YARRA CAPITAL MANAGEMENT

**Investment Commentary**
Month to 31 August 2022

# Yarra Emerging Leaders Fund (Direct)

## Gross returns as at 31 August 2022

| | 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 (Direct) | 1.75 | -0.21 | -5.64 | 7.78 | 10.23 | 12.22 | 13.10 |
| Emerging Leaders Combined Benchmark† | 2.37 | -0.30 | -7.85 | 7.64 | 8.96 | 9.86 | 8.30 |
| Excess return (before fees)‡ | -0.62 | 0.09 | 2.21 | 0.14 | 1.27 | 2.36 | 4.80 |

**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 2022

| | 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 (Direct) | 1.59 | -0.68 | -7.40 | 5.62 | 7.93 | 9.81 | 10.79 |
| Emerging Leaders Combined Benchmark† | 2.37 | -0.30 | -7.85 | 7.64 | 8.96 | 9.86 | 8.30 |
| Excess return (after fees)‡ | -0.78 | -0.38 | 0.45 | -2.02 | -1.03 | -0.05 | 2.48 |

**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 (Direct): November 1994
† 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 equities gained +1.2% during August reflecting a stronger than expected reporting season, with 1.4 times more beats than misses compared to consensus earnings expectations.

The Emerging Leaders Benchmark returned +2.4% for the month, taking its 12-month return to -7.9%. In comparison, the broader ASX300 gained 1.2% for the month while global indices declined (MSCI World Index -3.4%).

Within Energy (+7.7%), the sector has lifted strongly on the back of elevated energy prices (oil, gas and coal), led by Cooper Energy (COE, +20.0%), Karoon Energy (KAR, +15.0%) and Paladin Energy (PDN, +14.9%).

Materials was a strong performer (+8.5%) led by 29Metals (29M, +33.1%), Sayona Mining (SYA, +51.3%) Liontown Resources (LTR, +31.4%). Commodities exposed over the medium to long term to an increased uptake in electric vehicles and renewable energy generation were the strong performers.

Conversely, the worst performing sector was Real Estate (-3.5%) led by Centuria Capital (CNI, -11.8%), Arena REIT (ARF, -12.7%) and GDI Property (GDI, -7.6%), as companies downgraded dividend outlooks due to the rising cost of debt impacting cashflow growth.

### Key Contributors

OZ Minerals (OZL, overweight) – the copper producer was a positive contributor to the portfolio during the period following BHP's takeover offer for the company. The offer, priced at $25 per share, represented a 32% premium to the pre-bid price. With the OZL board rejecting the initial offer, we recognize the potential for BHP to return with a higher bid. The potential for a counterbidder to emerge is limited, in our view, given BHP's significant available regional synergies. We retain our fundamental positive view on OZL due to its two high quality, long life, 100% owned copper mines in South Australia – Prominent Hill and Carrapateena. We expect the company's copper production to double to >200ktpa by 2030, as Carrapateena moves to a block caving operation, and the company develops the greenfield West Musgrave copper/nickel deposit in Western Australia.

Pilbara Minerals (PLS, overweight) – the lithium producer was an outperformer during the period, with continued lithium price strength ahead of consensus forecasts. We believe PLS provides the most attractive exposure to lithium as a future facing commodity. The company's flagship project, the Pilgangoora spodumene project, is well positioned to benefit from continued high lithium prices. The project is in the process of undertaking a 100ktpa capacity expansion to 680ktpa, with a clear path to 1,000ktpa through additional –

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and capital efficient – brownfield expansions. The company is progressing a downstream lithium hydroxide strategy with partner POSCO and assessing the potential to produce a value-added lithium/salts product.

AUB Group (AUB, overweight) – the insurance broker outperformed during the month as the company guided to continued strong organic growth. AUB and peers SDF and PSI all reported organic growth outlooks between 6-12% for FY23, with AUB offering large additional EPS accretion from the Tysers transaction. Tysers has been performing well since acquisition, with an acceleration in year-to-date revenue growth from 6% to 8%. AUB's agencies business reported a particularly strong result, with FY22 profit before tax up 54% following a rebound in COVID depressed lines and the integration of the 360 Underwriting Solutions acquisition. AUB continues to offer strong growth at a reasonable price, with the medium-term outlook supported by high inflation, which is contributing to expectations of a longer premium hardening cycle.

**Key Detractors**

TPG Telecom (TPG, overweight) – the Australian telco underperformed during the period following a slightly disappointing (4% miss at the EBITDA level) result. We retain a positive view on the company given the mobile market is becoming more rational supporting repricing, as the value brand TPG can gain market share and technology shifts towards fixed wireless and fiber to the basement will favor TPG. We expect the momentum in the business to continue improving through F23 and the valuation remains attractive at 8 times EV/EBITDA.

Megaport (MP1, overweight) – the company underperformed during the period reflecting a weaker technology sector (-5% in August) and following strong recent outperformance. The FY22 result – which was pre-announced in July – confirmed a stronger than expected June quarter result across revenue (+10% q/q) and EBITDA (the first positive). We see strong growth from Megaport's core business connecting data centres to the cloud, with a strong global pipeline as businesses increase IT project investment. With its expansion into broader telecommunication services – which leverages the same infrastructure – the total addressable market has now more than doubled. While the company is currently at an inflection point, we believe earnings and cashflow will turn positive in the next year with significant long-term earnings and cashflow potential.

Nanosonics (NAN, overweight) – the disinfection medical device maker underperformed during the period reflecting slightly higher FY23 cost guidance vs. consensus and following strong recent outperformance. Our overweight position is premised on the company's global market leadership in a large and growing addressable market. While growth rates were interrupted by COVID, hospital access is now resuming and, following the transition of the GE distribution arrangement, we believe the company is well positioned to resume its long-term growth trajectory in the US. Nanosonics is also well placed to continue developing new markets in the UK, Europe and Japan. The company has attractive economics with a high level of recurring revenue from consumables and upside from accelerating the upgrade cycle and via new products.

**Key Purchases**

Sims Metals (SGM) – we initiated a position in the scrap metal recycler during the period. Follow a period of share price underperformance, we believe the company offers compelling value at current levels. SGM's US business SA Recycling is performing strongly, and we see further upside from bolt-on acquisitions in what has become a highly fragmented market. While capital expenditure is increasing, a skew towards improving environmental performance should position the business strongly relative to peers as environmental regulations tighten further.

Pilbara Minerals (PLS) – we increased our position in the lithium producer during the period. Pilbara Minerals (PLS). We see PLS as the most attractive exposure to lithium as a future facing commodity. We believe PLS provides the most attractive exposure to lithium as a future facing commodity. The company's flagship project, the Pilgangoora spodumene project, is well positioned to benefit from continued high lithium prices. The project is in the process of undertaking a 100ktpa capacity expansion to 680ktpa, with a clear path to 1,000ktpa through additional – and capital efficient – brownfield expansions. The company is progressing a downstream lithium hydroxide strategy with partner POSCO and assessing the potential to produce a value-added lithium/salts product.

Nine Entertainment (NEC) – we added to our position in the media company reflecting our constructive outlook for advertising spend, and NEC's ability to grow higher-margin digital revenues in a potentially softer environment. The company's sell off CYTD in part reflects the sell-off in Domain (DHG), which is 59% owned by NEC. The sell-off in both companies placed NEC, excluding DHG, on a 3.9 times FY23 EV/EBITDA multiple which we regard as attractive for a leading media company which is diversifying its revenue streams to be less cyclical, driven by higher margin digital revenues.

**Key Sales**

Eclipx Group (ECX) – we reduced our position following recent outperformance and to reflect the abnormally strong earnings contribution from end of lease income. We continue to hold a position reflecting our views on continued asset growth supported by market share gains, cost reduction opportunities to offset inflation and balance sheet strength which should support continued share buybacks.

Australian Clinical Labs (ACL) – we reduced our position during the period following recent outperformance. We continue to hold a position given available growth upside from normalisation post COVID-19 and market share gains available particularly in NSW and QLD. Further, productivity programs and cost synergies will support margin expansion and we are encouraged by continued industry consolidation opportunities.

Worley (WOR) – we modestly reduced our position in the energy, chemicals and resources engineer during the period following a period of strong performance. We remain overweight WOR. Following years of underinvestment in oil & gas projects, and with the more recent supply disruptions stemming from the war in Ukraine, expectations for project spend across WOR's traditional customer base has increased to 27% growth (y/y). There is also a strong pipeline of accretive capital spend required to decarbonise energy production and provide more sustainable solutions across chemical and resources customers.

**Key Active Overweights**

Link Group (LNK) – we are positive on the company because we see compelling value in its base share registry business and electronic conveyancing business, PEXA, which has been supported by recent corporate interest. Our positive view of PEXA is premised on the infrastructure-like characteristics of its property settlement exchange upon maturity, supplemented by numerous growth opportunities in immediate adjacencies.

Worley (WOR) – following years of underinvestment in oil & gas projects, and with the more recent supply disruptions stemming from the war in Ukraine, expectations for project spend across the engineering services firm's traditional customer base has increased to 27% growth (y/y). There is also a strong pipeline of margin accretive capital spend required to decarbonise energy production and provide more sustainable solutions across chemical and resources customers. We also believe that future incremental margins could surprise to the upside following the company's $375m cost-out program announced during the recent COVID-interrupted period.

OZ Minerals (OZL) – we retain an overweight position in the copper producer. The company was subject to a takeover offer from BHP during the period. The offer, priced at $25 per share, represented a 32% premium to the pre-bid price. With the OZL board rejecting the initial offer, we recognize the potential for BHP to return with a higher bid. The potential for a counterbidder to emerge is limited, in our view, given BHP's significant available regional synergies. We retain our fundamental positive view on OZL due to its two high quality, long life, 100% owned copper mines in South Australia – Prominent Hill and Carrapateena. We expect the company's copper production to double to >200ktpa by 2030, as Carrapateena moves to a block caving operation, and the company develops the greenfield West Musgrave copper/nickel deposit in Western Australia.

**Key Active Underweights**

WiseTech (WTC) – we remain underweight the Australian based provider of software services to the logistics industry. Historically, WTC's many acquisitions have diluted group margins, with the company's 38 acquisitions since 2016 creating issues for earnings quality. Despite announcing a positive financial result during the period, in part reflecting the rally in the longer dated end of the yield curve, we retain a preference for other names in the technology sector at this time.

Allkem (AKE) – we remain underweight Allkem, retaining a preference for Pilbara Minerals (PLS) amongst lithium exposures. While we recognize the company offers lithium supply diversity across both its brine (Olaroz), and hard-rock (Mt Cattlin) operations, we remain concerned with asset-specific risks. Firstly, Olaroz has faced significant operating challenges associated with chemical processing at altitude, while hyperinflation challenges in Argentina present a macro risk overlay. Finally, we retain a cautious view on the Mt Cattlin mine, which is a smaller and higher cost spodumene facility than competitor PLS's Pilgangoora operations.

Ampol (ALD) – our underweight is premised on a negative long-term view of the petrol station industry and oil refining. As electric vehicle (EV) penetration increases amid the growing need to decarbonise, we see a limited ability for ALD to switch its refuelling infrastructure to electric charging stations given increased competition (e.g. shopping malls) and as consumers increasingly charge at home. In the short term, higher margins at its Lytton refinery are more than offsetting relative weakness from the rest of its Fuels & Infrastructure (F&I) division, where ALD is unable to pass on higher fuel costs. In addition, its Convenience Retail division has benefited from the "shop local" theme, a trend we expect will reverse as consumer behaviour normalises post-COVID.

## Market outlook

Financial markets have now embraced the risk of recession in the US and Europe over the past quarter, and the gap between our more pessimistic forecasts for the global economy and the consensus has narrowed. Indeed, with the Fed signalling that financial conditions are close to neutral, we are edging closer to the point where the pace of monetary tightening will slow, providing some scope for risk markets to recover some lost ground.

The period of excess inflation is starting to recede, with prior surges in commodity prices retreating, an easing in supply constraints, and signs of slowing demand likely to compress elevated sales margins. As central banks continue to await firmer signs that inflation expectations have stabilised and for labour demand to ease, financial markets are faced with the positive news of less restrictive monetary policy and the negative news of likely weaker company earnings.

In a world of heighted concerns of recession in major developed economies, subdued economic activity in China and ongoing conflict between Russia and the Ukraine which has contributed to commodity shortages, high inflation and rising interest rates, the Australian economy presents as a relative safe haven.

Australia's economic data has remained robust in 1H2022, although we do expect economic activity to slow significantly in 2023 to average just 1.5%. While a local recession is possible in 2023, we believe Australia should be able to avoid a technical recession due to three key reasons:

1. Australia has been a net beneficiary of global commodity shortages. This surge in commodity prices saw Australia's export prices in A$ terms move to their highest levels since the 1880s in 1H2022. The consequence has been strong national income growth, profits growth and an improving underlying fiscal position.
2. The household sector continues to hold a significant buffer of over $160bn of excess savings relative to pre-COVID levels. Although we expect the impact of higher interest rates and higher living expenses will curtail consumer spending, we do expect the combination of rising wage growth and a run down in the level of savings to continue to support consumption spending.
3. Low levels of spare productive capacity, strong profit and low corporate debt have contributed to robust capital investment intentions.

Over the medium term we believe a recovery in net immigration levels into Australia and Australia's exposure to key commodities crucial to the global energy transition will provide a solid underpin for future economic growth.

While the RBA has been later than most other developed nations in tightening policy, tighter financial conditions in 2022 are likely to come via both significantly higher cash rates and a stronger currency. We expect that the RBA cash rate will finish the year at 2.85%, below market expectations of 3.25%, and view A$ as risks skewed to the upside. Australia's external accounts are in their best position since the early 1970s, providing an incentive for the A$/US$ to commence an appreciation cycle, together with the attractive carry on offer and the prospect the US$ uptrend will peak as the Fed pivots from its aggressive hiking strategy. We expect the A$ will finish 2022-23 at around 76 cents.

We are most overweight stocks within the Communication Services, Health Care and Information Technology sectors, and are underweight Real Estate, Energy and Materials.

## Sector allocation

| | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| Communication Services | 13.26 | 5.85 | 7.41 |
| Consumer Discretionary | 9.50 | 11.16 | -1.66 |
| Consumer Staples | 1.55 | 4.03 | -2.48 |
| Energy | 4.32 | 7.77 | -3.45 |
| Financials | 9.59 | 10.71 | -1.12 |
| Health Care | 8.00 | 3.99 | 4.01 |
| Industrials | 11.73 | 11.73 | 0.00 |
| Information Technology | 9.46 | 8.71 | 0.75 |
| Materials | 22.56 | 25.28 | -2.72 |
| Real Estate | 2.88 | 9.80 | -6.92 |
| Utilities | 0.00 | 0.97 | -0.97 |

## Top 5 holdings

| | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| OZ Minerals | 4.74 | 1.62 | 3.12 |
| Worley | 4.32 | 1.01 | 3.31 |
| Atlas Arteria | 4.30 | 1.44 | 2.86 |
| Carsales.com | 4.20 | 1.49 | 2.72 |
| Link Administration | 3.82 | 0.48 | 3.34 |

## Key active positions

| Overweights | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| Link Administration | 3.82 | 0.48 | 3.34 |
| Worley | 4.32 | 1.01 | 3.31 |
| OZ Minerals | 4.74 | 1.62 | 3.12 |
| **Underweights** | | | |
| Wisetech Global | 0.00 | 1.80 | -1.80 |
| Allkem | 0.00 | 1.55 | -1.55 |
| Ampol | 0.00 | 1.55 | -1.55 |

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 | -8.58 | 4.91 | 7.13 | 8.79 |
| Distribution return | 1.18 | 0.70 | 0.80 | 1.02 |

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 | November 1994 |
| Fund size | A$98.9 mn as 31 August 2022 |
| APIR codes | JBW0007AU |
| ARSN code | 089 909 106 |
| Distribution frequency | Semi-Annually |

| Estimated management cost | 1.90% p.a. |
|---|---|
| Buy/sell spread | +/- 0.20% |

The Yarra Emerging Leaders Fund (Direct) is not available for new investment. Where existing reinvestment instructions are in place, distributions may be reinvested.

## Applications and contacts

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

**Website** www.yarracm.com

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

**Disclaimers**

The Yarra Emerging Leaders Fund (Direct) is substantially invested in the Yarra Emerging Leaders 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. The Fund's benchmark comprises 50% S&P/ASX Midcap 50 Accumulation Index and 50% S&P/ASX Small Ordinaries Accumulation Index.

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