YARRA CAPITAL MANAGEMENT

Yarra Emerging Leaders Fund

Gross returns as at 31 July 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	9.04	-8.10	-2.44	6.60	9.92	12.62	11.12
Emerging Leaders Combined Benchmark†	10.31	-7.69	-6.32	5.69	8.82	9.80	7.14
Excess return (before fees)‡	-1.27	-0.42	3.88	0.91	1.10	2.82	3.98

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 management costs, meaning they do not reflect the deduction of any investment management fees and expenses 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 July 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	8.92	-8.39	-3.65	5.29	8.57	11.23	9.82
Emerging Leaders Combined Benchmark†	10.31	-7.69	-6.32	5.69	8.82	9.80	7.14
Excess return (after fees)‡	-1.38	-0.70	2.67	-0.41	-0.26	1.43	2.68

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* 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 increased during July, as market expectations increased that interest rates have peaked following weakening economic data, particularly offshore.

The Emerging Leaders Benchmark returned +10.3% for the month, taking its 12-month return to -6.0%. In comparison, the broader ASX300 gained +5.9% for the month and global indices were positive (MSCI World Index +7.9%).

After several months of declines the Information Technology sector (+19.2%) was the best performer, with Block Inc (SQ2, +19.9%), Data#3 (DTL, +32.3%) and Megaport (MP1, +20.8%) all outperforming as the sector benefitted from a rally in the longer dated end of the yield curve.

Elsewhere, Real Estate (+12.4%) bounced back from recent lows, led by Home Consortium (HMC, +18.6%) and Lifestyle Communities (LIC, +24.1%).

Conversely, the worst performing sector was Consumer Staples (-1.2%) which was dragged lower by Australian Agricultural Company (AAC, -14.3%), Elders (ELD, -10.4%) and Costa (CGC, -10.1%), companies which had previously been safe haven stocks and have negative correlations with inflation.

Portfolio review

Key Contributors

Megaport (MP1) – the company outperformed during the period after reporting a stronger than expected June quarter result across revenue growth (+10% quarter on quarter) and its first positive quarterly EBITDA result. We see strong growth from the core business connecting data centres to the cloud, with a strong global pipeline as businesses invest in IT projects. With its expansion into broader telecommunication services – which leverages the same infrastructure – the total addressable market more than doubles. While the company is currently at an inflection point for earnings and cashflow, we believe all metrics will turn positive in the next year offering significant long-term earnings and cashflow potential.

Nanosonics (NAN, overweight) – the disinfection medical device maker outperformed during the month as growth stocks found support following a period of underperformance. Our overweight position is premised on the company's global market leadership in a large and growing addressable market. While growth rates had been interrupted by COVID and access to hospitals, 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 and continue to develop new markets in the UK, Europe and Japan. Nanosonics has attractive economics with a high level of recurring revenue from consumables and upside from accelerating the upgrade cycle and new products.

Pinnacle Investment Management (PNI) – the investment manager outperformed during the period, supported by higher equity markets and the company reporting higher than expected performance fees. We remain positive on PNI going forward with continued inflows supported by strong products and international distribution, further margin expansion supported by the fixed cost nature of funds management businesses and new manager formation both organically and via acquisitions.

Key Detractors

Atlas Arteria (ALX, overweight) – the toll road operator underperformed during the month after IFM, which had built an approximate 15% stake in the company at above market levels the prior month, announced they were not in a position to make a bid at this time. We maintain an overweight position as we see a path towards significant value creation for ALX through concession extensions at APRR, achieved as a means of funding expansion projects, and settling the Dulles Greenway tolling regime. With IFM having put ALX into play, we do currently believe a privatisation transaction of some form remains a likely outcome.

Worley (WOR, overweight) – the energy services firm underperformed as crude oil WTI declined from the peak of US$120/bbl as economic data from China and the US continued to deteriorate. 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 (YoY). 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.

WiseTech (WTC, underweight) – the provider of software services to the logistics industry outperformed following a strong 12% upgrade to FY22 EBITDA guidance driven by accelerated organic revenue growth in its core and higher margin CargoWise product in 2H22. No significant businesses were acquired during the half; historically, WTC's purchases have diluted group margins, resulting in the lack of acquisitions also supporting the upgrade. The company also benefitted from the rally in the longer dated end of the yield curve, alongside other technology stocks. We remain underweight WTC with a preference for other names in the technology sector. The company's 38 acquisitions since 2016 has created issues for earnings quality and raised broader questions around corporate strategy.

Key Purchases

Nanosonics (NAN) – we increased our position during the period following a material sell-off in high growth stocks, which created an attractive entry point for investors with a long-term investment horizon. 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 and access to hospitals, 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 and continue to develop 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 new products.

Carsales.com (CAR) – we participated pro-rata in CAR's equity raising during the period to acquire the remaining 51% of Trader interactive, CAR's US based classifieds business. There is strong potential for growth from various drivers across the trader Interactive business, including: an uplift in dealer penetration, moving from a subscription based to a leads-based and higher yielding model, and an improvement in inventories on the site.

NextDC (NXT) – we took the opportunity to add to the portfolio's position in NXT during the month. NXT, along with its technology peers, has lagged the market in the calendar year to date. We believe the high recurring nature of NXT's revenues, its infrastructure like characteristics and tangible asset base are attractive. NXT has been excessively discounted and see no diminution to its growth trajectory. NXT trades on 23.6 times FY24 EV/EBITDA, which compares favourably to its more mature global peers.

Key Sales

Virtus Health (VRT) – we exited our position in the company following the successful takeover by BGH, which we supported, and which realised good value for investors. Our original investment thesis was premised on several factors: treatment markets rebounding following the COVID-related disruption, a strengthening competitive position in Australia given VRT's superior offering, and a market leading position in offshore markets Singapore, Denmark and Ireland. Lastly, VRT's balance sheet had improved, the growth strategy remains capital light and the company was trading at a compelling valuation.

Atlas Arteria (ALX) – we took the opportunity to trim the ALX position following the outperformance that resulted from IFM's approach. Despite IFM not following through with a formal bid (at this stage), we maintain an overweight position as we see a path towards significant value creation for ALX through concession extensions at APRR to help fund expansion projects and settling the Dulles Greenway tolling regime. With IFM having put ALX into play, we do believe a privatisation transaction of some form remains a likely outcome.

Sandfire Resources (SFR) – we reduced our exposure to the company during the period. With the DeGrussa project ceasing production in the coming months, Sandfire's production is entirely dependent on the MATSA project in southern Spain prior to the start-up of the Motheo project in Namibia. Sandfire is a higher cost producer than peer OZ Minerals (OZL), with a higher risk growth profile in our view. We believe the recent fall in copper prices is now largely complete given cost curve support, and as a result we are comfortable retaining our exposure to copper but have reduced our Sandfire position in preference to OZ Minerals.

Key Active Overweights

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 WOR's traditional customer base has increased to 27% growth (YoY). There is also a strong pipeline of margin accretive capital spend required to decarbonise energy production and provide more sustainable solutions for chemical and resources customers. We also believe incremental margins could be higher going forward after the company's $375mn cost-out program during COVID.

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. We hold a positive view of PEXA premised on the infrastructure-like characteristics of its property settlement exchange upon maturity, supplemented by numerous growth opportunities in immediate adjacencies.

Nanosonics (NAN) – our overweight position is premised on the company's global market leadership in a large and growing addressable market. The growth rates had been interrupted by COVID and access to hospitals, however, 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 and continue to develop 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 new products.

Key Active Underweights

WiseTech (WTC) – the provider of software services to the logistics industry outperformed following a strong 12% upgrade to FY22 EBITDA guidance driven by accelerated organic revenue growth in its core and higher margin CargoWise product, and a lack of acquisitions which have historically diluted group margins. We remain underweight WTC with a preference for other names in the technology sector. The company's 38 acquisitions since 2016 have created issues for earnings quality and raised broader questions around corporate strategy.

Vicinity Centres (VCX) – notwithstanding updated June-22 valuations reflecting sequential appreciation (-4bps in average cap rate to 5.31%), we see medium-term valuation risk in the shopping mall REIT amid the outlook for higher real rates and slowing rental growth. Further, we continue to believe that shopping mall REITs face structural issues, which are not yet fully captured, with VCX currently trading at 0.89 times trailing NTA and offering 5.8% forward dividend yield.

Ampol (ALD) – our underweight position 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, which 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.

Indeed, 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, and although we do expect economic activity to slow in FY23 we do not expect a recession in Australia 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 $150bn of excess savings (approximately 7% of GDP) relative to pre-COVID levels. Although we expect the impact of higher interest rates and higher living expenses to 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 the key commodities crucial to the global energy transition – including copper, lithium and iron ore – 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. While we expect that the RBA Cash Rate will finish the year at less than 2.5%, below market expectations of 3.0%, the A$ risk continues to skew 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, improving China economic data and the prospect the US$ uptrend will peak as the Fed pivots from its aggressive hiking strategy. We expect the A$ will finish 2022 at around 76 cents.

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

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	13.17	5.85	7.32
Consumer Discretionary	9.81	11.46	-1.65
Consumer Staples	1.43	3.95	-2.52
Energy	4.65	7.44	-2.79
Financials	9.54	11.12	-1.58
Health Care	9.49	4.16	5.33
Industrials	11.61	11.94	-0.34
Information Technology	10.52	8.88	1.64
Materials	19.24	23.77	-4.52
Real Estate	3.05	10.33	-7.28
Utilities	0.00	1.10	-1.10

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Worley	4.65	1.04	3.61
Atlas Arteria	4.26	1.45	2.81
Carsales.com	4.06	1.41	2.65
Link Administration	4.05	0.49	3.56
OZ Minerals	3.98	1.23	2.75

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Worley	4.65	1.04	3.61
Link Administration	4.05	0.49	3.56
Nanosonics	3.31	0.27	3.04
Underweights			
Wisetech Global	0.00	1.59	-1.59
Vicinty Centres	0.00	1.56	-1.56
Ampol	0.00	1.56	-1.56

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	-15.82	-0.16	4.37	7.90
Distribution return	12.18	5.45	4.19	3.33

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	A$69.7 mn as at 31 July 2022	
APIR codes	JBW0010AU	
Estimated management cost	1.25% p.a.	
Buy/sell spread	+/- 0.20%	
Platform availability	Asgard Ausmaq BT Panorama BT SuperWrap Financial Index	Hub24 Macquarie Wrap Mason Stevens MLC Wrap OneVue

Investment performance comparison of $50,000

After fees, since inception of the Yarra Emerging Leaders Fund, September 1997 to July 2022.

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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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