

Magellan Infrastructure Fund (Unhedged)

ARSN: 164 285 830

Fund Facts

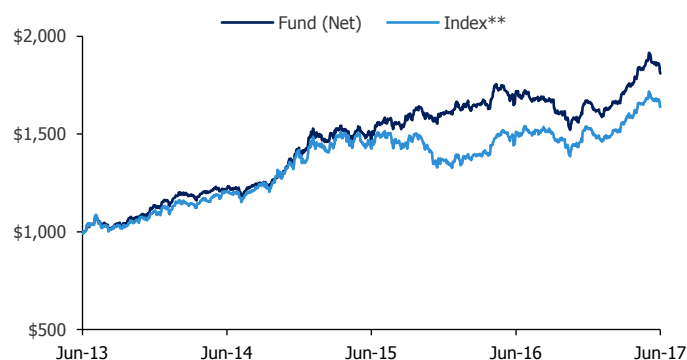
Portfolio Manager	Gerald Stack
Structure	Global Listed Infrastructure Fund (Unhedged)
Inception Date	1 July 2013
Management & Administration Fee ¹	1.05% per annum
Buy/Sell Spread ¹	0.15%/0.15%
Fund Size	AUD \$610.8 million
Distribution Frequency	Six Monthly
Performance Fee ¹	10.0% of the excess return 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.

¹All 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 \$1,000*



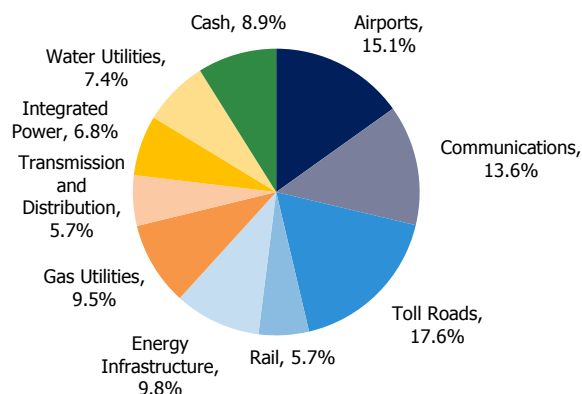
Fund Performance*

	Fund (%)	Index (%)**	Excess (%)
1 Month	-4.0	-3.1	-0.9
3 Months	5.3	5.0	0.3
6 Months	9.0	7.4	1.6
1 Year	5.2	8.5	-3.3
3 Years (% p.a.)	14.0	10.7	3.3
Since Inception (% p.a.)	16.0	13.2	2.8

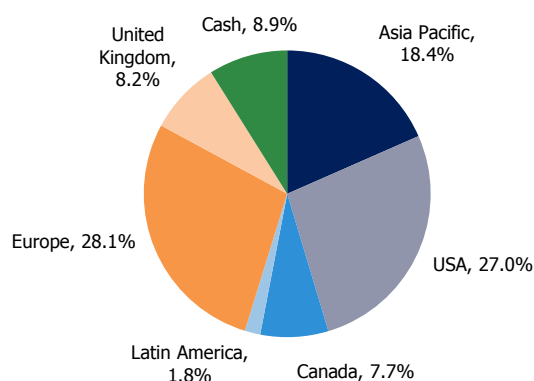
Top 10 Holdings

	Sector [#]	%
Transurban Group	Toll Roads	7.1
Enbridge Inc	Energy Infrastructure	5.1
Aeroports De Paris	Airports	5.0
Sempra Energy	Gas Utilities	4.8
Crown Castle International	Communications	4.6
United Utilities Group Plc	Water Utilities	4.3
National Grid PLC	Transmission and Distribution	3.9
Flughafen Zuerich AG	Airports	3.8
Sydney Airports	Airports	3.5
SES S.A.	Communications	3.4
TOTAL:		45.5

Sector Exposure[#]



Geographical Exposure[#]



* 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 March 2015, it was replaced by Magellan on 1 January 2015 with the S&P Global Infrastructure Index A\$ Unhedged Net Total Return.

[#] Sectors are internally defined. Geographical exposures are by domicile of listing.

Market Commentary

Global infrastructure stocks outperformed rising global stocks in the June quarter after lower bond yields boosted the relative attractiveness of long-duration assets such as infrastructure stocks and the defeat of the French presidential candidate who had promised to nationalise toll roads boosted French utilities and infrastructure stocks. Utilities were the fourth best-performing of the 10 industry classifications within the MSCI World Index.

In the US, government 10-year bond yields, the benchmark for global credit markets, fell 8 basis points to 2.31% over the quarter as reports showed the US economy was subdued as first-quarter GDP only grew at an annualised rate of 1.4%. The Federal Reserve looked through this to raise official interest rates by 25 basis points, and released statements reiterating its belief that inflation and economic growth will pick up.

In Europe, investors were reassured when the pro-EU Emmanuel Macron defeated the anti-EU populist Marine Le Pen in the second and final round of the French presidential election. French utilities surged 14% in May on Le Pen's defeat, a rally that prompted a more widespread rise in European infrastructure stocks. Offsetting this, UK utility stocks fell in June after the Conservatives were only able to form a minority government that is expected to be short-lived. Investors are concerned that a Labour government might nationalise key essential services and reduce the allowed profits of utilities.

Global stocks set record highs in the June quarter after US companies posted better-than-expected earnings for the first quarter, readings showed the US economy was expanding sufficiently and the Federal Reserve reconfirmed that monetary policy would only be tightened gradually.

Fund Commentary

The portfolio recorded a positive return in the June quarter.

At a stock level, the best-performers included investments in Aeroports de Paris, Flughafen Zuerich and Macquarie Atlas Roads. Aeroports de Paris surged 23% after the company confirmed fiscal 2017 profit guidance and lifted its forecast for traffic growth from about 2% to 3%. As well, the company enjoyed higher traffic at its airports and benefited from the French election result as Macron has promised to sell government stakes in major French assets, potentially including the state's 50.6% holding in the company. Flughafen Zuerich rose 13% on rising passenger numbers, up 8.3% year-to-date in May on the back of Swiss Airlines fleet renewal. Macquarie Atlas, which operates toll roads in France, the UK and the US, gained 9.6% on favourable traffic growth.

The worst-performing stocks included United Utilities and Enbridge. United Utilities shed 10% amid the general slump in UK utilities following the UK election as the Conservatives lost their parliamentary majority, and Labour, which has a policy of nationalising the utilities, has moved ahead in the polls. Enbridge fell 6.4% after first-quarter earnings fell short of expectations as its gas distribution unit underperformed.

Over the quarter, we increased our cash position from around 9% to approximately 10%. We are holding cash in anticipation that rate increases in the medium term will provide more favourable valuations for investing in infrastructure stocks. We expect the portfolio will become fully invested over the medium term as prevailing bond yields rise to more normal levels.

During the quarter, the portfolio reduced its exposure to satellite communication companies (part of the communication infrastructure sector) and increased holdings in airports and toll roads.

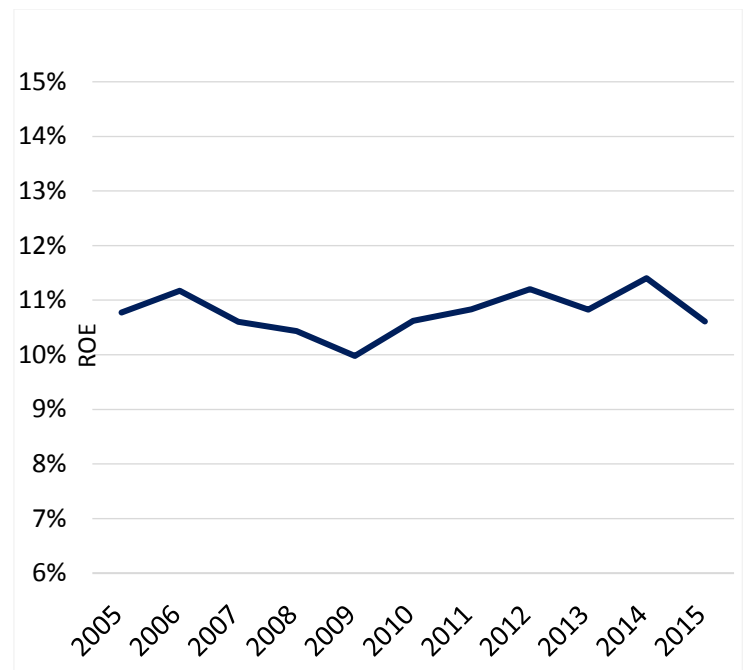
Movements in stocks are in local currency.

Topic in Focus Why invest in utilities?

Regulated utilities are known for their ability to generate moderate but predictable returns regardless of market conditions. For this reason, we often describe utility stocks as the 'lead in the keel' of our infrastructure portfolios. They allow us to navigate shifts in global equity markets with confidence as we seek to deliver annualised returns of 5% in excess of inflation through a market cycle.

Consider the exhibit below, where allowed returns for a sample of regulated US utilities within our investment universe barely fluctuated as interest rates declined when economic growth slowed. Over time, the stable and reliable earnings derived from transmission and distribution assets should deliver income and capital growth for investors.

Return on equity for selected US-based regulated utilities



Source: Company accounts.

Utility group includes Alliant Energy, Atmos Energy, Consolidated Edison, ITC, Eversource Energy, Southwest Gas, Southern Company, Westar Energy, WGL, Wisconsin Energy & Xcel

Utilities defined

Utilities are companies that produce and deliver basic essential services such as electricity, natural gas and water. These services are delivered by a network of assets that require the use of public rights-of-way. Crucially, these networks exhibit attributes of a natural monopoly: the extensive investments required to construct the assets make it difficult for another company to compete profitably against the incumbent. Due to this natural monopoly, governments have generally operated utilities but in recent decades they have handed the responsibility to private operators under licence.

To gain this licence, a utility agrees to submit to regulations that govern the rates it can charge customers. In return, the regulator commits to set prices in a manner that allows the utility to earn a rate of return commensurate with the risk borne and the costs incurred. While returns set by regulators can be modest compared with other sectors, utilities are often assured of a minimum return regardless of how the economy is performing because demand for their services is constant. Thus, utility stocks can provide stable earnings and cash flows.

Key earnings drivers

Under the regulatory compact, the utility submits to rate regulation in exchange for exclusive rights to operate within a market. Regulation allows the utility to recover its costs, as well as earn a reasonable rate of return. For its part, the regulator defines what costs can be recovered and what is a fair rate of return, which help determine the prices a utility can charge.

Determining rates

The process by which utility charges, or rates, are determined differs across countries and jurisdictions. At its core, a utility's rates are a function of its asset (or rate) base and the authorised rate of return.

One of the more common approaches used (particularly in North America) is 'cost of service'. This approach requires the regulator to determine the revenue requirement, which reflects the amount a utility must collect from its customers to recover its costs and earn a fair and reasonable return. To put it another way:

revenue requirement = operating expenses + (rate base multiplied by the rate of return).

The utility tends to concern itself with its 'rate base', and the rate of return, because these factors typically exert the greatest influence on the company's long-term earnings. By contrast, operating expenses assume less importance as a driver of returns, as these costs are typically passed onto consumers (i.e. utilities do not earn a return on expenses).

As noted, the approach to determining rates can differ across markets. In the UK, regulators use performance-based ratemaking to determine customer charges. While similar to cost-of-service ratemaking in some ways, performance-based ratemaking allows the utility to increase earnings by reducing or limiting costs (instead of increasing rates). The regulator, for example, may allow a utility to adjust its rates based on pre-determined productivity measures or other factors. The exhibit below provides a comparison of cost-of-service and performance-based rates.

Cost of service	Performance based
Rate base	Rate in year 1
x rate of return	+ inflation
+ operating expenses	+/- productivity
= revenue requirement / sales	+/- other
= rate	= rate in year 2

Incentive ratemaking is another regulatory approach that uses mechanisms to reward utilities for achieving certain operating targets (as opposed to performance-based cost metrics). Incentives may range from higher allowed returns for meeting energy-efficiency goals to return-on-equity adders for making specific investments. Conversely, (negative) incentives are tools used to penalise utilities for failing to meet certain operating standards.

The rate base

The rate base represents all capital employed by the utility to serve its customers. These might include buildings, power plants, poles, wires, transformers and pipelines.

Over time, the rate base declines as the capital base depreciates. Equally, the asset base grows whenever the utility invests in its capital base. For this reason, investors typically view most (regulated) capital investments as positive for earnings growth.

In countries such as Australia, Chile, New Zealand and the UK, the regulated asset base is the comparable reference used by regulators. It is, however, a term that carries no legislative backing. The regulated asset base, unlike the US 'rate-base' model, allows the regulator to amend contracts via an ordered review, or the revision or renegotiation of licences.

Rate of return

A utility's rate of return is an aggregation of costs for the different sources of funding (i.e. weighted-average cost of capital based on the utility's capital structure).

Hypothetical rate of return calculation

	% of capital structure	Cost of capital for element	% of capital structure
Common equity	45%	10%	4.50%
+ preferred equity	5%	8%	0.40%
+ long-term debt	45%	7%	3.15%
+ short-term debt	5%	5%	0.25%
= rate of return	100%		8.30%

As each source of funding has different costs, the mix can have a sizeable effect on the overall weighted rate of return. Moreover, a higher share of equity will usually translate into higher rates for consumers due to the higher cost of equity. This often requires regulators to establish limits on a utility's capital structure.

US utilities have a capital structure that ranges somewhere between 40% and 60% equity, although this can be higher in other parts of the world. US utilities often only concern themselves with their return on equity as the cost of debt is passed through to the customer. In jurisdictions such as the UK, however, regulation considers the entire return on capital.

Those unfamiliar with utilities might find any company with debt comprising more than 50% of the capital structure surprising as other industries typically carry less leverage. But the ability to have a more highly levered balance sheet is a function of earnings predictability, which is borne out of regulation.