

Magellan Core Infrastructure Fund

(MANAGED FUND) (TICKER: MCSI)

A diversified portfolio of 70-100 of the world's best infrastructure companies

ARSN 646 028 131

APIR MGE9182AU

AS AT 31 MARCH 2024

Fund Features

- An actively constructed portfolio of 70 - 100 securities that meet our proprietary definition of infrastructure, rebalanced in a systematic manner
- Highly defensive, inflation-linked exposure
- Investors can buy or sell units on the Cboe securities exchange like any other listed security or apply and redeem directly with the Responsible Entity

Fund Facts

Portfolio Manager	Gerald Stack	
Structure	Global Listed Infrastructure Fund, A\$ Hedged	
Objective	Achieve attractive risk-adjusted returns over the medium to long term through investment in a diversified exposure to infrastructure securities that meets the Investment Manager's definition of infrastructure.	
Investment Risks	All investments carry risk. While it is not possible to identify every risk relevant to your investment, we have provided details of the risks that may affect your investment in the relevant Product Disclosure Statement. You can view the PDS for the fund at www.magellangroup.com.au .	
Inception Date [^]	17 December 2009	
Management Fee ¹	0.50% per annum	
Buy/Sell Spread ²	0.15%/0.15%	
Minimum Investment ²	AUD\$10,000	
Fund Size/NAV Price	AUD \$312.2 million / \$1.4836 per unit	
Distribution Frequency	Semi-annually	
Cboe Ticker	MCSI	
Tickers	Solactive iNAV	ICE iNAV
Bloomberg (MCSI AU Equity)	MCSIAIV	MCSIAUIV Index
Refinitiv (MCSI.CHA)	MCSIAUDINAV=SOLA	MCSIAUIv.P
IRESS (MCSI.CXA)	MCSIAUDINAV	MCSI-AUINAV.NGIF
Visit www.magellangroup.com.au for more information, including: fund performance, unit prices and iNAV, investment insights, PDS & forms		

¹Transaction costs may also apply – refer to the Product Disclosure Statement. All fees are inclusive of the net effect of GST;

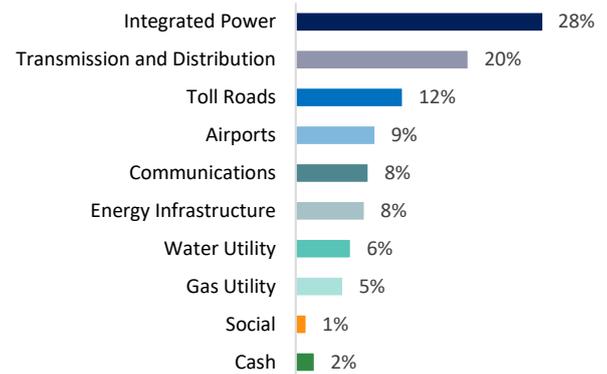
²Only applicable to investors who apply for units directly with the Responsible Entity.

Performance*

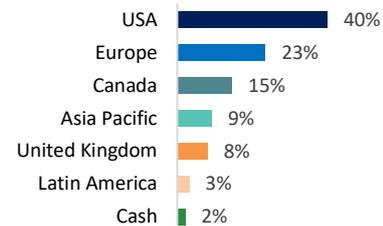
	Fund (%)	Index (%)**	Excess (%)
1 Month	2.9	4.6	-1.7
3 Months	0.0	2.6	-2.6
6 Months	9.2	10.6	-1.4
1 Year	-2.3	2.7	-5.0
3 Years (p.a.)	2.7	5.5	-2.8
5 Years (p.a.)	3.6	3.4	0.2
7 Years (p.a.)	4.8	4.3	0.5
10 Years (p.a.)	7.5	5.9	1.6
Since Inception (p.a.)	10.2	7.3	2.9

Past performance is not a reliable indicator of future performance.

Sector Exposure[#]



Geographical Exposure[#]



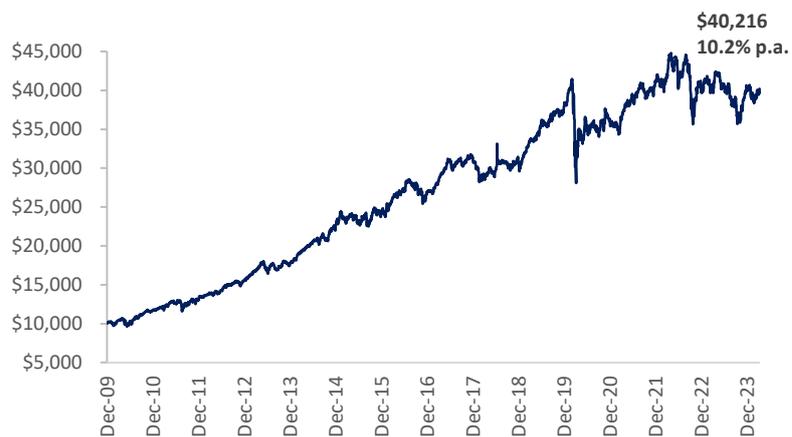
[^] The Fund was established on 17 December 2009 as an unregistered managed investment scheme. On 19 November 2020, the Fund's name was changed to MFG Core Infrastructure Fund and on 30 November 2020 the Fund was registered with ASIC as a registered managed investment scheme and became available to retail investors. On 11 January 2024, the Fund's name was changed to Magellan Core Infrastructure Fund.

* Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Fund Inception 17 December 2009. Returns denoted in AUD.

** S&P Global Infrastructure Index A\$ Hedged Net Total Return spliced with UBS Developed Infrastructure and Utilities Index (A\$ Hedged) Net Total Return prior to 1 January 2015. Note: as the UBS Developed Infrastructure and Utilities Index (A\$ Hedged) Net Total Return ceased to be published from 31 May 2015, it was replaced by Magellan on 1 January 2015 with the S&P Global Infrastructure Index (A\$ Hedged) Net Total Return.

[#] Sectors are internally defined. Geographical exposure is by domicile of listing. Cash exposure includes profit/loss on currency hedging. Exposures may not sum to 100% due to rounding.

Performance Chart growth of AUD \$10,000*



Past performance is not a reliable indicator of future performance.

Top 10 Positions

Company	Sector#	%
Ferrovial SE	Toll Roads	3.07
Enbridge Inc	Energy Infrastructure	3.04
National Grid Plc	Transmission and Distribution	2.99
Fortis Inc	Transmission and Distribution	2.96
TC Energy Corporation	Energy Infrastructure	2.94
Vinci SA	Toll Roads	2.89
Transurban Group	Toll Roads	2.88
Cellnex Telecom SA	Communications	2.85
Aena SME SA	Airports	2.77
Terna SpA	Transmission and Distribution	2.19
TOTAL:		28.57

Fund Commentary

The portfolio recorded a flat return (AUD hedged) for the quarter ended 31 March, with hopes for a near-term reduction in benchmark interest rates fading as monthly inflation readings eased at a slower-than-anticipated pace.

Stocks detracting the most during the three-month period were Cellnex, Xcel Energy and SBA Communications. Spanish communications company Cellnex declined during the quarter as bond yields in Europe moved higher. US utility Xcel Energy fell after the company was asked by a law firm – representing various insurers – to preserve a utility pole that had fallen within the vicinity of a major wildfire in Texas. The suggestion was that the law firm would seek damages if Xcel's subsidiary utility (Southwestern Public Service) were to be found negligent. Meanwhile, shares of wireless tower company SBA Communications declined on expectations that central bankers were unlikely to lower benchmark interest rates in the immediate near term. This decline also follows the strong share price performance towards the end of 2023.

Some of the largest stock contributors over the quarter included Ferrovial, Aena and TC Energy. Shares of Spanish toll road and airport operator Ferrovial climbed following the announcement of a higher-than-expected toll rate at its key 407 ETR asset. Tolls for this major asset had been frozen since the onset of the pandemic (February 2020). Spanish airport operator Aena rose following a strong start to 2024 traffic and a better-than-expected 2023 result. Shares of TC Energy increased after reporting above-consensus FY23 results and progress made towards its de-leveraging plan.

Stock contributors/detractors are based in local currency terms unless stated otherwise.

Outlook

Notwithstanding our expectations for greater volatility in the short to medium term driven by inflation and interest rates, we are confident that the underlying businesses we have included in our defined universe and in our investment strategy will prove resilient over the longer term. We regard the businesses we invest in to be of high quality and, while short-term movements in share prices reflect issues of the day, we expect that share prices in the longer term will reflect the underlying cash flows leading to investment returns consistent with our expectations.

The strategy seeks to provide investors with attractive risk-adjusted returns from infrastructure securities. It does this by investing in a portfolio of listed infrastructure companies that meet our strict definition of infrastructure. We believe that infrastructure assets, with requisite earnings reliability and a linkage of earnings to inflation, offer attractive, long-term investment propositions. Furthermore, we believe the resilient nature of earnings and the structural linkage of those earnings to inflation means that investment returns

¹ Written Evidence from Thames Water to the Inquiry of the Industry and Regulators Committee into Ofwat, the Water Industry and the Role of Government, 15 August 2023, <https://committees.parliament.uk/writtenevidence/123149/html/>

typically generated by infrastructure stocks are different from standard asset classes and offer investors diversification when included in an investment portfolio. In the current uncertain economic and investment climate, the historically reliable financial performance of infrastructure investments makes them attractive, and an investment in listed infrastructure has the potential to reward patient investors with a long-term time frame.

Case Study

(David Costello – Fund Manager)

Thames Water crisis presents compelling opportunity for Severn Trent and United Utilities investors

The unexpected resignation of Sarah Bentley as Chief Executive of Thames Water on 27 June 2023 roiled the United Kingdom's water sector and the corridors of power at Whitehall. Confronted by rampant inflation and an historically poorly maintained network, management projected that the privately owned company would need to spend ~£2 billion more than its authorised revenue allowance in the current five-year regulatory period.¹ Encumbered by persistent regulatory penalties and excessively geared, Thames was rapidly sinking deeper into financial distress. Compounding the company's woes, the prospect of crippling fines stemming from ongoing investigations of alleged environmental breaches by both the Environment Agency, and water regulator, Ofwat, posed a looming threat to the company's ability to finance its operations.

Concerned that Thames could collapse, threatening the provision of water and sewage services to nearly a quarter of the United Kingdom's population, His Majesty's Government drew up contingency plans to place the company into the special administration regime, a form of temporary nationalisation designed to ensure continuity of essential services while new owners are sought. Crisis talks between Thames Water's ultimate parent company, Kemble Water Holdings Limited, Ofwat, and the British Government yielded a conditional commitment that the Group's institutional shareholders would inject £750 million of equity into the business during the current AMP7 regulatory period, ending 31 March 2025.² Shareholders acknowledged that delivery of the company's turnaround plan would also require the provision of further equity support, indicatively sized at ~£2.5 billion, in the 2025 - 2030 regulatory period.³ Thames' shareholders noted, however, that this investment would be forthcoming only if supported by 'appropriate regulatory

² Thames Water, Thames Water Shareholder Funding Update, 10 July 2023, c <https://www.thameswater.co.uk/news/thames-water-shareholder-funding-update-10-july-2023>

³ Ibid.

arrangements',⁴ understood to include an assurance that Ofwat would approve cumulative real bill increases of ~40% for the next five-year regulatory period, that it would permit Thames to make distributions to the financing vehicle in the Kemble Group's byzantine corporate structure, and that its regulators would exercise leniency in assessing fines for environmental breaches. The prospect of a meaningful equity injection, and the testimony of the new Interim Chief Executives of Thames Water before a parliamentary inquiry on 12 July, that the business had ample liquidity and was not at risk of triggering special administration, quelled fears of Thames' imminent collapse. Relief would prove short-lived. Less than a month later, Leigh Day, a law firm, announced that it was commencing group litigation proceedings against Thames Water and five other water and sewage companies, claiming that they had systematically underreported pollution incidents, thereby allowing them to overcharge customers.⁵

The stream of negative headlines with regards to Thames Water weighed heavily on the performance of Magellan Infrastructure strategy holdings, Severn Trent and United Utilities, in the third quarter of 2023, a period during which the Magellan Select Infrastructure strategies maintained moderate positions in each of these names. Compounded by sharp rises in yields on UK Government bonds, the enterprise value of both United Utilities and Severn Trent's regulated businesses declined to a level broadly commensurate with the book value of their regulatory assets, a phenomenon last observed in the run-up to the 2018 general election in which Jeremy Corbyn campaigned for Labour on a platform of re-nationalising the UK's privatised water industry.

In the market's indiscriminate reaction to the Thames Water crisis, we perceived opportunity. Beyond their common sector and geographic exposures, Severn Trent and United Utilities bear little resemblance to Thames Water. The characteristics that distinguish Severn Trent and United Utilities on the one hand, and Thames, on the other, are reflected in their gearing, their achieved returns, and their environmental record:

- Gearing: as at 30 September 2023, Thames Water's £20.6 billion regulated asset base was geared to ~80%,⁶ with the company perilously close to being placed into a 'cash lock-up' under its 'senior regulatory asset ratio' debt covenant. By contrast, Severn Trent and United Utilities are, in our view, prudently financed, with debt funding ~61%⁷ and

59%⁸ of their adjusted regulatory capital values, respectively, in-line with the notional capital structure assumed by Ofwat in setting the cost of capital for the sector.

- Achieved returns: Over the first three years of the AMP7 regulatory period, persistent regulatory penalties have seen Thames deliver its shareholders a miserly real return on regulatory equity (RoRE) of ~1.9%, approximately half the level of the company's baseline return allowance. By contrast, Severn Trent and United Utilities are among only five companies in the sector that have outperformed their baseline return allowances in AMP7, delivering cumulative RoREs of ~8.9% and 7.8%, respectively.⁹
- Environmental record: Thames's chequered environmental record has also seen it ranked amongst the worst-performing companies in the sector in the Environment Agency's Environmental Performance Assessments (EPA) in the last two years. The businesses we hold in the Magellan Select Infrastructure strategies, by contrast, have among the best environmental credentials in the sector: United Utilities has secured the best possible four-star rating in two of the last three years, while Severn Trent achieved a sector record by securing its fourth consecutive four-star rating in the EPA's most recent assessment.¹⁰

Indeed, while Thames Water sank deeper into financial distress during the second half of 2023, we judge that United Utilities and Severn Trent's fundamental prospects improved. Our view reflects United Utilities and Severn Trent's accelerating growth outlook, the likelihood of an increased baseline return allowance in AMP8, and expectations of sustained regulatory outperformance:

- An accelerating growth outlook: United Utilities and Severn Trent's AMP8 business plans propose record levels of investment, supporting projections that growth in their regulatory capital value will accelerate from an anaemic low-single-digit real annualised rate in the current regulatory period to ~5.5 – 6.5% per annum, in real terms, in AMP8. Our

⁴ Ibid.

⁵ Leigh Day, First Environmental Collective Action Claim Launched on Behalf of Millions of Customers Overcharged by Water Companies, 9 August 2023, <https://www.leighday.co.uk/news/news/2023-news/first-environmental-collective-action-claim-launched-on-behalf-of-millions-of-customers-overcharged-by-water-companies/>

⁶ Thames Water, Interim Results for the Six Months Ended 30 September 2023, 5 December 2023, <https://www.thameswater.co.uk/media-library/home/about-us/investors/our-results/interim-2023-24/TWUL-Interim-Report-HY24.pdf>

⁷ Severn Trent, Fiscal 2024 Interim Results Presentation, 22 November 2023,

<https://www.severntrent.com/content/dam/stw-plc/homepage/severn-trent-results-presentation.pdf>

⁸ United Utilities, Fiscal 2024 Interim Results Presentation, 16 November 2023,

⁹ Ofwat, Monitoring Financial Resilience Report 2022-23, 19 October 2023, <https://www.ofwat.gov.uk/wp-content/uploads/2023/10/The-Monitoring-Financial-Resilience-Report-2022-23.pdf>

¹⁰ Environment Agency, Water and Sewerage Companies in England: Environmental Performance Report 2022, 12 July 2023, <https://www.gov.uk/government/publications/water-and-sewerage-companies-in-england-environmental-performance-report-2022/water-and-sewerage-companies-in-england-environmental-performance-report-2022>

conviction that Ofwat will approve the vast majority of spending proposed in these ambitious business plans reflects the legislative mandates that underpin the proposed spend: ~82% of the enhancement investment proposed by Severn Trent in its business plan is required to meet 2030 statutory requirements introduced during the current regulatory period, while 93% of United Utilities' proposed spend is driven by legislative obligations.¹¹ Significantly, regulators and policy makers appear to accept the need for this investment, with public pronouncements from Ofwat, the government, and the Labour opposition repeatedly acknowledging the need for a dramatic increase in investment in the next regulatory period.

- The likelihood of an increased baseline return allowance: Ofwat's early view of the cost of capital for AMP8, struck at ~3.29% in real terms, reflected prevailing market parameters during September 2022. Sustained increases in real yields on UK Government bonds since September 2022 suggest that AMP8 draft determinations, expected in June, will embed an increased weighted average cost of capital. Our analysis of bond markets suggests a ~1.25% increase to Ofwat's early view of the real risk-free rate if prevailing bond rates persist. We note that customary cross-checks undertaken by Ofwat also support a higher return, with depressed prevailing trading multiples on the sector's listed players consistent with higher implied discount rates. Pragmatically, we also note that the imperative for Ofwat to attract unprecedented levels of capital to the sector to deliver legislatively mandated environmental improvements creates a compelling incentive for the regulator to 'aim up' when selecting point estimates from the ranges derived from their econometric analysis.
- Expectations of sustained regulatory outperformance: Under Ofwat's regulatory framework, there are three primary levers through which water companies can achieve realised returns in excess of their authorised return allowance.
 - financing – achieving a weighted average interest rate on their debt portfolio below the regulator's cost of debt allowance;
 - outcome delivery incentives (ODIs) – delivering operational and customer service improvements that exceed performance commitments agreed in the company's regulatory determination, giving rise to incentive rewards; and

- totex – delivering the scope of work agreed in the company's regulatory determination at a lower total cost than the cost allowance provided by the regulator.

On the financing limb, United Utilities and Severn Trent's continued outperformance of Ofwat's cost of debt allowance in AMP8 is virtually assured. With structurally superior credit quality to most of their peers, Severn Trent and United Utilities are, in our view, almost certain to continue outperforming the regulator's embedded cost of debt assumption, which is struck by reference to sector-average debt costs. Moreover, their ability to better Ofwat's assumed cost of new debt in the next AMP reflects their regulatory halo and credit quality that is superior to the blended average of the bond index the regulator uses to set the allowance.

Similarly, on ODIs, we observe that Severn Trent and United Utilities are the only two companies in the sector that have achieved cumulative net rewards in the current AMP. While the increased emphasis on ODIs that are commonly defined and applied across the water sector in the next AMP has the potential to alter relative rankings, we note that both Severn Trent and United Utilities have consistently met or exceeded nearly 80% of their performance commitments in the current regulatory period, suggesting that their outperformance is likely to persist.

On totex, the record levels of investment expected in AMP8 create uncertainty as to the scope for meaningful outperformance. We note, however, that Severn Trent and United Utilities have secured authorisation to accelerate certain AMP8 investments into the current regulatory period. This early start, coupled with the extensive preparations both companies have made with their supply chain should position them well to deliver their scopes of work efficiently and in full.

While we perceive that this is a compelling opportunity, it should be acknowledged that the investment case for Severn Trent and United Utilities is not without risks.

Alongside the rest of the sector, Severn Trent and United Utilities remain subject to ongoing investigations by both Ofwat and the Environment Agency into the compliance of their wastewater treatment works with environmental permits.¹² We note, however, that Ofwat has initiated enforcement cases against six of Severn Trent and United Utilities' peers, has already notified three of the implicated companies of their provisional findings and expects to issue

¹¹ Severn Trent Water, Business Plan 2025 – 30: Investor Summary, 2 October 2023, <https://www.severntrent.com/content/dam/stw-plc/investors-02/business-plan-2025-2030/pr24-investor-summary.pdf>; United Utilities, PR24: Stronger, Greener Healthier – Our Plan for the North West, Business Plan Submission Presentation, 2 October 2023, <https://www.unitedutilities.com/globalassets/documents/corporate-documents/uu-pr24-business-plan-submission-presentation.pdf>

¹² Ofwat, Investigation into Sewage Treatment Works, <https://www.ofwat.gov.uk/investigation-into-sewage-treatment-works/>

a proposed decision in respect of these companies imminently.¹³ In this context, the probability of Ofwat launching an enforcement case against either Severn Trent or United Utilities, more than two years after starting their investigation, appears to us to be remote.

A lack of public disclosure on the progression of the Environment Agency's investigation renders the risk of adverse findings harder to handicap. We note, however, that United Utilities and Severn Trent's environmental credentials are unrivalled amongst their peers, and the management teams of both companies have expressed confidence in their compliance with environmental permits, suggesting that adverse findings are a tail risk. Should this tail event be realised, Severn Trent and United Utilities risk facing criminal prosecution and, if found guilty, could incur uncapped fines and civil penalties. In the final instance, however, the fines and penalties imposed on water companies in respect of environmental breaches are adjudged by the courts, having regard to the same sentencing guidelines that have historically given rise to fines that, in all but a few instances, have proved financially immaterial.

Severn Trent and United Utilities were also among the six companies named as defendants in the group litigation proceedings brought by the law firm, Leigh Day. We note, however, that the management teams of both Severn Trent and United Utilities are adamant the claims are entirely without merit, conflating 'combined sewer overflows' and 'pollution incidents' in a manner that is contrary to the express terms of the regulation.

Yet recent events suggest that the most significant near-term risk to our investment case arises from the prospect of further negative headlines with regards to Thames Water.

In December 2023, Ofwat challenged a dividend payment made by Thames to the Group's unregulated captive financing entity, Kemble Water Finance Limited (KWFL). The distribution, Thames said, was required to fund interest costs on debt issued by KWFL, an entity whose only source of cash flow is dividends from Thames Water. As KWFL is already in a precarious financial position, Ofwat's intercession virtually guarantees that KWFL will default on a debt payment due at the end of April 2024, and calls into question the solvency of the Kemble Group. Bonds issued by Kemble fell sharply in response, trading at deep discounts to their face value. Frenzied negotiations between Thames, Ofwat and the Government ensued.

On 28 March 2024, having reached an impasse in their negotiations, the shareholders of Thames Water issued a press release announcing that the regulatory arrangements expected to apply to the company in AMP8 rendered their business plan uninvestible. Having concluded that the conditions that underpinned their July 2023 commitment to provide £750 million of equity support during the current regulatory period had not been satisfied, Thames'

shareholders announced that the £500 million equity contribution due by 31 March 2024 would not be provided.¹⁴

The announcement leaves Thames teetering on the brink. While the company noted it has £2.4 billion of available liquidity,¹⁵ absent an equity injection, it is only a matter of time before the United Kingdom's largest water company breaches its debt covenants. A multi-notch credit rating downgrade, not inconceivable in the circumstances, would see the company breach the licence condition that requires it to maintain an investment-grade rating, creating a trigger for the government to put Thames into special administration. Press reports suggest that Thames remains locked in furious negotiations with the government, with options including a debt-for-equity swap and injection of equity by new shareholders being canvassed as potential solutions to the crisis. It seems clear, however, that the crisis will not revive proposals to renationalise the country's water industry. The Conservatives oppose such a move on ideological grounds. Moreover, Sir Keir Starmer, Leader of a Labour Party widely tipped to form government in the forthcoming general election, dropped the nationalisation of the water industry from Labour's policy platform in 2022, and in a January 2024 interview with the Reading Chronicle, reiterated his position, noting that "I don't think nationalisation is the answer".¹⁶

Despite any obvious direct implications for Severn Trent and United Utilities, the announcement from Thames Water's shareholders on 28 March saw the stock of both companies lurch lower. While further news regarding Thames may drive increased volatility in the near-term, patient long-term investors should seize the opportunities that arise when markets price risks indiscriminately, taking comfort in the possibility of outsized future returns.

¹³ Ibid.

¹⁴ Thames Water, Thames Water Shareholder Funding Update, 28 March 2024, <https://www.thameswater.co.uk/news/shareholder-update>

¹⁵ Ibid.

¹⁶ The Reading Chronicle, Sir Keir Starmer Speaks Out after Thames Water Supply Chaos, 27 January 2024, <https://www.readingchronicle.co.uk/news/24078516.sir-keir-starmer-speaks-thames-water-supply-chaos/>

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