YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 30 June 2022

Yarra Australian Real Assets Securities Fund

Gross returns as at 30 June 2022

	From 17 December 2015	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception^ % p.a.
Yarra Australian Real Assets Securities Fund	7.73	-5.12	-7.74	-1.03	0.60	6.25	9.53	7.92
S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Index*	6.84	-6.62	-8.84	1.86	0.08	5.26	NA	NA
Excess Return†	0.89	1.50	1.10	-2.89	0.52	0.99	NA	NA

Past performance is not a reliable indicator of future performance. Taxes payable by investors have not been taken into account. The figures shown have been provided for illustrative purposes – they are unaudited and subject to change. The total returns shown are gross of all fees, meaning they do not reflect the deduction of any investment management fees which would reduce returns and assume reinvestment of all distributions. Investment in the fund is not available on a fee free basis and this should be factored into any analysis of past performance.

Net returns as at 30 June 2022

	From 17 December 2015	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception^ % p.a.
Yarra Australian Real Assets Securities Fund	6.82	-5.18	-7.93	-1.87	-0.25	5.35	8.61	7.01
S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Index	6.84	-6.62	-8.84	1.86	0.08	5.26	NA	NA
Excess Return†	-0.02	1.44	0.91	-3.73	-0.33	0.09	NA	NA
Growth Return‡	NA	NA	NA	-24.82	-14.15	-12.46	-3.95	-2.49
Distribution Return‡	NA	NA	NA	22.96	13.90	17.81	12.56	9.50

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 of Yarra Australian Real Assets Securities Fund: December 2005.
* Effective 17 December 2015, the benchmark for the Yarra Australian Real Assets Securities Fund is the S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Index: a market cap weighted index of infrastructure, utilities and REIT securities included in the S&P/ASX300.
† Excess return: The excess return figures shown represent the difference between the portfolio's return and the benchmark return.
‡The Growth Return is measured by the movement in the Fund's unit price, ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders by way of income distribution in a 12-month period. It does not include distribution amounts deemed as capital distributions.

Market review

Australian Real Assets declined during the June 2022 quarter, but outperformed the broader market as a strong performance from Infrastructure & Utilities offset a sharp decline from the Real Estate sector.

The Custom Infrastructure, Utilities and A-REITs Accumulation Index returned -8.8% during the quarter, taking its 12-month return to +1.9%. In comparison, the broader S&P/ASX 300 Index returned -12.2% for the quarter and, globally, the MSCI World Index returned -14.2%. The ASX 300's forward P/E declined from 16.0 times to 12.5 times as the RBA lifted the official cash rate by 75 bps to 0.85%.

Within Infrastructure & Utilities (+4.2%) Tollroads and Utilities supported the benchmark. At a stock level, toll road operator Atlas Arteria (ALX, +23.1%) was the top performer due to its transparent inflation hedge embedded in its toll collections and, moreover, as IFM's global infrastructure fund took a 14.96% stake in the company, causing speculation of a possible takeover bid. Elsewhere, gas pipeline operator APA Group (APA, +8.2%) outperformed given its inflation-linked revenues and a renewed focus on its opportunities in the energy transition.

Conversely, REITs (-17.5%) declined sharply given their sensitivity to real interest rates. While Retail REITs declined the least amid strong consumer demand, Industrial and Diversified REITs declined sharply. Goodman Group (GMG, -21.4%) was the largest detractor to the benchmark's return after key tenant Amazon called out excess capacity in its fulfillment and transportation network. Other large falls came from fund manager REITs Charter Hall Group (CHC, -33.2%) and Centuria Capital (CNI, -35.3%).

Portfolio review

Key Contributors

Atlas Arteria (ALX, overweight) – the toll road operator outperformed due to its transparent inflation hedge and, moreover, as IFM's global infrastructure fund took a 14.96% stake in the company, causing speculation of a possible takeover bid. We maintain an overweight position based on ALX's strong liquidity and balance sheet position, discounted valuation and exposure to traffic recovery in Europe and the US. We see a path towards value creation for ALX through concession extensions at APRR achieved as a means of funding expansion projects and settling the Dulles Greenway tolling regime.

Charter Hall Group (CHC, underweight) – the fund manager REIT underperformed amid concerns around higher real yields and the prospect for lower FUM growth as the commercial real estate valuation cycle moderates. We remain underweight the stock based on our view that AUM growth and transaction volumes – which are running at elevated levels – will normalise in the medium term as the cap rate compression cycle slows. As the growth rate of the business slows from impressive double-digit levels, we expect the multiple to contract, likely putting pressure on the share price outlook. Within the real estate fund manager space, our preference is with Goodman Group (GMG).

Vicinity Centres (VCX, overweight) – the shopping mall REIT outperformed following a stronger-than-expected trading update and, moreover, due to its superior debt position versus peers given the rising interest rate environment. Management upgraded FY22 FFO to at or above 12.6 cents per share, reflecting better cash collection and the reversal of past provisions. We continue to see relative upside in the shopping mall REIT as Australia emerges from the COVID crisis. While we continue to believe that shopping mall REITs face structural rental challenges, we now believe this is well recognised with VCX trading at 0.9 times trailing NTA, and increasing direct transactional evidence at prices at or close-to prevailing NTA's. We view VCX as better positioned to navigate higher interest rates, with lower leverage and higher hedging than peers.

Key Detractors

APA Group (APA, underweight) – the gas pipeline operator outperformed in the period after hosting an investor day. Management highlighted its inflation-linked revenues and opportunities in the energy transition, particularly given the scale of investment required into variable renewable energy (VRE) and transmission. We remain underweight the company on the grounds that APA's initiatives to shift its business model towards electrification won't be sufficient. We expect it to be dwarfed by the discount increasingly applied to its gas pipeline business, particularly as planned government policies accelerate the shift to zero emissions sources. As a result, we no longer see its valuation (at a 12-month EV/EBITDA of 12.3 times) as sufficiently compelling when compared to large cap infrastructure alternatives.

Goodman Group (GMG, overweight) – the industrial REIT underperformed after key tenant Amazon called out excess capacity in its fulfillment and transportation network. We retain a small overweight position. The fundamentals for the business across key global markets are, in our view, strong, supported by tailwinds of e-commerce growth, supply-chain optimisation and a rebound in global industrial growth following COVID disruptions. We believe GMG can deliver strong earnings growth in FY22 with growing assets under management (at $60bn by year-end) and a strong development pipeline as the company benefits from the acceleration of e-commerce. In that context we do not see the headline valuation, at a 12-month forward EV/EBITDA of 21.0 times, as stretched.

GPT Group (GPT, overweight) – the diversified REIT underperformed despite reaffirming guidance during the period. Instead investors were focused on its debt burden going forward versus peers, with limited protection versus rising rates. Nevertheless, we believe GPT offers investors exposure to a high-quality, diversified commercial real estate portfolio. Its conservative balance sheet (gearing at <30%) and high level of liquidity ($1.2bn) provide us with confidence that the company is appropriately positioned for the forthcoming de-valuation cycle. Lastly, GPT's valuation has become more attractive at 0.73 times trailing NTA, which implies an approximate fall of 20% in gross asset values (when ascribing value to GPT's Funds Management business) – a more significant fall than our base expectations.

Key Purchases

Origin Energy (ORG) – we halved our underweight to the energy company during the period following recent underperformance. ORG has only a low level of Real Asset characteristics, so we would require compelling valuation to be overweight the name. ORG has announced the closure of its Eraring coal power plant which we view positively, given it positions the company as capital light participant in the energy transition with a large retail customer base.

Dexus Property (DXS) –we increased our position as the office REIT underperformed, but remain underweight. We believe structural risks emanating from COVID-19 are not yet fully reflected in its valuation, trading at 0.76 times trailing NTA. DXS in the medium-term is vulnerable to rental pressure and higher vacancy rates across its portfolio as businesses over time opt to renew less floor space than prior to Covid due to remote working theme. While we see DXS as a market leader in the office space domestically, we expect market vacancy rates to expand further (Sydney CBD 13%, Melbourne CBD 14%, June-21) limiting their capacity to offset market weakness through superior asset and tenant management.

Port of Napier (NPH) – we increased our position in the port operator during the period. NPH has experienced recent disruptions from weather, global supply chains and COVID-19, which we expect to normalise in the second half of its financial year. We find NPH's valuation appealing (at 17.9 times 12-month forward EV/EBITDA) given the company controls a high-quality asset with strong earnings visibility on volumes in the long term.

Key Sales

APA Group (APA) – we exited our underweight position during the period. We are negative towards the company on the grounds that APA's initiatives to shift its business model towards electrification won't be sufficient. We expect it to be dwarfed by the discount increasingly applied to its gas pipeline business, particularly as planned government policies accelerate the shift to zero emissions sources. As a result, we no longer see its valuation (at a 12-month EV/EBITDA of 13.3 times) as sufficiently compelling when compared to large cap infrastructure alternatives.

Centuria Capital Group (CNI) – we exited our position in the fund manager REIT during the period as concerns around higher real yields resulted in lower capacity to maintain FUM growth at elevated levels. While the company manages a diversified portfolio by property asset type and capital source, underpinned by listed investment vehicles (CIP and COF), we no longer find this attractive in the current environment.

Atlas Arteria (ALX) –following recent outperformance we trimmed our overweight. The company remains a high-conviction overweight in the portfolio based on its strong liquidity and balance sheet position, discounted valuation and exposure to traffic recovery in Europe and the US. ALX trades on less than 11.0 times normalised EV/EBITDA, which captures the disruption from COVID-19 as travel restrictions and lockdowns reduce traffic volumes in the short term. Beyond traffic normalisation, we see a path towards value creation for ALX through concession extensions at APRR achieved as a means of funding expansion projects and settling the Dulles Greenway tolling regime.

Key Active Overweights

BWP Trust (BWP) – we believe BWP trades at a compelling valuation versus peers – 1.0 times NTA (based on conservative cap rates) with a 4.7% forecast yield – when considering its strong operating outlook, driven by well-located properties that encourage high rates of lease renewals from tenant Bunnings. Further, the REIT has the lowest gearing levels in the sector at <17%, and is set to benefit from higher inflation given CPI leases account for around 53% of its lease structures.

Vicinity Centres (VCX) – we continue to see relative upside in the shopping mall REIT as Australia emerges from the COVID crisis. While we continue to believe that shopping mall REITs face structural challenges, we now believe this is well recognised with VCX trading at 0.9 times trailing NTA, and increasing direct transactional evidence at prices at or close-to prevailing NTA's. Due to its large exposure to Victoria (53% NTA), we expect short-term support as COVID cases across the state continue to fall.

GPT Group (GPT) – we believe GPT offers investors exposure to a high-quality, diversified commercial real estate portfolio. Its conservative balance sheet (gearing at <30%) and high level of liquidity ($1.2bn) provide us with confidence that the company is appropriately positioned for the forthcoming de-valuation cycle. Lastly, GPT's valuation has become more attractive at 0.73 times trailing NTA, which implies an approximate fall of 20% in gross asset values (when ascribing value to GPT's Funds Management business) – a more significant fall than our base expectations.

Key Active Underweights

APA Group (APA) – we remain underweight the company on the grounds that APA's initiatives to shift its business model towards electrification won't be sufficient. We expect it to be dwarfed by the discount increasingly applied to its gas pipeline business, particularly as planned government policies accelerate the shift to zero emissions sources. As a result, we no longer see its valuation (at a 12-month EV/EBITDA of 13.3 times) as sufficiently compelling when compared to large cap infrastructure alternatives.

Stockland (SGP) – our underweight position is premised on long-term concerns about the sustainability of what is now likely becoming the tail-end of booming domestic residential conditions driven by pandemic-related stimulus programs, heavily supporting the first home buyer segment currently. Over time, SGP's valuation likely faces downside risk given its exposure is to second-tier shopping centres (43% of NTA), where structural change is likely to accelerate, and to residential profitability (35% earnings, and 22% of NTA), where we see softer demand in the medium-term as the housing stimulus (HomeBuilder) rolls over and the impact of lower migration levels takes hold.

SCA Property (SCP) – we are underweight the shopping mall REIT on the grounds given its current valuation doesn't reflect the structural long-term headwinds for the industry, which has accelerated through the COVID period, as well as the impact from rising interest rates. Our preferred Retail REIT exposure is BWP, which trades at a compelling valuation versus peers – 1.0 times NTA (based on conservative cap rates) with a 4.7% forecast yield – when considering its strong operating outlook, driven by well-located properties that encourage high rates of lease renewals from tenant Bunnings. Further, the REIT is set to benefit from higher inflation given CPI leases account for around 53% of its lease structures.

Market outlook

We maintain our longer-term conviction in the Real Assets sector, underpinned by solid fundamentals and attractive underlying valuation support. The S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Accumulation Index offers a 12-month forward forecast dividend yield of 4.6%, an attractive 0.9% premium above the 10-year Australian bond rate with the index dividend yield to increase in future years as traffic levels normalise on patronage-based infrastructure assets.

We see opportunities in high quality infrastructure companies with strong inflation protection and exposure to recovering economies, qualities both present within the transportation infrastructure sector. Tollroads are at the forefront of the post COVID-19 recovery and at Atlas Arteria (ALX) we see several catalysts on the horizon and are not surprised to see recent corporate interest in the name. Chorus is a quality regulated utility trading on a 5.85% FY23 dividend yield with medium term upside in regulatory returns. We remain cautious towards utilities names with a high reliance on fossil fuels and difficulty in transitioning to a lower carbon environment namely AGL Energy (AGL) and APA Group (APA).

We see a mixed outlook across REIT sub-sector exposures moving into CY2022. Positively, we see recovering occupier demand – particularly as office workers return to the offices, and shoppers return back to shopping malls – following an elongated period of Covid-disruptions and restrictions concentrated in the major cities of Melbourne and Sydney (combined >50% A-REIT asset exposure). We expect this to drive improved leasing outcomes and support the rent collection trajectory. Additionally, a number of the REITs also have rents linked to CPI increases, providing an effective hedge to increasing inflation. However, accompanying this recovery, we expect into CY22 the prospect of higher interest rates to begin to slow and even decrease capital values (i.e. REIT NTA's) as investor acquisition return requirements begin to increase, and REITs see an end of the multi-year trend of falling borrowing costs (an important driver of earnings and dividend growth over the past 3 years).

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Transurban	21.09	19.84	1.25
Goodman	15.20	13.63	1.57
GPT	6.90	3.63	3.27
Vicinity Centres	6.64	3.19	3.45
Atlas Arteria	6.38	3.47	2.91

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
BWP Trust	4.47	0.84	3.63
Vicinity Centres	6.64	3.19	3.45
GPT	6.90	3.63	3.27
Underweights			
APA	0.00	5.98	-5.98
Stockland	0.00	3.87	-3.87
Aurizon Holdings	0.00	3.14	-3.14

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.

Sector allocation

	Portfolio %	Benchmark %	Active %
Infrastructure	42.55	32.52	10.04
Airport Services	0.00	0.60	-0.60
Highways & Railtracks	27.47	23.32	4.16
Communication Services	5.80	3.07	2.73
Railroads	0.00	3.14	-3.14
Marine Ports & Services	6.84	2.39	4.45
Information Technology	2.44	0.00	2.44
Utilities	2.33	13.01	-10.68
Electric Utilities	2.33	4.54	-2.21
Gas Utilities	0.00	5.98	-5.98
Multi-Utilities	0.00	2.49	-2.49
Real Estate Investment Trusts (REITs)	53.21	54.48	-1.27
Specialized REITs	5.54	3.66	1.88
Diversified REITs	11.46	16.39	-4.94
Industrial REITs	15.20	14.58	0.62
Office REITs	3.00	5.32	-2.31
Retail REITs	16.27	13.87	2.40
Other	1.74	0.66	1.09
Cash and receivables	1.91	0.00	1.91

Features

Investment objective	To achieve a balance of income and medium-to-long term capital growth by investing primarily in Australian listed infrastructure, utilities and REIT securities. In doing so, we aim to outperform the S&P/ASX 300 Custom Infrastructure, Utilities and A-REITs Index over rolling three year periods.	
Recommended investment time frame	5 - 7 + years	
Fund inception	December 2005	
Fund size	A$18.4 mn as at 30 June 2022	
APIR code	JBW0030AU	
Estimated management cost	0.85% p.a.	
Buy/sell spread	+/- 0.15%	
Platform availability	Asgard BT Panorama	Hub24

Applications and contacts

Investment into the Yarra Australian Real Assets Securities Fund can be made by Australian resident investors only.

Website www.yarracm.com

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