nevertheless, the Victorian outbreak and tighter lockdown measures have provided a more cautious near term outlook, even if the recovery in the remaining 75% of the national economy continues. We have lowered our expectations for 3Q economic growth as the ramifications from the extension of the Victorian lockdown and stringent criteria to exit the lockdown become more evident. In addition, we have lifted our expectations for the A$ to finish 2020 at 75-80c which will weigh on 2021 economic growth. We now expect that the Australian economy will decline by 6% in 2020 (previously -5%) and expand by 5% in calendar 2021 (previously +6%).

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 Communication Services, Energy and Consumer Discretionary sectors, and underweight Real Estate, Consumer Staples and Financials.

## Sector allocation

| | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| Communication Services | 9.66 | 3.96 | 5.70 |
| Consumer Discretionary | 9.82 | 7.44 | 2.38 |
| Consumer Staples | 2.36 | 6.44 | -4.08 |
| Energy | 7.73 | 3.77 | 3.96 |
| Financials | 22.54 | 26.28 | -3.75 |
| Health Care | 9.56 | 11.86 | -2.30 |
| Industrials | 9.54 | 7.48 | 2.06 |
| Information Technology | 3.66 | 4.08 | -0.42 |
| Materials | 19.34 | 20.10 | -0.76 |
| Real Estate | 0.00 | 6.88 | -6.88 |
| Utilities | 3.63 | 1.72 | 1.91 |

## Top 5 holdings

| | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| BHP | 10.52 | 6.70 | 3.82 |
| Westpac | 6.41 | 3.80 | 2.61 |
| ANZ | 6.11 | 3.11 | 3.00 |
| Commonwealth Bank of Australia | 6.07 | 7.25 | -1.18 |
| Atlas Arteria | 4.03 | 0.37 | 3.66 |

## Key active positions

| Overweights | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| BHP | 10.52 | 6.70 | 3.82 |
| Atlas Arteria | 4.03 | 0.37 | 3.66 |
| Origin Energy | 3.61 | 0.59 | 3.02 |
| **Underweights** | | | |
| CSL | 2.36 | 7.79 | -5.43 |
| National Australia Bank | 0.00 | 3.44 | -3.44 |
| Wesfarmers | 0.00 | 3.23 | -3.23 |

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 | -20.32 | -8.82 | -3.40 | -1.90 |
| Distribution return | 10.57 | 11.28 | 8.60 | 8.32 |

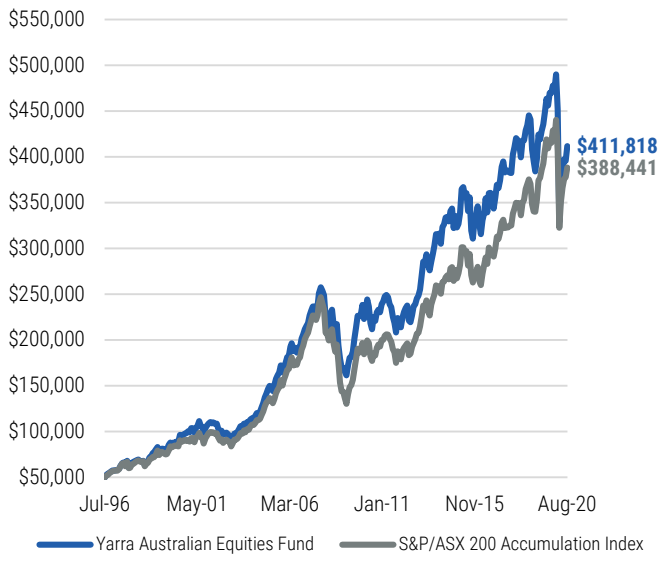
The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders 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 companies listed on the Australian Securities Exchange. In doing so, the aim is to outperform the S&P/ASX 200 Accumulation Index over rolling 3-year periods. | |
| Recommended investment time frame | 5 - 7 + years | |
| Fund inception | July 1996 | |
| Fund size | Pooled Fund A$112.81mn as at 31 August 2020 | |
| APIR codes | JBW0009AU | |
| Estimated management cost | 0.90% p.a. | |
| Buy/sell spread | +/- 0.15% | |
| Platform availability | AMP Flexible Lifetime<br>AMP PortfolioCare<br>AMP Wealthview<br>ANZ Grow Wrap<br>Asgard<br>BT Panorama<br>BT Wrap<br>Colonial FirstWrap<br>Freedom of Choice<br>Hub24<br>IOOF Pursuit Select | Macquarie Wrap Accumulator<br>Macquarie Wrap Consolidator<br>Netwealth<br>North<br>Oasis<br>OnePath<br>PortfolioOne<br>PowerWrap<br>SmartWrap<br>Wealthtrac |

## Investment performance comparison of $50,000

After fees, since inception of the Yarra Australian Equities Fund, July 1996 to August 2020.




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 S&P/ASX 200 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 Australian Equities Fund can be made by Australian and New Zealand resident investors only.

**Website** www.yarracm.com

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

**Disclaimers**

The Yarra Australian Equities Fund is substantially invested in the Yarra Australian Equities Pooled Fund ('Pooled Fund'). References in this document to the underlying assets or investments of the Fund generally relate to the assets held in the Pooled Fund.

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