YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 31 December 2022

Yarra Emerging Leaders Fund

Gross returns as at 31 December 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	-3.24	7.67	-11.44	4.55	6.85	11.14	10.89
Emerging Leaders Combined Benchmark†	-4.18	7.37	-12.46	5.54	5.64	8.66	7.00
Excess return (before fees)‡	0.94	0.29	1.02	-0.99	1.21	2.48	3.89

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 December 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	-3.34	7.33	-12.54	3.26	5.53	9.77	9.59
Emerging Leaders Combined Benchmark†	-4.18	7.37	-12.46	5.54	5.64	8.66	7.00
Excess return (after fees)‡	0.84	-0.04	-0.08	-2.28	-0.11	1.11	2.59

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

Australian equities gained 9.4% during the December quarter, with all sectors recording positive returns.

The Emerging Leaders Benchmark returned +7.4% for the quarter, taking its 12-month return to -12.5%. In comparison, the broader ASX300 gained +9.1% for the quarter and, globally, the MSCI World Index gained +9.9%.

All sectors delivered positive returns for the quarter, with Utilities (+18.0%) the best performing sector, which comprises only AGL Energy (AGL, +18.0%).

Within Financials (+13.7%), the sector performed strongly over the quarter as the market factored in higher expectations around the pace of net interest margin expansion led by Bendigo & Adelaide Bank (BEN, +26.0%), Challenger (CGF, +3.3%) and Judo Capital (JDO, +22.7%).

Conversely, the weakest performing sector was Information Technology (+1.9%) with Link Administration (LNK, +24.6%), Codan Limited (CDA, -27.7%) and Wisetech Global (WTC, -2.4%) being the key movers for the period.

Portfolio review

Key Contributors

Evolution Mining (EVN, overweight) – our position in the gold miner was a positive contributor during the month, with the gold price rising to US$1,828/oz at period end. Following a period of significant underperformance relative to its listed peers, reflecting disappointing production levels and guidance downgrades, we see attractive valuation support for EVN. While gearing levels – around 30% (D/D+E) – are higher than peers, the risk of an unexpected capital raise to support the balance sheet is considerably over-played in our view. AUD denominated gold prices remain robust, and we continue to see price support for gold in the near to medium term.

Link Administration (LNK, overweight) – the company's price recovered somewhat during the quarter following sharp underperformance in the prior quarter post the termination of the agreed takeover from Dye & Durham's. We still see considerable value in LNK and a pathway to crystalising value, with the value accretive demerger of its stake in PEXA a pertinent example.

Sandfire (SFR, overweight) – the copper producer was a positive contributor to the portfolio, with copper prices increasing by 3.9% in December. We are attracted to copper as a commodity given its leverage to electrification as a key material in batteries and electric motors. We participated in the company's $200m Entitlement Offer during the period and view the raising as an important de-risking event for the balance sheet. The company is now better funded to complete the Motheo project in Namibia, and progress drilling activities to increase mine life at the MATSA asset in Southern Spain. A further de-risking of these projects, coupled with the outlook for copper markets, will continue to generate share price outperformance in our view.

Nanosonics (NAN, overweight) – the disinfection device company outperformed during the period despite no new updates. The business continues to perform well, with double-digit growth in the installed base, the successful transition of the US distribution capability from GE and recovery in consumables volumes as COVID disruption moderates.

EBOS (EBO, overweight) – the pharmaceutical distributor outperformed during the period, supported by a positive investor day. The investor day reiterated our positive view toward the company, with defensive earnings growth opportunities evident across both its health care and animal care divisions. Both divisions are in growth markets, are increasing market share and improving margins, leading to attractive earnings growth. Furthermore, both divisions have opportunities to supplement organic growth via acquisitions, with the company having a strong track record of identifying, acquiring and successfully integrating suitable targets.

Key Detractors

Reliance Worldwide (RWC, overweight) – the plumbing supplies company underperformed during the period following James Hardie's (ASX listed peer) weaker than expected market update. The market is showing concern for a falling demand environment and RWC FY23 estimates were lowered after the August result. We believe RWC's reaction to JHX's update is un-warranted. We believe RWC is a compelling opportunity with the market pricing for a significant decline in earnings (P/E of only 12 times vs 17 times mid cycle), while we remain constructive on the demand environment given the defensive nature of the majority of RWC's repair and remodelling sales. In addition, the widespread and strong US freeze over the holiday period in late December should provide a strong boost to sales as repairs are undertaken to rectify frozen pipes.

Select Harvests (SHV, overweight) – the almond producer underperformed during the period after providing a weaker than expected result and outlook. The outlook for the almond price and cost inflation both deteriorated compared to prior expectations. We continue to hold the position given almond prices are currently depressed below sustainable levels, costs are currently abnormally high, and in our view the downside is protected by a large tangible asset base which includes land and water assets.

Megaport (MP1, overweight) – the network as a service solutions company underperformed after a weaker than expected September quarterly result across customer volume metrics and higher than expected capex. We note the June quarterly result was stronger than expected and that the September quarter is a seasonally less important period. Longer term we see strong growth from its 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. The company is currently at an inflection point for earnings and cashflow; we believe it will turn positive in the next year, with significant long-term earnings and cashflow potential.

Collins Foods (CKF, overweight) – the fast service restaurant company underperformed during the period after a weaker than expected 1H23 result and outlook. While the KFC businesses across both Australia and Europe reported strong sales growth, the margin outlook was downgraded given higher than expected cost inflation and a focus on maintaining volume market share growth. The Taco Bell business reported weaker than expected results and the new store rollout was put on hold. We continue to hold an overweight position given we view the margin pressures within both KFC businesses as largely temporary with a recovery in the medium term. While the probably of success with the Taco Bell format has reduced, there is now limited value currently reflected in the share price for this format.

Eclipx Group (ECX, overweight) – the fleet management company underperformed during the period, despite reporting a result and providing outlook commentary that was either consistent with or modestly beat expectations. ECX has a strong executive team which should moderate the risk from the recently announced CEO departure, with his replacement being the existing CFO who has a strong track record and is well regarded. Industry data indicating a moderation in used car prices could partly explain the underperformance given the potential reduction in end of lease income, albeit this is already reflected in consensus expectations. We continue to hold an ECX position given continued asset growth, supported by market share gains, cost reduction opportunities to offset inflation and balance sheet strength to underpin continued share buybacks.

Key Purchases

Evolution Mining (EVN) – we increased our position in the gold producer during the period. Following a period of significant underperformance relative to listed gold peers due to disappointing production levels and guidance downgrades, we now see attractive value support for EVN. While gearing levels – around 30% – are higher than peers, the risk of an unexpected capital raising to support the balance sheet is considerably over-played in our view. AUD denominated gold prices remain robust, and we continue to see price support for gold in the near-to-medium term.

Sandfire Resources (SFR) – we have increased our exposure to the company during the period. We like copper as a commodity given its leverage to electrification as a key material in batteries, electric motors and related infrastructure. We participated in the company's $200m Entitlement Offer during the period and view the raising as an important de-risking event for its balance sheet. The company is now better funded to complete the Motheo project in Namibia, and progress drilling activities to increase the mine life at its MATSA asset in Southern Spain. On our view, further de-risking of these projects, coupled with the outlook for copper markets, will continue to generate share price outperformance.

Judo Capital (JDO) – we established an overweight position during the period. JDO is the leading challenger bank providing loan products to small and medium size businesses in Australia. We believe there is a significant market share opportunity, with the company currently holding only 2% market share and offering superior service and no other scale competitors. JDO is an ADI (authorised deposit-taking institution) which provides the bank with a more diversified and lower cost of funds compared to other small cap financials which are unable to source deposits. JDO is also in a strong capital position, with sufficient equity capital to support the loan book increasing from the current $6bn up to over $15bn. The valuation is attractive; the company trades at around book value, with a medium-term P/E multiple below 11.0 times.

Key Sales

Pilbara Minerals (PLS) – we divested our position in Pilbara Minerals (PLS) during the period, reflecting the company having been in the ASX100 for approaching 12 months.

Australian Clinical Labs (ACL) – we reduced our position in the diagnostic services company following recent outperformance, maintaining a relative preference for healthcare companies Nanosonics (NAN) and Integral Diagnostics (IDX). We continue to hold a small ACL position given non COVID-19 market growth (upside from normalisation post COVID-19) and market share gains (in particular NSW / QLD), productivity programs and cost synergies to support margin expansion and continued industry consolidation opportunities.

IGO (IGO) – we reduced our position in IGO during the period following strong recent performance on continued lithium price strength, ahead of consensus forecasts. We retain our positive thesis on IGO, premised on the miner's $US1.4bn Greenbushes and $A1.25bn Western Areas (WSA) acquisitions, and its existing portfolio of high-quality assets. Greenbushes gives IGO exposure to a high-quality, long-dated lithium asset (>20 years mine life) and completes IGO's suite of battery commodities, with the company already producing nickel, copper and cobalt.

Key Active Overweights

Worley (WOR) – we remain overweight the professional project and asset services company. 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 (y/y). 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.

Reliance Worldwide (RWC) – we regard the plumbing supplies company as a compelling opportunity, with the market pricing for a significant decline in earnings (P/E of only 12 times vs 17 times mid cycle) while we remain constructive on the demand environment (both in the trough and longer term) given the defensive nature of the majority of RWC's repair and remodelling sales (~ 80% of sales) are not tightly correlated with the new housing sector. In addition, the widespread and strong US freeze over the holiday period in late December should provide a boost to sales as repairs are undertaken to rectify frozen pipes.

Nine Entertainment Group (NEC) – we remain constructive on the media company's ability to grow higher-margin digital revenues in a potentially softer advertising environment in 2H23. NEC's sell-off CYTD in part reflects the sell-off in Domain (DHG). The sell-off in both companies placed NEC (excluding DHG) on a 4.5 times FY23 EV/EBITDA multiple which view as an attractive valuation for a leading media company which is diversifying its revenue streams to be less cyclical and higher margin.

Auckland Airport (AIA) – we view AIA as a very high quality, defensive exposure that is recovering from the disruption to international travel caused by COVID-19. The company's key asset is a gateway airport with a favourable and well settled regulatory structure and strong long term growth outlook. AIA trades on 22.2 times EV/EBITDA which we regard as a fair multiple, however this does not capture the embedded value in its large land bank around the airport.

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 are also attracted to the opportunity to improve the profitability of Encar, CAR's South Korean business.

Key Active Underweights

WiseTech (WTC) – we remain underweight the technology company with a preference for other names in the technology sector given WTC's demanding valuation of 77 times 1-year Fwd P/E. We believe WTC has and continues to build an exceptional product in CargoWise, which should continue to attract and retain large and key freight forwarders. We do, however, struggle to justify paying 77 times for WTC's high-quality earnings growth given the prevalence of more attractive opportunities in the tech space.

Whitehaven Coal (WHC) – we remain underweight Whitehaven Coal. While this position was a key detractor for the portfolio during the period as coal prices continued to trade at significantly inflated levels, we view current prices for both thermal and metallurgical coal as unsustainable, and well in excess of cost curve support. Additionally, we are conscious of coal's diminishing role in the global energy mix as stationary energy systems shift to lower carbon intensity.

Vicinity (VCX) – the portfolio retains an underweight position to the retail focussed REIT. While well diversified across retail centre type, number and geography, we expect to observe a weaker consumer begin to impact speciality retailers in 2023, making real rental growth extremely difficult to achieve. With higher debt costs expected, we view this as creating a more challenged dividend outlook, as well as accelerating valuation pressures as cap rate expansion occurs in a higher interest rate environment, driving asset backing (NTA) lower. At current valuation levels, we don't see sufficient absolute valuation support (0.84 times NTA and offering 5.8% dividend yield) and subsequently remain underweight.

Lynas Rare Earths (LYC) – we remain underweight the rare earths miner. While we recognise the longer-term thematic of rare earths being an important raw material for battery powered electric motors, we remain concerned on near-term commodity pricing headwinds. Rare earths production and refining is dominated by China, and Lynas is one of few ex-China major producers. Recent efforts in the US through the Inflation Reduction Act to pivot rare earths sourcing away from China present a longer-term opportunity for Lynas. However, we view NdPr pricing as unsustainable at current levels, and are happy to remain underweight LYC.

Aurizon (AZJ) – we have an underweight position in the rail freight operator, which we view as a well-managed company facing a difficult task of transitioning earnings away from a heavy reliance on coal haulage. Whilst AZJ's 6.8% FY24 dividend yield screens as attractive, we do not believe there is sufficient value to compensate investors for the elevated risk profile of the business at this time.

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 markets anticipating the end of the Fed tightening cycle may be at hand, financial conditions have eased considerably in the US as credit spreads narrowed, the equity market rallied and the US$ declined.

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 2022, although we do expect economic activity to slow significantly in 2023 to average just 1.5%. While a local recession is possible in 2023, we believe Australia should be able to avoid a technical recession 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 $260bn 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.
3. Low levels of spare productive capacity, strong profit and low corporate debt have contributed to robust capital investment intentions.

In the medium term we believe a recovery in net immigration levels into Australia and Australia's exposure to key commodities crucial to the global energy transition 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 have come via both significantly higher cash rates, higher government bond yields and wider corporate bond spreads. Following the December rate hike of 25bps we believe the RBA is now very close to the finish of the tightening cycle. Officially we expect a final 15bps hike in February. Indeed, we believe the RBA inflation forecasts will likely be downgraded slightly in February 2023 which will be used to put a full stop to the current rate tightening cycle. The A$/US$ has finally started to appreciate, after a long period of relative weakness. With Australia's external accounts remaining in excellent health, our expectation that Australia's economic growth will be more robust than its peers and the prospect the US$ uptrend will peak as the Fed pivots from its aggressive hiking strategy we expect the A$/US$ will appreciate to the mid-70s by mid-2023.

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

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	12.37	5.65	6.72
Consumer Discretionary	9.45	10.78	-1.33
Consumer Staples	1.26	3.91	-2.65
Energy	4.61	8.41	-3.80
Financials	10.72	11.12	-0.40
Health Care	7.02	4.59	2.43
Industrials	11.78	11.65	0.13
Information Technology	9.31	7.81	1.51
Materials	21.59	24.36	-2.77
Real Estate	4.04	10.77	-6.73
Utilities	0.00	0.94	-0.94

Top 5 holdings

	Portfolio %	Benchmark %	Active %
OZ Minerals	4.64	1.82	2.82
Worley	4.61	1.09	3.52
Carsales.com	4.24	1.42	2.82
Reliance Worldwide	3.67	0.46	3.22
NextDC	3.53	0.81	2.72

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Worley	4.61	1.09	3.52
Reliance Worldwide	3.67	0.46	3.22
Nine Entertainment Co.	3.43	0.52	2.92
Underweights			
Wisetech Global	0.00	1.71	-1.71
Whitehaven Coal	0.00	1.70	-1.70
Vicinity Centres	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	-24.09	-2.26	1.37	6.40
Distribution return	11.55	5.52	4.16	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$79.4 mn as at 31 December 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 December 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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