YARRA CAPITAL MANAGEMENT

Investment Commentary
Month to 31 May 2023

Yarra Emerging Leaders Fund

Gross returns as at 31 May 2023

	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	-1.27	3.25	7.33	12.82	8.21	11.26	11.13
Emerging Leaders Combined Benchmark†	-1.63	-0.19	-0.62	9.39	5.68	8.95	6.98
Excess return (before fees)‡	0.36	3.43	7.94	3.44	2.53	2.31	4.15

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 May 2023

	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	-1.37	2.93	6.00	11.43	6.87	9.89	9.83
Emerging Leaders Combined Benchmark†	-1.63	-0.19	-0.62	9.39	5.68	8.95	6.98
Excess return (after fees)‡	0.26	3.11	6.62	2.04	1.19	0.94	2.84

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: 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

The Australian small and mid-cap market performed poorly in the month of May, with nearly every sector delivering negative returns. Whilst the 10-year bond yield rose to 3.6%, on the resumption of cash rate hikes.

The Emerging Leaders benchmark returned -1.6% for the month, taking its 12-month return to -0.6%. The broader S&P/ASX 300 delivered -2.5% return for the period and, globally, the MSCI World Index returned -0.9%.

Utilities (+13.1%) was the top performing sector, explained by AGL Energy (AGL, +13.1%) after the market became increasingly comfortable with the electricity generator and energy retailer's near-term earnings outlook, supported by higher wholesale electricity costs.

Information Technology (+7.0%) was the only other sector to rally during the month. WiseTech (WTC, +9.2%) and NEXTDC (NXT, +11.8%) were the primary contributors, as the market's confidence in Artificial Intelligence (AI) applications as a driver of demand growth continued to strengthen.

Conversely, Consumer Discretionary (-7.2%) was among the worst performers for the period with IDP Education (IEL, -22.5%) as a main detractor. The $1.1 billion fall in value of IEL was triggered by the Canadian government's decision to widen access to its Student Direct Scheme to rivals. Underperformance from several retailers including Lovisa (LOV, -22.5%), Premier Investment (PMV, -13.9%) and Super Retail (SUL, -15.5%) further pressured the sector's performance during the month.

Portfolio review

Key Contributors

NEXTDC (NXT, overweight) – following the announcement of its largest ever individual contract the previous month, the data centre provider continued to outperform as the market's conviction in Artificial Intelligence (AI) applications as a driver of demand growth grew. Most notably, global leading specialist chip maker Nvidia's commentary around AI driven demand growth supported previous comments made by NXT management.

Worley (WOR, overweight) – our overweight position in the leading provider of global engineering services was a source of outperformance in May. The company provided a strong operating update at its annual investor day, with leading indicators (Factored Sales Pipeline +36%, Rolling 12 Month Bookings +28%, Backlog +8%) all improving. Additionally, WOR reported 39% of revenue for the half was higher margin sustainability-related work. We expect revenue to grow 13-15% in FY23, with leading indicators (Factored Sales Pipeline +36%, Rolling 12 Month Bookings +28%, Backlog +8%) and structural drivers (capital investment required to decarbonise) pointing to strong top-line growth. Margins are also set to accelerate over the coming years as WOR benefits from a more consolidated industry structure, operating leverage, and active mix management.

Kelsian (KLS, overweight) – the transport services operator outperformed in May, despite no material company specific news. We maintain a positive view across the three divisions of Australian buses, US buses and Australian tourism. We believe the Australian bus business will return to earnings growth given the defensive nature of its existing contacts (i.e. with cost pass through), extra charter work and improved staff availability. The US bus business has a strong demand outlook from new and existing customers, and pricing increases to offset cost inflation. The Australian tourism assets will benefit from the post-COVID recovery across both international and domestic visitors, with a number of years of pent-up demand.

Key Detractors

oOh! Media (OML, overweight) – the outdoor media company underperformed in May given short term cyclical headwinds to revenue and higher than expected costs on contract renewals. We continue to hold an overweight position in OML given cyclical media market upside in the longer term, with the outdoor media category set to expand its share of traditional advertising (digital product / improved audience measurement). Lastly, OML is improving its market share of the outdoor category, we expect cost growth will be limited – the company has high fixed cost leverage – and the balance sheet is strong which provides support to the current share buyback.

Allkem (AKE, underweight) – our underweight position in the lithium producer was a portfolio detractor during the month. Lithium carbonate prices rallied strongly from recent lows across the period to end the month up 60% at $42k/t. In addition, AKE announced plans to merge with peer Livent Corporation (LTHM.US), with the merger ratio implying a 7% premium for AKE shareholders. Our preference amongst lithium exposures is IGO. While we recognize Allkem offers lithium supply diversity across both brine (Olaroz), and hard-rock (Mt Cattlin) operations, we are concerned with its material asset-specific and geopolitical risks.

Nanosonics (NAN, overweight) – the disinfection medical device company underperformed during the period following significant outperformance in prior months, despite no specific company news. We remain positive on the long-term growth opportunity as the global market leader in probe disinfection: we expect strong organic sales growth will be driven by adoption of the product in existing markets including the US, Europe and the UK. We are also positive on the opportunity to expand into new markets such as Japan and China, the upgrade cycle for the next generation Trophon product and the company's strong pipeline of new product activity which is supported by significant R&D investment.

Key Purchases

Region (RGN) – we initiated a position in the suburban shopping mall owning REIT in the period. We believe RGN's retail asset base, which comprises 96 predominantly neighbourhood shopping centres, will prove to be resilient during the consumer downturn. This is supported by its high skew to supermarket/anchor tenant income (46% total Net Operating Income), affordable specialty rents (8.7% average occupancy cost) and high overall portfolio occupancy (98%). The stock valuation is attractive, at 0.95 times net asset backing and offering a 5.8% dividend yield.

NEXTDC (NXT) – we added to our position in the data centre provider during the period. Following the announcement of its largest ever individual contract the previous month, NXT has continued to outperform as the market's conviction in Artificial Intelligence (AI) applications as a driver of demand growth grew. Most notably, global leading specialist chip maker Nvidia's commentary around AI driven demand growth supported previous comments made by NXT.

Netwealth (NWL) – the portfolio increased its position in the leading independent wealth management platform provider during the month. NWL is set to continue its strong revenue growth for the foreseeable future and capture an outsized level of funds under administration as Australia's wealth management industry fragments away from the historically dominant players. In our view, NWL's valuation of 23 times FY24 EV/EBITDA does not capture its long-term growth opportunity, high incremental margins and strong cash flow generation.

Key Sales

OZ Minerals (OZL) – we exited our position in the copper producer during the period, following completion of the $28.25/share all-cash takeover from diversified miner BHP.

Lottery Corporation (TLC) – we divested our position in the lotteries business given the company now sits outside the portfolio's mandate. We continue to hold a favourable view of the stock, noting that while jackpot sequences are largely luck dependent and vary week-to-week, we expect they will normalise over time with limited implications for our long-term view. With cash generative assets underpinned by long-dated licenses, we continue to view TLC as an attractive blend of growth and yield at a reasonable asking price for what we view as a high-quality business (16.0 times EV/EBITDA and offering a 3.5% div yield).

Nanosonics (NAN) – we reduced our position in the disinfection medical device company following significant outperformance in prior months, but remain positive on the long term growth opportunity as the global market leader in probe disinfection. We expect strong organic sales growth will be driven by adoption of the product in existing markets such as the US, Europe and the UK, expansion into new markets like Japan and China, the upgrade cycle for the next generation Trophon product and a strong pipeline of new product activity supported by significant R&D investment.

Key Active Overweights

Reliance Worldwide (RWC) – the market is showing concern for a weaker demand environment for the manufacturer and distributor of plumbing and heating parts, with RWC's FY23 earnings estimates now lowered after recent market updates. We view RWC as a compelling opportunity; while the market is pricing for a significant decline in earnings (P/E of only 15.3 times vs 17.0 times mid-cycle), we remain constructive on the demand environment given the defensive nature of RWC's revenue base of which the majority relates to non-discretionary repair activity.

NEXTDC (NXT) – the portfolio holds an overweight position in NXT which we view as holding a leading position in the domestic data centre market with a proven ability to deploy capital into its data centres at attractive returns. NXT's recent and very large 36MW increase in contracted capacity demonstrates the continued structural growth of demand for data centre capacity in the Australian market, mirroring global trends. We view NXT's current 29 times FY25 EV/EBITDA multiple as attractive given these trends.

Worley (WOR) – we remain overweight the leading provider of global engineering services. WOR's earnings recovery is in its early stages following COVID impacts across FY20-22. Revenue is expected to grow 13-15% in FY23 with leading indicators (Factored Sales Pipeline +36%, Rolling 12 Month Bookings +28%, Backlog +8%) and structural drivers (capital investment required to decarbonise) pointing to strong top-line growth ahead. Margins are also set to accelerate over the coming years as WOR benefits from a more consolidated industry structure, operating leverage, and active mix management.

Key Active Underweights

WiseTech (WTC) – we remain underweight the logistics industry software solutions provider, with a preference for other names in the technology sector given WTC's demanding valuation of 92.0 times 1-year forward P/E. We believe WTC is continuing to build an exceptional product in CargoWise which should continue to attract and retain large and key freight forwarders. Despite WTC's high-quality earnings growth, we struggle to justify paying 92.0 times earnings given the more attractive opportunities available in the sector (e.g. XRO).

Allkem (AKE) – we remain underweight the lithium producer, instead retaining a preference for lithium exposure via IGO. While we recognize Allkem offers lithium supply diversity across both brine (Olaroz), and hard-rock (Mt Cattlin) operations, we remain concerned by asset-specific risks. Olaroz has faced significant operating challenges associated with chemical processing at altitude, while hyperinflation challenges in Argentina present a macro risk overlay. Mt Cattlin is a smaller and higher cost spodumene mine than IGO's Greenbushes operations. The proposed merger with Livent Corporation (LTHM.US) offers increased vertical integration, but further focuses AKE in South America.

Washington H Soul Pattinson (SOL) – we do not hold a position in the diversified investment company. At this time we see better direct investment opportunities available than those offered through SOL's broad suite of investments across the telco, mining, manufacturing, healthcare and funds management sectors. We also remain cautious on the company's exposure to coal via its 37.8% stake in coal miner New Hope (NHC).

Market outlook

We have been of the view that the June quarter 2023 will mark the top of the interest cycle for most of the developed world, however, global central banks are seemingly prepared to continue hiking interest rates despite evidence inflation is moderating, lending availability tightened and economic growth is faltering. With respect to the latter, we have received confirmation that the Euro Area entered recession and the Federal Reserve staff have retained their forecast that a modest recession in the US is likely. Nevertheless, it seems the appetite for policy makers to persist with the tightening cycle into Q3 has remained, with central bankers seemingly perplexed at why services inflation has yet to ease and why the labour market has yet to ease appreciably. It is possible that a pause in the hiking cycle in June by the Fed will set the scene for a pause across most of the developed world, however, the risk of overtightening and even weaker economic activity is now a real prospect. We believe the US labour market is set to post more modest employment gains from mid-23 which in concert with improving labour supply will continue to moderate wage growth and help underwrite the commencement of a gradual easing cycle in the US by the end of 2023. However, we have to acknowledge that the message from most central banks is that further hikes may be required and an interest rate easing cycle is not in prospect.

This weak economic growth narrative in concert with enthusiasm over the potential impacts from AI has seen large cap 'growth' stocks drive a narrow but strong equity market rally. This has largely hidden from view an ongoing negative earnings revision cycle which in concert with rising bond yields is leaving aggregate markets valuations looking more challenging.

Economic growth has also slowed in Australia, recording just 0.3%qoq growth in the March quarter and much of this growth can merely be traced to strong population growth and ongoing engineering construction projects. It is clear the prior tightening of monetary policy is having a material impact on the interest rate sensitive parts of the economy. Nominal retail sales have slowed to 0% six -month annualised, following on from declining volumes in recent quarters. Building approvals continue to decline and are likely to decline further in coming months as declining housing affordability outweighs the impact of an under supplied housing market. Moreover, it is also clear that despite the Federal Budget forecast to return to surplus, that government demand growth is waning even faster than private demand growth.

Nevertheless, after describing the May decision to increase interest rates as finally balanced, the Reserve Bank of Australia (RBA) followed up with a further hike in June and has flagged that further tightening may be required. The RBA has clearly shifted its focus to worrying about weak productivity growth and high unit labour costs as the main reason for fearing inflation may be higher than it forecasts. We think this ignores the fact that average compensation per hour has not risen sharply, and the main reason for high unit labour costs is a surge in hours worked and employment as the influx in immigration is absorbed into a slowing economy. This shift in the RBA's focus risks a further hike in July or August, however, in our view the RBA would have been better served to pause after the May rate hike, rather than risking a harder economic landing.

Australia should still be able to avoid a technical recession due to four key reasons:

1. Australia has been a net beneficiary of global commodity shortages and the prior surge in commodity prices. Commodity prices are now off their peaks, and although they remain very elevated from a historical perspective, the impact of moving through the peak will be for nominal GDP growth will slow quickly over the next 6 months, removing some of the cushion that has protected corporate profits, tax receipts and wage growth.
2. The household sector continues to hold a significant buffer of excess savings which can be used to smooth consumption growth amid acute cost of living pressures. Nevertheless, our analysis suggests that the residual of the savings buffer skews to older households, leaving younger and more indebted households exposed. As such we remain particularly cautious on discretionary retail spending.
3. Australia remains incredibly well placed to benefit from the global energy transition. Lithium is already a A$10bn export industry for Australia and Australia is the world's dominant producer. Electric Vehicle sales are forecast to increase 10 times by 2030 and Australia has the world's 2nd largest copper resource. LNG is an important energy transition fuel, and currently accounts for 23% of global electricity generation. Australia just happens to be the world's equal largest exporter of LNG. The limiting factor nearer term is that escalating costs and project delays risk pushing out the economic benefits.
4. Net migration into Australia contracted in 2021 for the first time since 1945. However, a very strong recovery was recorded through 2022 and a record level of net migration has occurred in recent months, ensuring that Australia's population growth will exceed 2% in 2023. This will be the primary mechanism keeping Australia out of recession, yet it comes with the complication of exacerbating the rental shortage evident across all capital cities.

While the RBA has been later than most other developed nations we believe financial conditions are now firmly in the restrictive zone. From our perspective, the RBA's focus on global growth, trends in household spending and the outlook for inflation and labour markets in informing their future decisions suggest that multiple additional hikes are unlikely to be required. Surprisingly, the RBA cited the A$ and house prices as a catalyst for the May rate hike, neither of which had risen materially. While interest rate hikes in Australia will remain a month-to-month proposition for the next six months, our bias is that the RBA should have concluded its hiking cycle yet an ever-shifting RBA framework suggest they may hike again in July or August. It is unlikely that policy easing will be delivered in 2023, however, we do expect that the RBA will commence a modest easing cycle in 1H24.

The A$/US$ had been under downward pressure as markets grappled with a seemingly more hawkish Fed and a relatively more dovish RBA. However, the RBA has recently sounded more hawkish than the Fed the A$ has started to appreciate. With Australia's external accounts remaining in excellent health, our expectation that Australia's economic growth will prove more robust, and the prospect the US$ down trend will persist as the Fed pivots from its hiking strategy to an easing cycle in 2023, we expect the A$/US$ will appreciate to the mid-70s towards the end of 2023.

We are most overweight stocks within the Communication Services, Health Care and Industrials sectors, and are underweight Energy, Real Estate and Consumer Discretionary.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	11.91	6.16	5.76
Consumer Discretionary	8.06	10.84	-2.78
Consumer Staples	1.27	3.63	-2.35
Energy	0.00	6.67	-6.67
Financials	11.46	10.73	0.74
Health Care	9.10	5.11	3.99
Industrials	16.11	13.16	2.95
Information Technology	10.70	8.87	1.83
Materials	22.04	23.56	-1.52
Real Estate	5.15	10.20	-5.05
Utilities	0.00	1.08	-1.08

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Reliance Worldwide	5.37	0.64	4.73
NEXTDC	5.28	1.26	4.02
Worley	4.98	1.17	3.81
Carsales.com	4.73	1.68	3.05
Iluka	4.25	0.92	3.33

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Reliance Worldwide	5.37	0.64	4.73
NEXTDC	5.28	1.26	4.02
Worley	4.98	1.17	3.81
Underweights			
Wisetech Global	0.00	2.51	-2.51
Allkem	0.00	1.71	-1.71
Washington H. Soul Pattinson	0.00	1.51	-1.51

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	-7.99	5.47	2.66	6.51
Distribution return	14.00	5.96	4.21	3.37

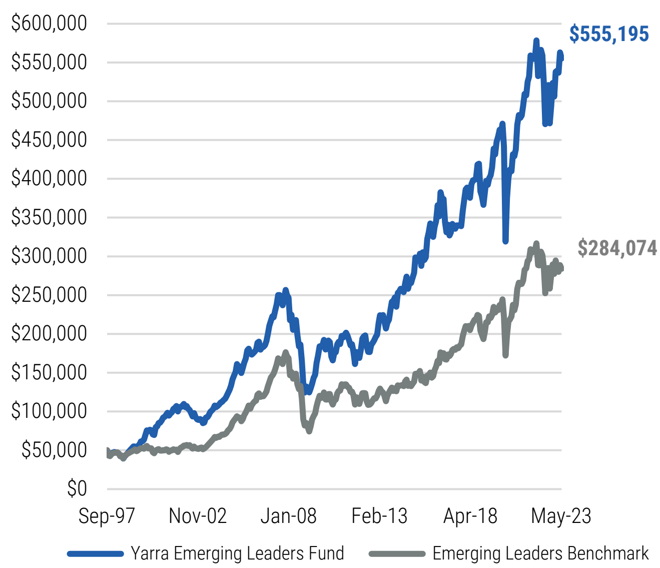
The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders 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$88.8 mn as at 31 May 2023	
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 May 2023.



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Applications and contacts

Investment into the Yarra Emerging Leaders Fund can be made by Australian resident investors only.

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