MAGELLAN ASSET MANAGEMENT LIMITED

Half Yearly Investor Report

Magellan Infrastructure Fund | December 2014

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Head of Investments and Portfolio Manager
Magellan Infrastructure Fund

Dear Investor,

I am pleased to write to you as an investor in the Magellan Infrastructure Fund ('MIF' or the 'Fund') for the six months ended 31 December 2014.

Over the period, the Fund returned 8.9%, net of fees, which was 2.6% better than the market benchmark (the UBS Developed Infrastructure & Utilities Net TR Index hedged to AUD). For the year ended 31 December 2014, the Fund returned 22.4%, 0.5% less than the market benchmark.

On 1 July 2013, we launched an unhedged version of the Fund. Over the period, the Magellan Infrastructure Fund (Unhedged) ('MIFU') returned 14.5%, net of fees, which is 0.4% better than the market benchmark (the UBS Developed Infrastructure and Utilities Net Total Return Index (AUD)). For the year ended 31 December 2014, MIFU returned 23.3%, 1.4% less than the market benchmark.

The Fund is currently measured against the UBS Developed Infrastructure & Utilities Net Total Return Index (Hedged to AUD). Unfortunately, UBS has decided to discontinue production of this index on 1 April 2015. As a result, we are changing the benchmark to the S&P Global Infrastructure Net Total Return Index (Hedged to AUD), effective 1 January 2015. Historically, the S&P index has performed similarly to the UBS index.

Although returns in recent years have been pleasing, we judge infrastructure (when properly defined) to be a low-risk asset class that should provide investors with long-term returns in the order of inflation +4-5% per annum (as we have commented in previous investor reports). Infrastructure assets were oversold during the global financial crisis ('GFC') and the returns they have achieved over the last three years (Fund 18.4%, market benchmark 16.7%) reflect the market re-focusing on the asset class's attractive, conservative fundamentals.

Portfolio Strategy

Generally speaking, infrastructure assets are natural monopolies that provide an essential service to the community. Over time, we expect that the stable, reliable earnings generated by such assets will lead to a combination of income and capital growth for our investors.

[1]This is an index produced by MSCI Inc. that aims to represent large- and mid-cap equities across 23 Developed Markets countries. The index covers approximately 85% of the free float-adjusted market capitalisation in each country. The index is presented here showing returns in Australian Dollars.

The Fund seeks to provide its investors with superior risk-adjusted returns from the infrastructure asset class. It does this by investing in listed infrastructure companies that have attractive characteristics at discounts to their assessed values.

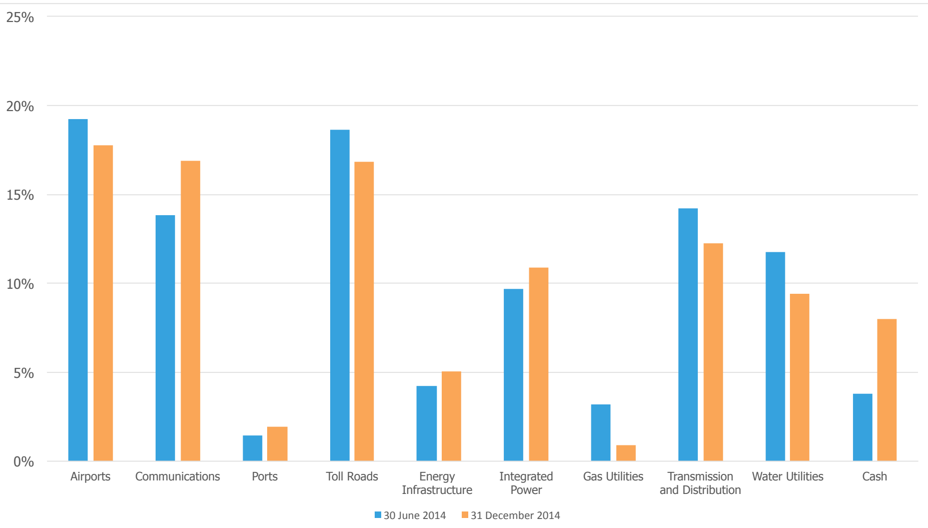
The Fund's investment universe is strictly defined and only includes businesses that exhibit predictable cashflows (as many investors would appreciate, providing an essential service does not necessarily translate to durable cashflow generation). The universe excludes infrastructure stocks whose earnings are assessed as having material exposure to competition, commodity prices (including oil prices), or unacceptable sovereign or regulatory regimes. This removes risk from the Fund, allowing it to deliver more predictable returns than broader infrastructure indices through the economic cycle, while also protecting its investors' capital. This importance of a disciplined approach to defining the investment universe was apparent in the recent solid performance of the Fund (it outperformed the benchmark by 1.4% for the month of December 2014) when many of the stocks we exclude were negatively impacted by falling oil prices.

As we have outlined in previous investor reports, the universe of infrastructure assets that we consider for the Fund is dominated by two main sectors:

- **Utilities,** including both regulated energy utilities and regulated water utilities. Utility regulation generally requires the utility to efficiently provide an essential service to the community and, in return, permits the utility to earn a fair rate of return on the capital it has invested in its operations. As the utility provides a basic necessity, e.g. energy or water, demanded volumes are expected to be steady under most scenarios and the consequent earnings of regulated utilities are expected to be stable.

- **Infrastructure**, which includes airports, ports, toll roads, energy infrastructure and communications infrastructure. Regulation of infrastructure companies is generally less intensive than regulation of utilities, allowing companies to accrue the benefits of volume growth. As economies develop, grow and become more interdependent, we expect the underlying level of aviation, shipping and vehicle traffic to increase. As a result, the revenues and earnings derived by infrastructure assets are expected to grow in a predictable manner over the medium term.

Figure 1: Fund by Sector. Source: Magellan



The Fund's investment approach is susceptible to underperforming investment market benchmarks in rising markets, but is also expected to provide more stable, reliable investment returns when markets are declining.

Portfolio Summary

On 31 December 2014, the Fund consisted of 28 investments (in comparison with 30 investments at 30 June 2014). The top ten investments represented 56.5% of the Fund at 31 December 2014, compared with 56.2% at 30 June 2014.

The composition of the Fund by sector at 30 June 2014 and 31 December 2014 can be seen in Figure 1.

The composition of the Fund by geography at 30 June 2014 and 31 December 2014 can be seen in Figure 2.

In January 2015, the Fund paid a distribution of 0.94 cents per unit in respect of the six months ended 31 December 2014.

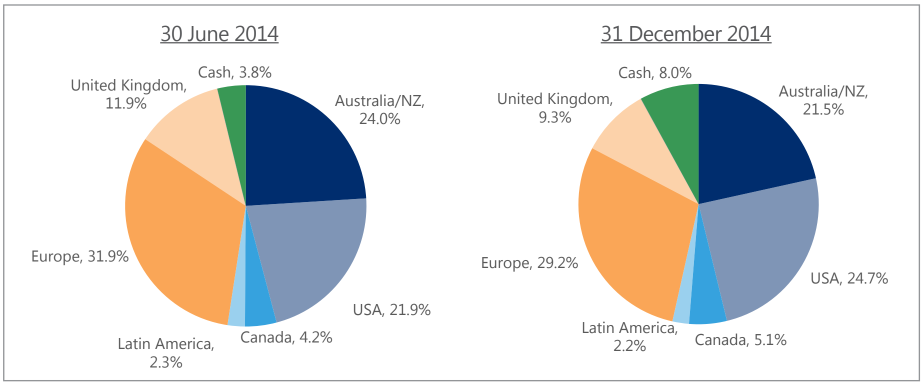
During the period the portfolio was changed only marginally both from a sector and regional viewpoint. The major change was an increase in weighting to US mobile telephony tower company, Crown Castle.

Risk of Increasing Interest Rates

In our view, the major risk currently faced by infrastructure and other asset classes is the impact of a potential increase in bond yields.

We expect interest rates to rise over the medium term. Increasing interest rates

Figure 2: Composition of the Portfolio by Geography. Source: Magellan



represent a challenge for all investment classes and infrastructure, although better placed than many assets, is not immune from these risks. While prevailing interest rates have been well below historical averages since the global financial crisis, we do not believe that long-term infrastructure investors made their investment decisions during the period since the GFC based on prevailing interest rates, but on a higher, more historically normal level of interest rates. As a consequence, while increasing interest rates represent a risk for investors in infrastructure assets, we believe that the risk over the medium to long term is not that interest rates rise from present levels, rather than rise materially above "normal" levels.

The risks posed by an increase in interest rates are somewhat different for utilities and infrastructure assets.

- **Utilities:** Utilities operate under a compact with their communities under which the utility provides a reliable, efficient service and invests for the future, in return earning a fair return on the capital invested in its operations. Utilities are not able to exploit their natural monopoly power, but they are protected from both the fluctuations of the economic cycle and changes in variables outside their control, such as interest rates. Ultimately, the key determinant of the level of returns generated by regulated utilities is the return approved by their regulators. An increase in interest rates should lead to an increase in the approved rate of return (so that the utility continues to be able to earn a fair return). However, a utility can suffer because of mismatches and lags between increases in interest rates and subsequent accompanying increases in approved regulatory returns. Regulatory rates of return have been sticky as interest rates have declined and we expect that there will also be stickiness as they rise.

- **Infrastructure:** Infrastructure assets typically have an ability to pass the effects of inflation through to consumers via the price of the infrastructure service (e.g. tolls on a toll road are normally linked to inflation). However, where an infrastructure asset is partially funded by debt, an increase in interest rates (that is not accompanied by an increase in inflation) can increase the cost of the debt (with a lag if the debt interest costs are hedged) and, therefore, reduce the returns available to investors.

One of the interesting effects of the GFC has been the significantly increased focus of debt markets on the reliability of the debt of high-quality infrastructure and utility assets. The companies in which we invest now have access to more sources of debt, longer term debt and significantly cheaper debt than pre-GFC. As a consequence, almost all of the companies in which we invest have the significant majority of their debt in fixed interest rate structures that will insulate them from any rise in interest rates in the shorter term.

Company in Focus – Enbridge

Enbridge Inc. is one of North America's largest energy infrastructure companies. It owns and operates the world's largest crude oil and liquids transportation system across Canada and the United States. This asset base is dominated by a petroleum pipeline network that delivers more than 2.2 million barrels per day.

The company also owns a vast network of natural gas-related transmission and midstream assets in the region. Additionally, Enbridge owns and operates Canada's largest natural gas distribution utility in Ontario, Quebec and New Brunswick, as well as parts of New York State in the US. More recently, Enbridge diversified its asset portfolio by entering into the clean energy sector through wind, solar and geothermal assets.

So why does the Fund own this stock? For some time, Magellan has recognised two important observations in the North American energy infrastructure space:

- **North America is undergoing an energy transformation.** From a supply perspective, new technologies have allowed the industry to unlock massive reserves that were once inaccessible and uneconomical. The production growth has subsequently caused transportation shortages and bottlenecks between supply regions (e.g. Western Canadian oil sands) and major demand markets (e.g. US Gulf Coast). This has ultimately resulted in regional pricing differences/ dislocations.

- **Infrastructure can capitalise on price dislocation.** The lack of market access essentially means that oil and gas producers can't achieve the premium prices being paid at the major demand hubs. New and/ or additional pipeline capacity would obviously solve this, allowing the infrastructure owner to capture much of the price dislocation (or differential). For Canadian producers, this differential is estimated to be as much as $50 million per day, according to the Canadian Chamber of Commerce.

This is where Enbridge comes in. The company has an established pipeline network that gives it a competitive advantage in terms of providing both access and additional capacity. The following exhibit shows a map of the company's liquids pipeline network, which illustrates the strategic value of its system – that is, delivering crude oil supplies from Alberta (Canada) and the Dakotas (US) to refineries in the US Midwest and Gulf Coast. Enbridge is also well positioned to bring supplies to eastern and western Canada for access to key foreign markets.

Enbridge's liquids pipelines, which generated 68% of the company's total FY13 earnings, are comprised of crude oil and liquids pipelines/terminals across Canada and the US. As noted earlier, the entire network has the capacity to transport more than 2.2 million barrels each day. Assets within this segment are primarily made up of:

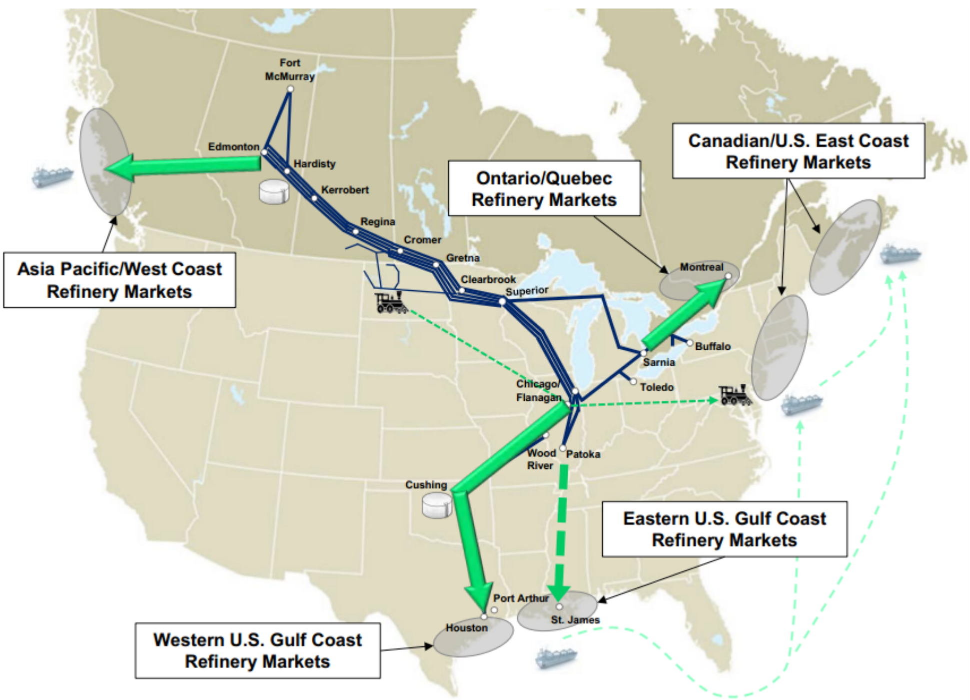
- The Mainline System, which is a common carrier system that brings crude products from western Canada to the US Midwest and eastern Canada.
- Regional Oil Sands Pipelines, which is a network of pipelines that link western Canadian reserves to key delivery points such as the Mainline System and other long-haul pipelines.
- The Spearhead System, a fully contracted pipeline that connects the US Midwest to North America's key market hub (Cushing, Oklahoma).
- The Seaway Pipeline (50% interest), which takes crude from Cushing to the US Gulf Coast region.

The Liquids Pipelines will continue to generate the majority of Enbridge's overall earnings as most of its planned investments are geared to this business. As it stands today, the company has $33 billion in secured growth investments for 2014-2018, of which almost $30 billion (or 91%) will be directed towards further spending on crude pipeline assets.

Besides the strategic value and growth potential of Enbridge's liquids pipelines, Magellan is equally attracted to the quality of returns the company expects to generate from these assets. Most of the $30 billion in liquid pipeline projects are expected to earn low- to mid-teen returns (ROE basis over full asset life) under regulated tariffs or long-term take-or-pay contracts. Furthermore, the regulated/contracted earnings are also linked to inflation.

Enbridge's investment program is not without risk, especially around construction and financing. However, investors should gain comfort from the fact that Enbridge has delivered $20 billion of projects since 2008 – 95% of which have been to plan and the rest coming in under budget. Funding wise, the company has already pre-funded most of its needs with only $1.5 billion

Figure 3: Enbridge Pipeline Network. Source: Enbridge



of equity needed through 2018 – an amount Magellan is confident Enbridge can manage.

Importantly, Enbridge has limited near-term exposure to crude oil prices. Most of the company's earnings have no direct exposure to commodity prices as a result of it not owning physical crude oil or natural gas. Enbridge also limits its risk to volumes as many of its assets are main transmission lines, rather than gathering lines which are typically more sensitive to production activity around a particular reserve basin. To provide a toll-road analogy, Enbridge's pipeline assets are akin to major arterial highways linking large metropolitan areas, as opposed to local roads serving specific communities. This effectively means stable and predictable volume throughput (or demand) for Enbridge's pipelines.

To summarise, the ultimate outcome should be a positive one for Enbridge investors – a continuation of double-digit annual earnings growth (10-12%) through 2018, supplemented by dividend growth of 33% in 2015, followed up by annual increases of 14-16% over the 2015-18 period. All of this growth will occur under a proven low-risk business model.

Company in Focus – Vopak

Headquartered in the Netherlands, Vopak owns liquid storage tanks located in ports around the world. In total, the company has 80 'terminals' in over 28 countries, with an aggregate tank capacity of 33 million cubic meters. The capacity of these tanks is contracted to customers, typically on a multi-year basis and the contracts are largely structured on a take-or-pay basis - meaning that Vopak receives the majority of its fees whether the customer uses the capacity or not. We view this contract structure positively, as there is little linkage between Vopak's revenues and volume throughput, which can be sensitive to commodity prices.

Vopak's asset base is diversified in terms of the regional and product markets in which it operates. 38% of the company's capacity is located in the Netherlands, 21% in EMEA (Europe, the Middle East and Africa), 22% in Asia, 10% in North America and 5% Latin America. In terms of the types of products, Vopak's earnings are split into oil products (approximately 50%), chemicals (20%), biofuels (10%) and liquefied natural gas (2.5%).

As a rule, the company derives profits from the imbalance between the geographic energy supply and demand sources around the world. Such imbalances exist for different types of oil products; for example, Europe exports petrol to the Americas while importing diesel and bunker (ship fuel). These imbalances create a need to store oil at both transport origins and destinations. Vopak's expertise, reputation and track-record allow it to get approval to develop new terminals and ensure its assets are located appropriately within the global energy supply chain.

This complexity in the global energy supply chain creates opportunity for Vopak. As demand continues to grow in regions with limited oil production, such as Asia, Vopak should be able to continue generating attractive returns and develop new projects.

However, Vopak's business is not without its risks. The company needs to maintain assets in the right trade-lanes, which requires ongoing execution from the management team (although this risk is somewhat reduced by having a relatively diversified asset base). Vopak has been pressured by increases in competing storage capacity in some regions, although its overall asset utilisation remains robust at 89%.

Another area of risk (and opportunity) is the level of demand for Vopak's oil storage capacity by specialised 'oil traders'. These traders will often buy oil and sell it 'forward' for delivery at a

Figure 4: Major oil product trade flows. Source: Vopak Company Filings

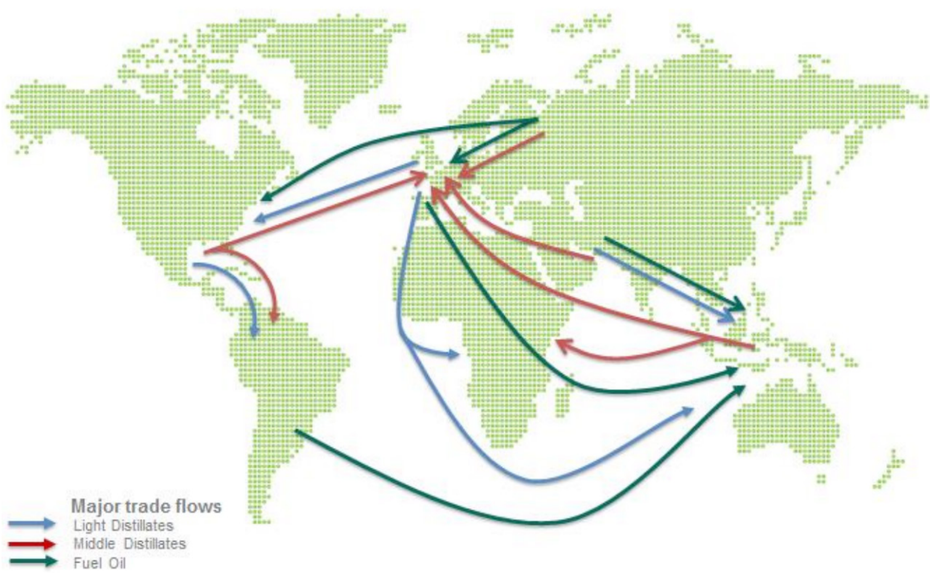
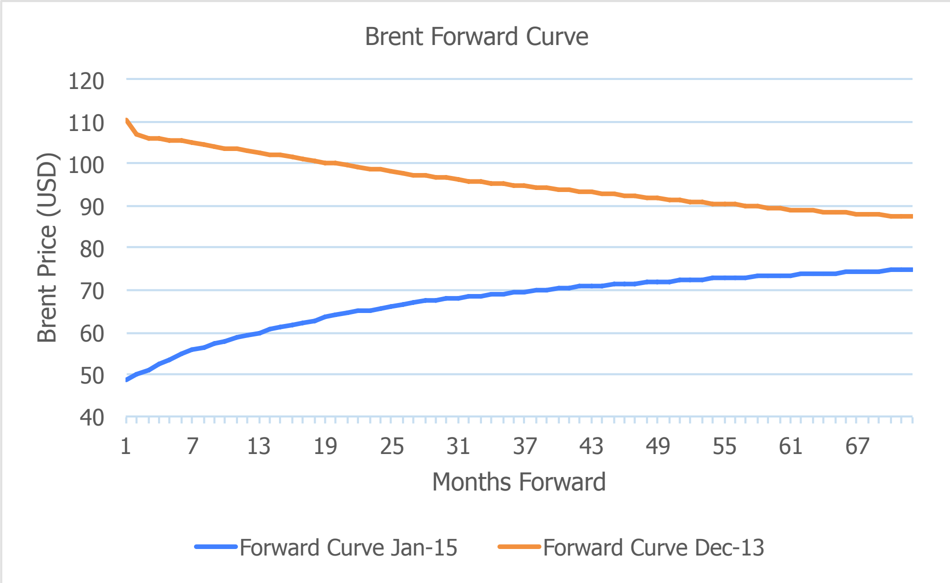


Figure 5: Brent Forward Curve change December 2013 to January 2015. Source: Thomson Reuters



future date to lock in a profit. However, this activity requires the forward price to be above the current price and over the past few years this has not been the case. This has reduced the demand for oil storage in key hubs, such as Rotterdam, and contributed to marginally weaker utilisation and storage fees in some regions. However, following the recent oil price decline the 'forward curve' has reversed (see figure 5). As a result, demand for Vopak's capacity should grow in its key trading hubs and this part of the market will begin to act as a tail-wind rather than head-wind.

To summarise, Vopak is exposed to the energy industry through its operations, but has limited direct exposure to the price of oil itself. As a result, Vopak fits into Magellan's strategy of investing in low-risk infrastructure companies that are able to deliver steady, reliable returns. The company has continued to generate attractive returns on its investments, considering the risks its undertaking, with annual returns on invested capital of 16% to 20% between 2009 and 2013. We expect that it will continue to do so for the foreseeable future.

Conclusion

Magellan believes that infrastructure 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 differ from standard asset classes and offer investors valuable diversification when included in an investment portfolio. An investment in listed infrastructure can be expected to reward patient investors with a three- to five-year timeframe.

Yours sincerely,

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