Magellan Infrastructure Fund (Unhedged)

ARSN: 164 285 830

Fund Facts

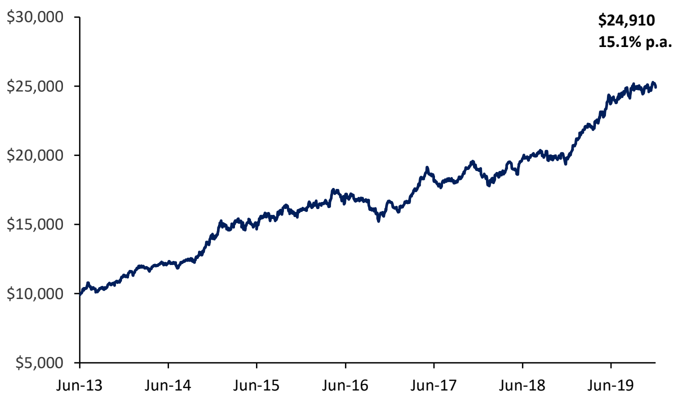
Portfolio Manager	Gerald Stack
Structure	Global Listed Infrastructure Fund (Unhedged)
Inception Date	1 July 2013
Management Fee[1]	1.05% per annum
Buy/Sell Spread[1]	0.15%/0.15%
Fund Size	AUD $1,183.2 million
Distribution Frequency	Six Monthly
Performance Fee[1]	10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (S&P Global Infrastructure Index A$ Unhedged Net Total Return) and the Absolute Return Hurdle (the yield of 10-year Australian Government Bonds). Additionally, the Performance Fees are subject to a high water mark.

[1]All fees are inclusive of the net effect of GST

Fund Features

- Benchmark-unaware exposure to global listed infrastructure
- Conservative definition of core infrastructure
- Relatively concentrated portfolio of typically 20 to 40 investments
- Maximum cash position of 20%
- $10,000 minimum investment amount.

Performance Chart growth of AUD $10,000*



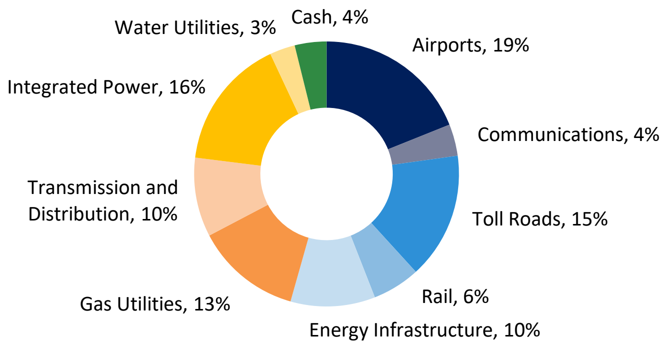
Fund Performance*

	Fund (%)	Index (%)**	Excess (%)
1 Month	-0.7	0.3	-1.0
3 Months	-0.6	0.6	-1.2
6 Months	4.9	5.1	-0.2
1 Year	25.5	25.9	-0.4
3 Years (% p.a.)	14.5	11.4	3.1
5 Years (% p.a.)	12.3	8.9	3.4
Since Inception (% p.a.)	15.1	12.2	2.9

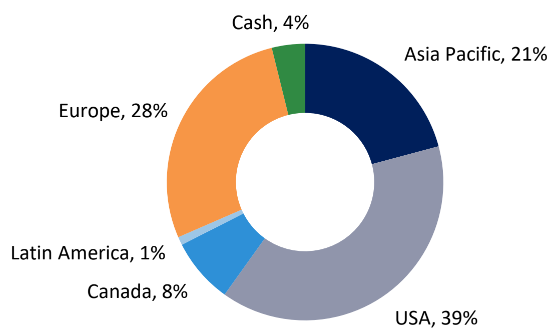
Top 10 Holdings

	Sector#	%
Transurban Group	Toll Roads	6.6
Atmos Energy Corp	Gas Utilities	5.9
Atlas Arteria	Toll Roads	5.4
Enbridge Inc	Energy Infrastructure	5.2
Aena SME SA	Airports	5.1
Aeroports De Paris	Airports	5.0
Xcel Energy Inc	Integrated Power	5.0
Eversource Energy	Integrated Power	4.8
Sempra Energy	Gas Utilities	4.5
Sydney Airports	Airports	3.9
	TOTAL:	51.4

Sector Exposure#



Geographical Exposure#



Sectors are internally defined. Geographical exposures are by domicile of listing. Exposures may not sum to 100% due to rounding.

* 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 1 July 2013.

** S&P Global Infrastructure Index A$ Unhedged Net Total Return spliced with UBS Developed Infrastructure and Utilities Net Total Return Index (AUD). Note: as the UBS Developed Infrastructure and Utilities Net Total Return Index (AUD) 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$ Unhedged Net Total Return.

Fund Commentary

The portfolio recorded a negative return for the quarter. The Stocks that detracted the most on a contributions basis included the investments in Aguas Andinas of Chile, Atmos Energy and Xcel Energy of the US. Aguas Andinas plunged 20% as talk intensified that street riots over the cost of living would prompt the Chilean government to cut the rate of return the water utility enjoys. Atmos shed 1% as a rise in bond yields lead to a snubbing of safer equities over what proved a weak quarter for utilities. Xcel Energy fell 2% after a jump in profit of 5% for the third quarter fell slightly short of expectations for the electricity and gas utility.

Stocks that added the most on a contributions basis were the investments in Enbridge of Canada, ADP of France and Sydney Airport. Enbridge rose 13% after adjusted earnings per share of 56 Canadian cents beat forecasts. ADP added 8% after higher traffic helped third-quarter earnings and the latest counts showed the campaign to force a referendum on whether or not the French government could sell all or some of its 50.6% stake in the Paris airport system was well short of the number needed. A change to the French constitution in 2008 allows a referendum on certain issues if 20% of members of parliament and 10% of the electorate – about 4.7 million people – back the proposal. The latest counts showed barely one million people have signed the online petition that has until March to reach its target. Sydney Airport rose 10% after domestic traffic rose and an inflation result of 1.7% for the 12 months to September increased talk that interest rates would stay low in Australia.

Movements in stock prices are in local currency.

Stock story: American Water

In the US, more than two trillion gallons (9.1 trillion litres) of water are lost each year – that means 20% of treated water is wasted. About 900 billion gallons (4.1 trillion litres) of untreated sewage every year pours into US waterways. The problem is about 240,000 water mains break each year, which is no surprise given that many of country's pipes were laid early to mid-last century and they had a lifespan of only 75 to 100 years. This year, 44% of US water-pipe infrastructure is expected to be assessed as 'poor', 'very poor' or 'life elapsed', another way of saying 'needs replacing'. As for quality, the American Society of Civil Engineers gave US drinking water a 'D' in 2017 while the country's wastewater facilities was rated 'D+' – some of the body's harshest assessments of US infrastructure.

Billions of dollars would need to be spent in coming years to improve the US's water and wastewater systems. But this will be difficult given the size and fragmented nature of the industries. The US is home to about 50,000 water systems where 84% of the population is served by water systems run by municipal authorities. About 10,000 of the US's water systems serve fewer than 3,000 customers and about 1,400 are under some sort of enforcement action to remedy deficiencies. The country maintains 15,000 wastewater systems where 98% of the US population is served by city authorities. About 2,200 of these wastewater systems are under some sort of formal enforcement action. (By way of comparison, the US hosts only 3,800 electrical and 1,400 gas systems.)

American Water Works, the largest listed water utility in the US, eyes the problems with the US's water and wastewater systems as an opportunity to expand while earning higher returns for investors from what is a low-risk industry operationally – unlike gas lines, water mains and pipes typically don't explode. The strategy of the New Jersey-based company that earned US$3.4 billion in revenue in fiscal 2018 from servicing 14 million people across 46 US states and one Canadian province has three prongs.

American Water's main focus is to boost the amount of capital on which it can earn a regulated but fair return by spending US$20 billion to US$22 billion over the next 10 years to improve its network. In the US (and elsewhere), utilities are granted monopoly rights in an area. In exchange, regulators ensure essential services stay affordable by limiting the return a utility can earn on its capital investment. The setup means that the best way for a utility to boost revenue is to increase the amount of approved capital spending on which it can earn a regulated return.

American Water, which enjoys an average weighted return of 9.8% from its regulated activities, expects to replace nearly 2,000 miles (3,200 kilometres) of mains and collection pipes over the next five years. As American Water has typically replaced only about 0.8% of its pipeline network a year (which, in industry jargon, translates to a 130-year replacement cycle), the company has a vast opportunity to invest in its network to ensure robust growth in regulatory revenue in coming years.

American Water's second prong is to expand through takeovers. American Water plans to spend up to US$1.2 billion on acquisitions from 2020 to 2024 and there are plenty of targets because only 16% of the US's water systems and just 2% of the wastewater systems are investor-owned. Last year, the company finalised 19 purchases in eight states that added more than 50,000 regulated connections. That boosted the number of deals completed since the start of 2015 to 82, which came with 173,000 new customers in 10 states.

The city authorities that operate many water systems in the US are keen to sell because offloading assets eases their financial stress and they are under political pressure to improve water quality – something American Water is better at than they are. That American Water has a strong operating history, a good reputation and is familiar to many state regulators streamlines takeover approvals.

The third prong is that management is focused on running American Water more efficiently. Management intends to reduce expenses to 31.5% of revenue by 2023, down from 35% in 2019 and from 46.1% in 2010. The company is cutting its cost-to-income ratio by adopting technology, improving supply systems and by scrutinising costs.

The three prongs have helped American Water deliver solid shareholder gains in the past five years – the company has recorded a compounded growth rate of 10% in dividend payments and average annual revenue growth of 3% over the period. In coming years, they are likely to help American Water deliver to investors what they expect from infrastructure and utility assets – namely, dependable and transparent earnings streams spiced with some capital growth.

To be sure, none of American Water's strategies is guaranteed to succeed to the extent sought; dealing with so many regulators has its time-consuming side and regulators could always make unfavourable decisions when it comes to regulated returns. Climate change could complicate operations of water utilities. The company has financed takeovers and capital spending with debt of US$7.6 billion at the end of 2018. Even allowing for these qualifications, American Water has fulfillable plans in place that are likely to provide investors with secure cash flows and some capital growth from low-risk activities in coming years.

Four arms

The history of American Water traces to 1886 when the American Water Works & Guarantee Company was founded. While much happened in between, 2003 was a year of note because American Water was acquired then by the German utility RWE, which in 2008 listed the company via a 'spin-off'.

American Water these days consists of four businesses. The most important is the regulated business that operates metered water services in about 1,600 communities in 15 states, each with a regulator. This unit's assets consist of 51,000 miles (82,000 kilometres) of pipes, 621 water-treatment plants, 1,000 wells, 130 wastewater plants, 1,300 water-storage facilities and 1,400 pumping stations. This regulated business brings in more than 85% of the company's revenue even though water customers on average pay less than one US cent per gallon. About 25% of regulated revenue is sourced from New Jersey while another 20% comes from Pennsylvania.

American Water's unregulated arm (or 'Market-Based Business' as the company calls it) includes its Contract Operations Group, which runs water facilities for cities and businesses. Another is the Homeowner Services Group, which offers services to 1.5 million homeowners and small businesses to guard against the cost of repairing water and sewer pipes. Lastly, the Military Service group provide water services to about 16 US military bases.

With these businesses, American Water is primed to help improve the US's decrepit water and wastewater systems in coming years while keeping investors happy.

Sources: Company filings and website