YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 31 March 2021

Yarra Ex-20 Australian Equities Fund

Gross returns as at 31 March 2021

	From 25 July 2018^	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception % p.a.*
Yarra Ex-20 Australian Equities Fund	3.18	4.15	3.79	47.30	5.95	7.72	6.91	7.63
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	6.08	2.59	1.37	43.03	NA	NA	NA	NA
Excess return (before fees)‡	-2.90	1.56	2.42	4.26	NA	NA	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 31 March 2021

	From 25 July 2018^	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception % p.a.*
Yarra Ex-20 Australian Equities Fund	2.23	4.07	3.56	45.99	4.95	6.56	5.65	6.35
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	6.08	2.59	1.37	43.03	NA	NA	NA	NA
Excess return (after fees)‡	-3.84	1.48	2.19	2.95	NA	NA	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 prepared on an exit to exit basis – they include all ongoing fees and expenses and assume reinvestment of all distributions.

^ **Effective 25 July 2018 the Fund's investment strategy, name and benchmark was changed. Performance prior to 25 July 2018 is provided here for consistency purposes only – the historical performance data shown relates to the previous strategy and should not be used to assess past or future performance of the Fund. See here for further information. Performance data relating to the previous strategy is available upon request. 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 Ex-20 Australian Equities Fund: August 2010.

\# The benchmark for the Yarra Ex-20 Australian Equities Fund has been amended since the Fund's inception. Effective 25 July 2018, the benchmark is the S&P/ASX 300 ex S&P/ASX 20 Accumulation Index, replacing the S&P/ASX 300 Accumulation Index.

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

Market review

Australian equities rose in the March quarter as stronger-than-expected earnings more than offset rising bond yields globally.

The S&P/ASX 300 Ex-20 Accumulation Index increased 1.4% for the quarter, taking its 12-month return to 43.0%. In comparison, the broader ASX 300 returned 4.2% for the quarter and 38.3% for the year. Returns had been stronger as companies delivered one of the best reporting seasons on record, with 3.2 times more beats than misses. However, equities de-rated in the second half of the period as the Australian 10-year bond yield rose 82 bps to 1.79%.

Consumer Discretionary (+10.4%) outperformed other sectors by a large margin during the period as constituents benefited from the re-opening economy. Within Consumer Services (+13.5%), the return of domestic travel buoyed SeaLink Travel (SLK, +38.1%), Flight Centre (FLT, +13.5%) and Corporate Travel Management (CTD, +12.1%), while Tabcorp (TAH, +22.0%) received a takeover bid for its media and wagering division (which it subsequently rejected).

As beneficiaries of the higher bond yield environment, regional banks (+17.3%) were also among the strongest performers. Further, Bank of Queensland (BOQ, +15.1%) announced the acquisition of ME Bank – increasing its loan book by 57% – while Bendigo and Adelaide Bank (BEN, +10.9%) delivered a strong 1H21 result, supported by very low impairment charges and strong lending growth.

Conversely, the worst performing sectors were Utilities (-1.8%) and Information Technology (-8.7%). AGL Energy (AGL, -15.8%) underperformed following a disappointing 1H21 result, with the company proposing a de-merger of its coal generation and retail assets during the period. Losses were widespread across the tech sector (given the impact of higher bond yields on their long-dated cash flows). The worst performers included Xero (XRO, -13.8%), Wisetech Global (WTC, -5.4%), Altium (ALU, -21.6%) and Appen (APX, -35.7%).

Portfolio review

Key contributors

Vocus Group (VOC, overweight) – the telco outperformed during the period after receiving a takeover bid and delivering a better-than-expected 1H21 result. A consortium comprising Macquarie Infrastructure and Real Asset Holdings (MIRA) and Aware Super made an offer of $5.50 per share following due diligence on the business during the period. Meanwhile, the result highlighted positive momentum in the Networks division, with VOC taking share from competitors following a large number of deals in 1H21 and management talking to a strong pipeline for the full year. The result and takeover bid supported our investment thesis on the stock; namely that the combination of good management, improving fundamentals and quality of the asset base will result in significant upside. The management team remains focused on integrating and simplifying the various acquired businesses, unifying its product offering and increasing customer product penetration. We remain confident in the longer-term revenue and margin opportunities that will come from successfully implementing these improvements.

Incitec Pivot (IPL, overweight) – the company outperformed in response to improved fertiliser prices, with Tampa ammonia rising +102% q/q to $US545/t. Our positive view remains premised on key commodities (urea and DAP) reverting to mid-cycle levels. Furthermore, other factors which had weighed on performance throughout FY19 and FY20 – weather-related issues, plant outages and COVID-related disruption – are now largely behind the company. Lead indicators suggest higher demand for the commodities and the explosives business is experiencing more stable pricing as mining demand normalises in North America. At 19.1 times forward earnings, IPL trades well below the wider Industrials sector (at 27.6 times).

Nine Entertainment (NEC, overweight) – the media company outperformed during the period after its 1H21 result. EBITDA lifted 41.7% to $355.4mn y/y – 5.9% ahead of consensus forecasts – driven by lower costs and a strong performance from its Stan and BVOD divisions. Further, management indicated the free-to-air ad market was recovering, guiding for revenue to increase in the low to mid-single digits in 3Q20, and signed a letter of intent with Google in which NEC receives payment for the tech giant to use its news content. Our thesis remains premised on a supportive valuation, its high-quality digital assets (Stan, 9Now and Domain), a number of savings initiatives in the short term and a continued recovery in ad markets. We do not yet believe this environment is factored into NEC's valuation, with the stock trading at 17.4 times 12-month forward earnings. We also don't think sufficient value is attributed to its subsidiaries (Stan and Domain) when considering their long-term growth profile.

Key detractors

TPG Telecom (TPG, overweight) – the telco underperformed during the period after the chairman (the founder of TPG and a 17% shareholder) resigned from his position to pursue other interests, and following a modestly disappointing FY20 result. While the resignation creates a potential share overhang, we do not believe it will change the company's strategy and hold a positive view of the company's chief executive. In regards to the result, FY20 EBITDA declined 10%, 2% below consensus forecasts, due to COVID-related headwinds in the Mobile division. Our positive thesis remains premised on the recently completed Vodafone merger, which in our view will unlock significant synergies. The combined entity is well placed to harness its infrastructure, scale and balance sheet to compete with incumbents Telstra (TLS) and Optus through its lower-cost structure. Moreover, it provides TPG the ability to bypass the NBN with a Fixed Wireless offering, moving away from low margin re-seller economics to high margin ownership economics.

Link Group (LNK, overweight) – the company underperformed after one of its suitors, SS&C, withdrew its takeover offer. The PEP/Carlyle consortium's offer – which remains on the table – values LNK's base business on 14.6 times FY22 earnings which compares to 16.1 times for listed peer CPU. The implied valuation multiple of PEXA is 15.5 times EV/EBITDA compared to globally listed equity exchanges which trade on more than 19 times forward EV/EBITDA and growth oriented domestic marketplaces such as SEK, CAR and REA which trade on 24 times forward EV/EBITDA. Our positive view of PEXA is premised on infrastructure like characteristics of the property settlement exchange upon maturity supplemented by numerous growth opportunities in immediate adjacencies. We support LNK's move to prioritise the trade sale process of PEXA, which in our view will unlock material value.

Deterra Royalties (DRR, overweight) – the company underperformed during the period without any material news, with its 1H21 largely in line with expectations and iron ore remaining elevated at above $US165 per tonne. We continue to hold a positive view of DRR'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 a 12-month forward EV/EBITDA of 11.3 times and offering a 5.5% 12-month forward dividend yield.

Key purchases

Genworth Mortgage Insurance (GMA) – we established a position in the mortgage insurer during the period. In our view GMA is conservatively positioned for any issues arising in its deferred loan book as the company continues to build reserves ($134mn in 2H20), with delinquency rates improving in tandem with the unemployment rate (falling to 5.8% in February). While reserve releases are unlikely until FY22, we expect the company to resume dividends in FY21 with a forecast dividend yield of 4.4%. We see GMA's valuation as attractive: at 0.75 times NTA, the company trades at a sharp discount to recent LMI market transactions, with Arch Re purchasing Westpac's (WBC) LMI business at book value during the period. More broadly, we view GMA as an attractive exposure to Australia's improving housing market through lower claims expense and

higher new business volumes along with being the most positively exposed insurer to rising interest rates.

Tyro Payments (TYR) – we took recent underperformance as an opportunity to establish a small position in the payments company. TYR underperformed following a terminal outage that affected 30% of its merchants for several days. In our view the outage is a one-off issue that doesn't materially impact the long-term growth opportunity. While challenges such as higher churn and lower front book additions are inevitable in the short term given the extensive outage and lack of lock-in contracts, we do not believe they will persist in the longer term. As the lead provider of software that allows payment terminals to be integrated into point-of-sale (POS) systems, TYR remains in a defendable position versus peers such as the banks which rely on a clunky intermediary. Moreover, short-term headwinds are more than reflected in TYR's valuation, with the stock trading at 4.4 times forward sales – a significant discount to technology peers.

Alumina (AWC) – we increased our position in the alumina producer during the period as the pricing outlook improved for the commodity. We expect global aluminium demand to continue to improve as China's consumption continues to outpace expectations and the Transportation sector recovers. More broadly we continue to hold a positive view of AWC's high-quality assets and strong earnings, cash flow and capital management potential. As a result, we see its valuation (at a forward P/E of 17.3 times with a 5.8% forecast dividend yield) as attractive.

Key sales

Sydney Airport (SYD) – we exited our position in the airport operator due to the outlook for a more protracted recovery in international travel, underappreciated risks arising from airline and tenant agreements and the prospect of higher interest rates in the long term. Most airline agreements are scheduled for renewal in July 2021 which, if they are not extended, may result in adverse pricing outcomes for the airport operator. While we continue to view SYD's assets as high-quality with strong barriers to entry, we see the stock as fully valued at a CY22 EV/EBITDA of 20.9 times earnings when considering these risks.

Reece (REH) – we exited our position in the plumbing and bathroom supplier during the period following strong outperformance. We no longer see the stock's valuation as supportive (at 16.0 times forward EV/EBITDA) despite the company's positive operating outlook. We believe the stronger housing environment in Australia and the significant growth potential in US business MORSCO is now fully reflected in the share price. Our preferred housing exposures at this time are James Hardie (JHX), Bluescope Steel (BSL) and Mirvac Group (MGR).

ResMed (RMD) – we reduced our position following recent outperformance. We continue to believe RMD's core sleep apnea division will rebound strongly 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 active overweights

Vocus (VOC) – we are overweight the telco based on our view that the combination of good management, improving fundamentals and quality of the asset base will result in significant upside. The management team has made significant progress in integrating and simplifying the various acquired businesses, unifying its product offering and increasing customer product penetration – driving significant longer-term revenue and margin opportunities. In regards to the recently announced takeover bid (at $5.50 per share), we view the offer as credible, and are more optimistic it will result in a binding offer following management's recent improvements.

APA Group (APA) – our overweight position is based on our view that APA's valuation – at an EV/EBITDA of 12.7 times and with a 5.3% forecast dividend yield – is 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 considering that the COVID-19 crisis has had minimal impact on earnings. In the medium term, we see dividend upside driven by lower funding costs, scope for higher payout ratio and conservative balance sheet position.

Iluka Resources (ILU) – we are overweight mineral sands producer based on improving confidence that zircon and rutile markets are improving, with the current pace of the recovery exceeding our expectations amid the global economic recovery. We regard the industry structure as attractive (consolidated supply), with less pricing volatility compared to previous cycles. As a result, we see ILU's valuation as attractive (at 6.7 times EV/EBITDA). While the outlook for rare earths appears promising in the context of a strong demand profile (as a component for electric vehicles) and potential government support, we ascribe limited value given it is long-dated opportunity with significant execution risks.

Key active underweights

Sonic Healthcare (SHL) – we are underweight the company on the grounds positive vaccine outcomes are likely to create an earnings headwind for the company which, in 2020, saw significant earnings support from its COVID-19 testing services. While short-term earnings will remain robust, we expect EBITDA to decline in FY21 as fewer tests are issued. We no longer view its valuation as sufficiently compelling versus alternatives, with the company trading at 22.2 times FY22 earnings.

Sydney Airport (SYD) – our underweight position is premised on the outlook for a more protracted recovery in international travel, underappreciated risks arising from airline and tenant agreements and the prospect of higher interest rates in the long term. Most airline agreements are scheduled for renewal in July 2021 which, if they are not extended, may result in adverse pricing outcomes for the airport operator. While we continue to view SYD's assets as high-quality with strong

barriers to entry, we see the stock as fully valued at a CY22 EV/EBITDA of 20.9 times earnings when considering these risks.

Xero (XRO) – we are underweight the accounting software provider because we believe its strong growth outlook is fully factored into its valuation, but its potential risks are not. XRO trades at 18.5 times EV/sales, reflecting lofty expectations for subscriber growth to accelerate as the company continues to expand overseas and for add-on products and services to drive higher average revenue per user (ARPU). However, international expansion carries significant risks due to greater competition in more fragmented markets, with significant ongoing product reinvestment required for XRO to maintain its advantages relative to peers.

Market outlook

The Australian economy finished 2020 with strong momentum and incoming data suggests this momentum has spilled over into 2021. A trend decline in new COVID-19 infections in developed countries and the successful commencement of vaccine programs in concert with exceptionally loose financial and fiscal settings has helped underpin confidence in the global economic recovery. We expect global economic growth will accelerate to average 5.5% in CY21, compared to the average global growth rate from 1980 to 2019 of 3.5%. Although this is strong global growth by historical comparison, we believe the Australian economy will more than keep pace. Indeed, our estimates of real time economic activity suggest Australia is currently expanding faster than any G7 country and we expect Australian economic growth will average 6% in 2021.

The driving force of the recovery into 2021 will be consumption growth. The combination of the highest household saving ratio since the mid-1970s in concert with rising asset prices, declining unemployment, rising hours worked and improving consumer confidence is expected to underpin a 7.0% rise in consumption growth in 2021. Although concerns have persisted over fiscal fade via lapsing fiscal stimulus measures, our analysis has long suggested that the extension of some fiscal programs, the pull forward of income tax cuts and the recovery in labour income as furloughed workers return to work is sufficient to avoid a bout of fiscal fade weighing on household income growth. From our perspective, the fundamentals for household consumption growth in 2021 are as strong as any period in the past 30 years.

A secondary force assisting the recovery is the upswing in new housing approvals, housing finance approvals and house prices. Despite a sharp drop in net migration and earlier concerns over house price declines, sentiment regarding housing has been buoyed by record low interest rates, a shift in responsible lending onus back to the borrower, large government incentives for construction, and the strong guidance by the RBA that interest rates will remain at current levels for the next 3 years. These factors have seen detached housing approvals surge to a record high, which will support construction activity throughout 2021.

Our expectation is that additional fiscal stimulus in the US and additional QE in major offshore markets, in concert with the extension of the QE program in Australia, will leave a pro-growth fiscal and monetary environment for both economic growth and earnings growth in Australia.

The RBA's explicit aim of QE is to lower Australian longer-term bond rates and lower the A$. We expect the RBA to be partially successful in moderating the appreciation of the A$, however, upward pressure on the A$ will likely remain as the global economic recovery continues. We continue to expect the A$ to finish 2021 at 80c.

We are most overweight stocks within the Telecommunication Services, Energy and Media & Entertainment sectors, and are underweight Financials, Real Estate and Industrials.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	15.71	5.01	10.70
Consumer Discretionary	10.05	9.15	0.90
Consumer Staples	3.30	4.48	-1.18
Energy	9.55	6.01	3.54
Financials	6.75	14.03	-7.28
Health Care	7.44	9.14	-1.70
Industrials	6.27	9.73	-3.46
Information Technology	7.56	7.02	0.54
Materials	17.53	19.74	-2.20
Real Estate	5.87	12.72	-6.85
Utilities	5.24	2.97	2.27

Top 5 holdings

	Portfolio %	Benchmark %	Active %
James Hardie Industries	5.37	2.10	3.28
APA	5.24	1.40	3.84
Vocus	4.26	0.40	3.86
Atlas Arteria	4.21	0.68	3.54
Link Administration	3.95	0.33	3.62

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Vocus	4.26	0.40	3.86
APA	5.24	1.40	3.84
Link Administration	3.95	0.33	3.62
Underweights			
Sonic Healthcare	0.00	1.99	-1.99
Sydney Airport	0.00	1.98	-1.98
Xero	0.00	1.81	-1.81

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.	Since inception % p.a.
Growth return	43.82	2.70	3.82	3.61
Distribution return	2.17	2.25	2.73	2.74

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 capital distributions.

Features

Investment objective	To achieve medium-to-long term capital growth through exposure to Australian Securities Exchange listed securities excluding the largest 20 by market capitalisation (as defined by the S&P/ASX 20 Index). In doing so, the aim is to outperform the S&P/ASX 300 ex S&P/ASX 20 Accumulation Index over rolling 3-year periods.	
Recommended investment time frame	5 - 7 + years	
Fund inception	August 2010	
Fund size	A$14.5 mn as at 31 March 2021	
APIR code	JBW0052AU	
Estimated management cost	0.90% p.a	
Buy/sell spread	+/- 0.15%	
Platform availability	Asgard BT Panorama BT Wrap Hub24	Macquarie Wrap Accumulator Macquarie Wrap Consolidator

Applications and contacts

Investment into the Yarra Ex-20 Australian Equities Fund can be made by Australian resident investors only.

Website www.yarracm.com

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

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