MAGELLAN ASSET MANAGEMENT LIMITED

# Half Yearly Investor Report

## Core Infrastructure Strategy | December 2015

By Dennis Eagar, Portfolio Manager, Magellan Core Infrastructure

Dear Investor,

I am pleased to write to you as an investor in the Magellan Core Infrastructure Strategy (the 'Strategy') for the six months ended 31 December 2015. The objective of the Strategy is to provide shareholders with reliable, inflation linked returns through all stages of the economic cycle.

The universe of infrastructure assets that we consider for the Strategy is made up of two main sectors:

• **Utilities:** Utilities comprise approximately 62% of the Strategy and includes both regulated energy utilities and regulated water utilities. Utilities are typically subject to economic regulation. The terms of regulation typically require a utility to efficiently provide an essential service to the community and, in return, permit the utility to earn a fair rate of return on the capital it has invested in its operations. As a utility provides a basic necessity, e.g. energy or water, there is minimal fluctuation in demanded volumes in response to the economic cycle, while the price charged for the utility service can be adjusted with limited impact upon demanded volumes. As a result, the earnings of regulated utilities have been, and are expected to continue to be, stable irrespective of economic conditions.

• **Infrastructure:** This includes airports, ports, toll roads, and communications infrastructure. Regulation of infrastructure companies (where it exists) is generally less intensive than regulation of utilities and this allows companies to accrue the benefits of volume growth (i.e. the returns of infrastructure companies are linked to growth in passengers, vehicles or containers). As economies develop, grow and become more inter-dependent, we expect the underlying level of aviation, shipping vehicle, and wireless data traffic to increase. As a result, the revenues and earnings derived by infrastructure assets are expected to grow.

A key feature of the portfolio construction process for the Strategy is the application of what we call "the 75% rule". This relates to those companies whose assets are a mixture of assets that Magellan classifies as infrastructure and those assets that do not meet our strict requirements. In those circumstances, we require at least, and on a consistent basis, 75% of the earnings of the company to be derived from the assets that meet our definitional requirement before it can be included in the Strategy.

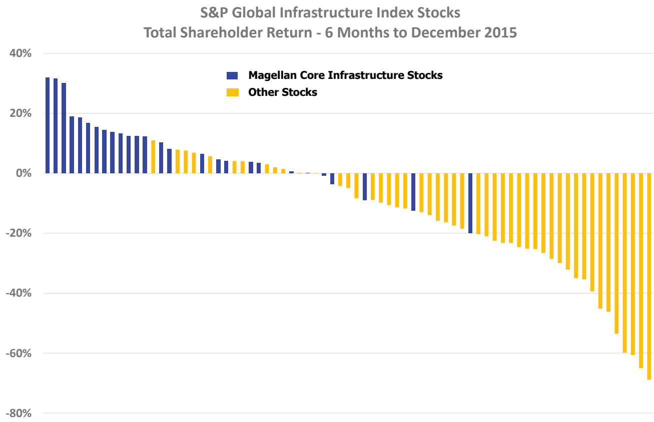
## Portfolio Summary

The Strategy generated a return of +9.3% before fees hedged in Australian dollars for the six months to 31 December 2015, outperforming the benchmark S&P Global Infrastructure Index return of -6.5% by +15.8%.

The last six months have provided a clear demonstration of the importance of how a global listed infrastructure investor defines their investment universe. As we have noted in previous investor letters, Magellan applies a conservative definition of the infrastructure investment universe that is designed to provide investors with predictable, through the cycle, inflation linked returns. This means that Magellan excludes those stocks from the investable universe whose earnings are materially impacted by competition, sovereign risk and, importantly in the last year, changes in commodity prices. Outperformance over listed infrastructure and global equities benchmarks reflects the limited exposure of the Strategy to stocks impacted by falling energy prices and, to a lesser extent, emerging markets.

To illustrate this point, Figure 1 shows the Total Shareholder Return (TSR) in local currency of the constituent stocks in the benchmark S&P Global Infrastructure Index for the six month period ended 31 December 2015 as well as the stocks held in the Strategy over the same period.

**Figure 1:** S&P Global Infrastructure Index Stocks.




Source: Magellan Asset Management Limited

The graph clearly shows why the Strategy has out-performed so strongly over the period – it not only held stocks that performed well over that period but, just as importantly, it avoided stocks that performed poorly.

75 of the 89 stocks in the Strategy generated a positive shareholder return in the period. Particularly strong returns were provided by US utilities subject to actual and likely takeover activity being Piedmont Natural Gas (Total Shareholder Return (TSR) of +63.8%), Teco Energy (+53.7%) and Empire District Electric Co (+31.8%). Other strong performers included Mexican airport company GAPB (+44.6%), Sydney Airport (+30.1%), and other US utilities Westar (+26.3%), PNM Resources (+26.1%) and Atmos Energy (+24.6%).

All sectors held by the Strategy except Energy Infrastructure delivered positive returns for the period, with the Airports sector providing a weighted average TSR of +18.5%, the Power Transmission & Distribution sector +13.1%, Integrated Power +12.8% and Gas Utilities +11.9%. The Energy Infrastructure sector was clearly impacted by the fall in oil prices, however, we remain confident that this will have only marginal impacts on the earnings of those stocks held in the Strategy.

Geographically, the Strategy's Latin American exposures generated a TSR of +17.9%, US stocks were up +13.5% and Australian/New Zealand stocks provided a TSR of +12.9%.

As previously mentioned, the performance of the benchmark was negatively impacted by stocks with a material exposure to oil prices. Examples of significantly weighted stocks in the index caught up in the commodity price falls included Kinder Morgan Inc (TSR of -59.9% for the period), The Williams Companies Inc (-53.6%) and Cheniere Energy Inc (-46.2%).

The top 10 holdings in the Strategy at 31 December 2015 were:

**Figure 2:** Top 10 holdings in the Strategy at 31 December 2015:

| Stock | Sector | Weights (%) |
|---|---|---|
| **TranCanada Corp** | Energy Infrastructure | 3.1 |
| **Power Assets Holdings** | Integrated Power | 3.1 |
| **Transurban Group** | Toll Roads | 3.1 |
| **National Grid PLC** | Transmission and Distribution | 2.9 |
| **Snam Rete Gas SpA** | Gas Utilities | 2.9 |
| **Enbridge Inc** | Energy Infrastructure | 2.8 |
| **Atlantia SpA** | Toll Roads | 2.7 |
| **Sydney Airports** | Airports | 2.6 |
| **SES GDR** | Communications | 2.5 |
| **United Utilities Group Plc** | Water Utilities | 2.4 |

Source: Magellan Asset Management Limited

During the period, the following changes were made to the portfolio:

### Additions:

- Spanish company Cellnex Telecom – this company listed during the period. It owns networks of towers in Spain that broadcast TV, radio and mobile telephony; and

- French domiciled Eurotunnel – this company owns the rail tunnel between the UK and France. It qualified for inclusion in the portfolio after disposing of a ferry business that Magellan did not classify as investable for the Strategy and consequently passed the 75% rule.

### Deletions:

- US utility UIL – due to its pending takeover by Spanish company Iberdrola, the combined entity would fail the 75% rule;

- German port company Hamburger Hafen – the company was removed because it now fails the 75% rule due to the expansion of its intermodal business, essentially moving containers to hinterland destinations in competition with other transport companies;

- US utility Vectren Corp was removed because it is on the cusp of failing the 75% rule due to increased non-regulated merchant power business and almost certain to fail the rule in 2016; and

- US utility Centrepoint Energy was removed because it failed the 75% rule due to increased non-regulated energy trading business.

**Risk factors in the current environment, including interest rates**

During the period, we've seen an environment of lower growth in China, uncertainty in equity markets, continuing downward pressure on the prices of resources, the start of a Federal Reserve ('Fed') tightening cycle and signs of a potential high yield credit squeeze and repricing. These are all cause for us to reflect on our approach to risk.

Magellan seeks to take a holistic view of infrastructure which considers various risk factors in whether an asset meets our definition and standards for investing. The stability of earnings are determined by more than an asset's competitive position; there is a range of other risk factors which will influence earnings streams.

We assess many risk factors, but the past few months highlights a few worth considering:

- **Sovereign risk:** We avoid countries where political decisions can easily be made which undermine the contractual position or potential earnings of a company. Additionally, we only invest in countries where the judicial system and law is sound so that contractual positions can be enforced in need;

- **Regulatory risk:** We avoid regulatory jurisdictions where regulatory processes are opaque or inconsistently applied;

- **Commodity price risk:** We do not invest in businesses which are materially reliant on the price of the product which they transport e.g. many pipeline businesses and MLPs in the US are excluded from our universe for this reason; and

- **Leverage risk:** We avoid businesses with high leverage or where their ability to service their debt is tight relative to their earnings.

This last point has become of particular focus as a consequence of the Fed raising rates in December 2015. The outlook for rates is for further tightening globally and for longer tenor rates to increase over the next few years.

**Impact on the businesses in which we invest**

We are confident that the underlying businesses in which we invest have strong capital management and are well placed to manage successfully any inevitable increases in base lending rates. These businesses have:

- Strong credit metrics i.e. they have a level of leverage that underlying earnings can comfortably support, and have strong debt service ratios. We estimate that, on average, the companies in our investment portfolio generate free cash to service debt of more than four times their annual debt service. We view that as a strong buffer particularly given the stability of the underlying earnings;

- Improved their credit ratings over time as their earnings and credit metrics have improved. These solid investment grade credit ratings are important to ensure they have access to multiple credit markets at all times regardless of credit cycles;

- Access to various debt markets (e.g. US, Europe, Canada, Australia), meaning they are not reliant on any single market;

- Available liquidity and credit facilities to fund expansion or liquidity requirements;

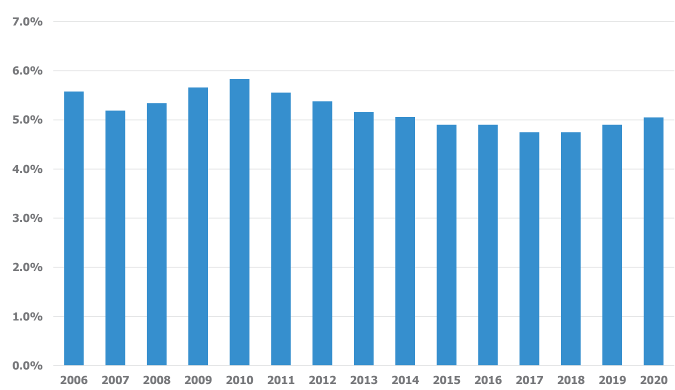
- Lengthened and de-risked their debt maturity profiles so that the average repayment term dates are typically 8 to 10 years out, and repayments of debt in any single year is not excessive relative to the total debt burden;

- Managed interest rate exposure by undertaking material interest rate hedging or issuing fixed rate bonds;

- Reduced the cost of their borrowings throughout 2010 to 2015 by taking advantage of cheaper credit (lower base rates and margins), but they also have further opportunity to reduce debt costs over the medium term by replacing more expensive "old" debt which is becoming due for repayment over the next few years.

It is important to note this last point. While interest rates are likely to increase in the US in the next few years, the average cost of debt of the US stocks in the Strategy is likely to continue to fall as maturing debt is replaced with cheaper debt. As an illustration, Figure 3 shows consensus forecasts for the average cost of debt for Kansas based power utility Westar. It shows the average cost of debt falling until 2018. This is because much of the debt maturing over the next two years was raised around the time of the global credit market crisis in 2008 to 2009 and is therefore significantly more expensive than the debt Westar is likely to raise in the next two years regardless of base interest rates or margins.

**Figure 3:** Westar Energy Inc Average cost of debt:




Source: Magellan Asset Management Limited

So overall, we remain confident that these businesses are well placed to continue to meet our investment expectations over the medium term and through a period of rising rates.

## Portfolio Outlook and Strategy

The Strategy is designed to provide reliable returns over the medium-to-longer term. Excluding the impact of FX effects, Magellan expects the Strategy to provide a gross return of inflation plus 5% to 6% over the medium term.

Magellan believes that infrastructure and utility assets, with requisite earnings reliability and a linkage of earnings to inflation offer an attractive, long-term investment proposition. Furthermore, given the predictable nature of earnings and the structural linkage of those earnings to inflation, the investment returns generated by infrastructure assets are different from standard asset classes and offer investors valuable diversification when included in an investment portfolio. In the current uncertain economic and investment climate, the reliable financial performance of infrastructure investments makes them particularly attractive and an investment in listed infrastructure can be expected to reward patient investors with a three to five year timeframe.

Yours sincerely,

**Dennis Eagar**
**Portfolio Manager**

## Contact Details

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Performance is compared to the Global Infrastructure Benchmark which comprised of the following: from inception to 31 December 2014, the benchmark is UBS Developed Infrastructure & Utilities Index NTR Index (Hedged to AUD) and from 1 January 2015 onwards, the benchmark is the S&P Global Infrastructure NTR Index (Hedged to AUD). Both indices are market capitalisation weighted indices that are designed to measure the equity performance of listed Infrastructure and Utility stocks. Index results assume the reinvestment of all distributions of capital gain and net investment income using a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. The index is hedged to Australian dollars.

GIPS® DISCLOSURE

Magellan claims compliance with the Global Investment Performance Standards (GIPS®). For the purpose of complying with GIPS, the Firm is defined as all discretionary portfolios managed by Magellan. The Magellan Core Infrastructure Hedged to AUD composite is a global Strategy investing in strictly defined or "pure" infrastructure companies (typically 80-120). To achieve investment objectives, the composite may also use derivative financial instruments including, but not limited to, options, swaps, futures and forwards. Derivatives are subject to the risk of changes in the market price of the underlying securities instruments, and the risk of the loss due to changes in interest rates. The use of certain derivatives may have a leveraging effect, which may increase the volatility of the composite and may reduce its returns. A list of composites and descriptions, as well as policies for valuing investments, calculating performance, and preparing compliant presentations are available upon request by emailing data@magellangroup.com.au

^ The representative portfolio is an account in the Composite that closely reflects the portfolio management style of the Strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio may differ from those of the composite and of the other accounts in the composite. Information regarding the representative portfolio and the other accounts in the composite is available upon request. Industry and Geographical Exposures are calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio.