YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 31 March 2023

Yarra Ex-20 Australian Equities Fund

Gross returns as at 31 March 2023

	From 25 June 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	5.52	2.74	8.31	4.21	20.39	7.10	7.60	7.82
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	5.46	-0.80	3.27	-4.22	16.11	NA	NA	NA
Excess return (before fees)‡	0.06	3.53	5.04	8.43	4.28	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 2023

	From 25 June 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	4.56	2.66	8.07	3.29	19.32	6.11	6.41	6.59
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	5.46	-0.80	3.27	-4.22	16.11	NA	NA	NA
Excess return (after fees)‡	-0.90	3.46	4.80	7.50	3.21	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 June 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. 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 gained 3.5% during the March quarter with Communication Services being the top contributor and the Energy sector being the largest negative performer.

The S&P/ASX 300 Ex-20 Accumulation Index returned +3.3% for the quarter, taking its 12-month return to -4.3%. In comparison, the broader ASX300 gained +3.3% and, globally, the MSCI World Index climbed by 7.9%.

Communication Services (+11.6%) was the top performing sector during the period. REA Group (REA, +25.4%) performed well over the quarter, alongside Domain Holdings (DHG, +30.4%) as investors anticipate that we are getting close to the trough in the real estate listings cycle, oOh! Media (OML, +28.8) was a positive contributor as it reported a stronger than expected result.

Within Information Technology (+10.1%), the Xero (XRO, +27.3%) share price rose after announcing plans to reduce the size of its workforce by 15% and NEXTDC (NXT, +14.9%) rallied post its 1H23 earnings update, Wisetech (WTC, +28.5%) rallied early in the quarter as the tech sector responded positively to the risk on environment as the Fed and RBA moved closer towards terminal interest rates.

Conversely, the weakest performing sector was Energy (-2.9%), with the crude oil price down 38% since peaking at US$122 per barrel in early March last year, the Energy companies struggled with margins, Beach Energy (BPT, -10.1%) and the decline in the coal price (-51%) has impacted the performance of coal producers, Whitehaven Coal (WHC, -25.5%) and New Hope Corporations (NHC, -10.7%).

Portfolio review

Key Contributors

United Malt (UMG, overweight) – the global commercial malt processor and distributor outperformed during the period after receiving a takeover bid from peer Malteries Soufflet priced at $5.00/share (+45% premium to prior closing price). It emerged that Malteries Soufflet has submitted four bids for UMG since

December 2022, indicating strong interest in UMG's assets. We believe that the likelihood of a deal proceeding is high.

Reliance Worldwide (RWC, overweight) – the manufacturer and distributor of plumbing and heating parts outperformed early in the quarter as the 30-year US mortgage rates compressed ~30bps and the market's belief that the Fed was getting closer to the top of this rate hiking cycle strengthened. RWC also outperformed after its March Investor Day at which it announced two new products which should drive EBIT upgrades in later years (FY25+). We view RWC as a compelling opportunity, with the market pricing for a significant decline in earnings (P/E of only 14.5 times vs 17.0 times mid cycle) whereas we remain constructive on the demand environment given the defensive nature of RWC's revenue base, the majority of which relates to repair and remodelling sales.

Xero (XRO, overweight) – the leading provider of cloud-based accounting software outperformed during the period after announcing plans to reduce the size of its workforce by 15%. The cost-out will lead to a reduction in operating expenditure/sales from the recent levels of 83-85% over recent results down to a more sustained level of ~75% from FY24. We think XRO is a compelling opportunity at current levels and that future earnings should benefit from further cloud penetration in international markets, stronger take-up of platform revenues and an eventual rebound in net subscriber additions.

Key Detractors

Incitec Pivot (IPL, overweight) – the manufacturer and distributor of fertilisers and explosives products underperformed over the period, as the price for Tampa ammonia fell 55% over the last three months on weaker gas prices in Europe and weaker demand. After IPL announced the sale agreement for its WALA asset (20 March 2023), the group is now much less exposed to movements in ammonia pricing going forward. IPL achieved a better-than-expected sale price for WALA of U$1.68bn and announced a value accretive offtake agreement with CF Industries. We expect that IPL will be able to commence its previously announced buyback of A$400m after its 1H23 result and may upgrade the buyback program with the A$1.25bn of net cash proceeds from the WALA sale.

Liontown Resources (LTR, underweight) – the lithium developer outperformed during the period, despite falling lithium prices, following a takeover offer from US-listed lithium producer Albermarle. The $2.50/share offer represented a 63% premium to last close, with the company trading above terms on expectations of a further bump in the bid following its rejection of the initial proposal. We continue to see further downside to lithium prices and prefer existing operator Pilbara Minerals (PLS) given its lower risk profile, strong balance sheet, and low capital intensity growth profile.

WiseTech (WTC, underweight) – the leading developer of software solutions for the logistics industry rallied early in the period as the tech sector responded positively to the risk-on environment as the Fed and RBA got closer to their respective terminal interest rates. We remain underweight WTC, with a preference for other names in the technology sector (e.g. XRO) 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.

Key Purchases

Iluka Resources (ILU) – we instigated a new position in the mineral sands producer during the period. We see solid structural support for key mineral sands commodities zircon and titanium dioxide as demand improves in China post COVID impacts, and existing mine supplies decrease on falling grades and production challenges. ILU is the world's largest zircon producer and the fifth largest producer of titanium feedstocks, and is moving into rare earths production with the Eneabba refinery currently under development in Western Australia. Rare earths are a by-product of mineral sands mining, and a key component of permanent magnets that are critical to electric motors including those in electric vehicles and wind turbines. With 90% of the world's rare earths currently produced in China, we see additional strategic value in ILU's rare earths business.

United Malt (UMG) – we increased our position in the global commercial malt processor and distributor during the period. At the time of purchase, we saw an opportunity for an improvement in earnings and an unnecessary concern for an equity raising. UMG faced several short-term headwinds (Canadian drought, heightened freight rates, grain prices, and energy costs) with ineffective contractual terms that led to significantly reduced FY22 earnings. With those short-term pressures easing, and with the roll-out of new contractual terms, we saw a pathway to improving earnings. UMG is now in receipt of a takeover bid from peer Malteries Soufflet priced at $5.00/share (+45% premium to prior closing price). We believe that the likelihood of a deal proceeding is high.

Northern Star Resources (NST) – we increased our position in the gold miner during the period. We see further support for the gold price given macro uncertainty, and an expectation that the current interest rate rise cycle is nearing an end. We continue to favour NST's solid assets and strong cost control. Aspirations to grow the business from current production of ~1.5Moz pa to >2Moz pa by 2026 are achievable within the current portfolio led by the Thunderbox mill expansion project and improving grades at Pogo (Alaska). In our view, NST remains the quality name in the gold sector.

Key Sales

OZ Minerals (OZL) – we exited our position in the copper producer during the period. The company is under a $28.25/share takeover bid from diversified miner BHP that is supported by the OZL board and deemed "fair and reasonable" by the Independent Expert. As a result, we view risks to deal completion as low and see limited potential for future outperformance given that OZL is trading close to deal terms.

Atlas Arteria (ALX) – we exited the toll road owner during the period. The stock is trading close to an enterprise value equivalent to where it was trading before undertaking its value destructive acquisition of the Chicago Skyway toll road. In recent months, the outlook for all three of ALX's major assets has deteriorated leading to a permanent downgrade in our view of portfolio quality. We now believe that ALX's major asset – the APRR concession – will ultimately go through a re-tender process and that the restructure of Dulles Greenway will require considerable additional equity (instead of releasing equity).

Incitec Pivot (IPL) – we trimmed our position in the manufacturer and distributor of fertilizers and explosives products during the period to manage our portfolio risk exposures. IPL announced the sale of its WALA asset during the period, achieving a better-than-expected sale price of U$1.68bn. IPL also announced a value accretive offtake agreement with CF Industries. We expect that IPL will soon be able to commence its previously announced buyback of A$400m and may upgrade the buyback program with the A$1.25bn of net cash proceeds from the WALA sale.

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 and RWC's FY23 earnings estimates have now been lowered after recent market updates. We view RWC as a compelling opportunity, with the market pricing for a significant decline in earnings (P/E of only 14.5 times vs 17.0 times mid cycle) whereas we remain constructive on the demand environment given the defensive nature of RWC's revenue base, the majority of which relates to repair and remodelling sales.

Carsales (CAR) – we remain overweight the online car classifieds company based on improving yields from products such as Instant Offer and Select in Australia (~50% of CAR valuation). We are also constructive on the outlook for Trader Interactive, CAR's US business (~30% CAR valuation), which has strong potential from various drivers (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). We also like the opportunity to improve the profitability of Encar, CAR's South Korean business, as well as the increased stake in CAR's Brazilian business, Webmotors.

Worley (WOR) – we remain overweight the global and leading provider of 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 +16%, Rolling 12 Month Bookings +23%, Backlog +7%) 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

Brambles (BXB) – we remain underweight the global provider of pallet pooling solutions to various FMCG producers. Brambles currently has strong momentum (16% underlying profit growth in 1H23), with expectations for 15-18% over FY23 and we expect a return to positive FCF from FY24. We are cautious on the sustainability of the current high level of profit and believe that market is already factoring the positive swing in free cash flow at current levels.

Sonic Healthcare (SHL) – our underweight position in Australia's largest pathology provider is premised on our view of a sluggish outlook for business-as-usual operational volume growth, lower earnings in the coming period as high margin COVID testing services continue to normalise, and a tough cost environment given industry wide staffing and funding challenges. Despite this, we do see business capacity for acquisitive growth, with evidence of this in early April with the $310m acquisition of Diagnosticum in Germany. Finally, SHL's valuation is not yet compelling, with the stock trading on 23.6-times forward P/E and 10.7-times EV/EBITDA.

Cochlear (COH) – we remain underweight the global producer of hearing technologies. While COH's key developed and emerging markets have largely recovered following COVID as hospital capacity issues normalise, we are cautious on the outlook for some operating costs in the higher inflation environment, and on the implied stock valuation metrics at current levels of 47.5-times forward P/E and 30.0-times EV/EBITDA. Given strong underlying ear implant demand globally – supported by COH's ongoing investment into clinical awareness – we do think the company is well positioned to return to its historical growth rates, and indeed should be supported by the release of its new Nucleus 8 sound processor. Within the large-cap healthcare sector, our preference remains with our overweight to the global sleep-apnea device supplier ResMed.

Market outlook

The June quarter 2023 will mark the top of the interest cycle for most of the developed world. With ongoing evidence of inflation moderating, tightening in lending availability and downgrades accumulating for economic growth, including the Federal Reserve staff formally forecasting a modest recession in the US, the appetite for policy makers to persist with the tightening cycle is rapidly evaporating. Although the Fed may choose to hike in May, the decline in headline inflation has returned real interest rates to zero and our nowcasting for US economic growth continues to suggest the US has been contracting modestly since late 2022. We believe the US labour market is set to post more modest employment gains in 2Q23 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 from September 2023.

We continue to argue that Australia presents as a safe haven from both the perspective of more robust growth relative to the G7 peer group and as having good leverage to signs of a trough in the economic cycle in China. Although both the RBA

and we expect economic activity to slow significantly in 2023 to average just 1.5%, we believe Australia should be able to avoid a technical recession due to four 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 1H22, and even though commodity prices are now off their peaks they remain very elevated from a historical perspective. The consequence has been strong national income growth, profits growth and an improving underlying fiscal position. Indeed, the Commonwealth Budget will likely be close to surplus for the 2023 financial year.
2. The household sector continues to hold a significant buffer of over $270bn 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. Albeit we remain particularly cautious on discretionary retail spending, given most of the excess savings can be traced to older and wealthier households.
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. Iron ore obviously remains Australia's biggest export and China the dominant customer. However, we expect the global energy transition will be steel intensive, opening up new customers.
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 appears likely in coming months, ensuring that Australia's population growth will be close to 2% in 2023.

While the Reserve Bank of Australia (RBA) has been later than most other developed nations in tightening policy, tighter financial conditions in 2022 have come via both significantly higher cash rates, higher government bond yields and wider corporate bond spreads. Following the February and March rate hikes of 25 bps, we believe financial conditions are now in the restrictive zone and the RBA is now close to the finish of the tightening cycle. Importantly, it is clear the RBA is now openly considering pausing the hiking cycle. 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. Interest rate hikes in Australia will remain a month-to-month proposition for the next six months, however, our bias is that the last hike has likely been delivered this cycle. It is unlikely that policy easing will be delivered in 2023, however, we do expect that the RBA will commence an easing modest easing cycle in 1H24.

The A$/US$ has been under downward pressure as markets grappled with a seemingly more hawkish Fed and a relatively more dovish RBA. Nevertheless, both central banks are in the concluding phases of the tightening cycle. 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 aggressive hiking strategy to an easing cycle in 2023, we expect the A$/US$ will appreciate to the mid-70s through 2H CY23.

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

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	12.24	4.50	7.74
Consumer Discretionary	8.03	7.57	0.46
Consumer Staples	3.53	4.29	-0.76
Energy	0.00	3.95	-3.95
Financials	11.97	14.32	-2.35
Health Care	4.27	9.48	-5.20
Industrials	12.48	12.36	0.11
Information Technology	12.84	5.99	6.85
Materials	22.77	22.68	0.09
Real Estate	0.00	11.24	-11.24
Utilities	5.32	3.61	1.71

Top 5 holdings

	Portfolio %	Benchmark %	Active %
QBE Insurance	5.42	2.52	2.90
Origin Energy	5.32	1.66	3.66
Carsales.com	4.88	0.97	3.91
Northern Star	4.44	1.65	2.79
Worley	4.32	0.63	3.70

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Reliance Worldwide	4.32	0.34	3.98
Carsales.com	4.88	0.97	3.91
Worley	4.32	0.63	3.70
Underweights			
Brambles	0.00	2.17	-2.17
Sonic Healthcare	0.00	1.95	-1.95
Cochlear	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.	10 years % p.a.
Growth return	0.23	16.83	3.73	3.64
Distribution return	3.05	2.50	2.38	2.76

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$12.2 mn as at 31 March 2023	
APIR code	JBW0052AU	
Estimated management cost	0.90% p.a	
Buy/sell spread	+/- 0.15%	
Platform availability	BT Panorama Hub24	Praemium

Applications and contacts

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

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