Fund Update: 30 September 2018

Magellan Infrastructure Fund

ARSN: 126 367 226

Fund Facts

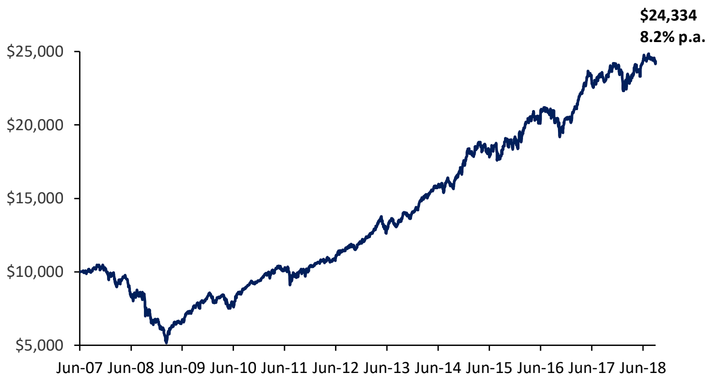
Portfolio Manager	Gerald Stack
Structure	Global Listed Infrastructure Fund, $AUD Hedged
Inception Date	1 July 2007
Management & Administration Fee[1]	1.05% per annum
Buy/Sell Spread[1]	0.15%/0.15%
Fund Size	AUD $1,594.1 million
Distribution Frequency	Six Monthly
Performance Fee[1]	10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (S&P Global Infrastructure Index A$ Hedged 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
- Seeks to substantially hedge the capital component of the foreign currency exposure back to Australian dollars
- Maximum cash position of 20%
- $10,000 minimum investment amount.

Performance Chart growth of AUD $10,000*



Fund Performance*

	Fund (%)	Index (%)**	Excess (%)
1 Month	-0.9	-1.0	0.1
3 Months	-0.2	-1.5	1.3
6 Months	4.8	3.6	1.2
1 Year	5.7	-1.1	6.8
3 Years (% p.a.)	9.9	7.9	2.0
5 Years (% p.a.)	12.7	8.9	3.8
7 Years (% p.a.)	13.7	10.5	3.2
10 Years (% p.a.)	11.3	7.5	3.8
Since Inception (% p.a.)	8.2	5.3	2.9

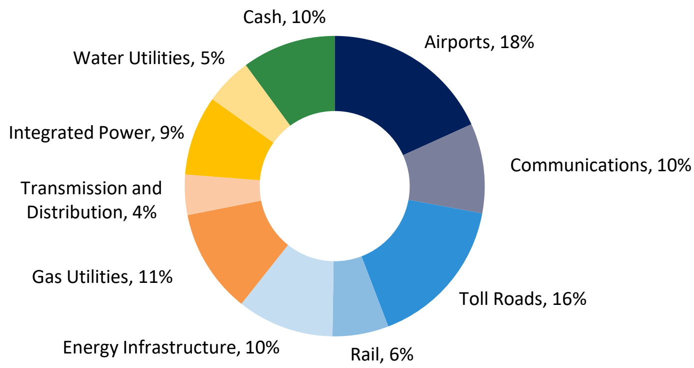
Fund Risk Measures^

	5 Years	Since Inception*
Upside Capture	0.6	0.7
Downside Capture	-0.2	0.4

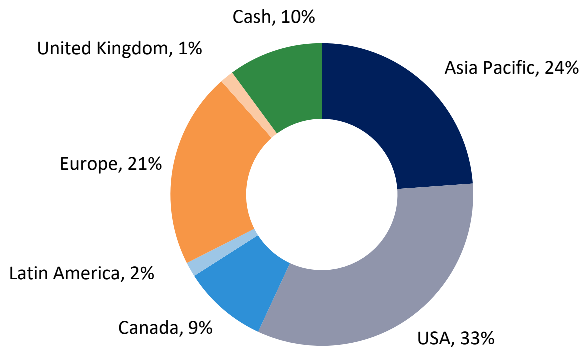
Top 10 Holdings

	Sector#	%
Transurban Group	Toll Roads	7.9
Crown Castle International	Communications	5.8
Atmos Energy Corp	Gas Utilities	5.2
Atlas Arteria	Toll Roads	4.8
Sempra Energy	Gas Utilities	4.6
Canadian Pacific Railway Ltd	Rail	4.6
Aeroports De Paris	Airports	4.5
Enbridge Inc	Energy Infrastructure	4.4
Aena SME SA	Airports	3.9
American Tower Corp	Communications	3.8
	TOTAL:	49.5

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 2007.
** S&P Global Infrastructure Index A$ Hedged Net spliced with UBS Developed Infrastructure and Utilities Net Total Return Index (hedged to AUD). Note: as the UBS Developed Infrastructure and Utilities Net Total Return Index (hedged to 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$ Hedged Net Total Return.
^ Upside/downside capture shows if a fund has outperformed the global market during periods of market strength and weakness, and if so, by how much. The MSCI World Net Total Return Index AUD Hedged has been used as the representative of the global market to calculate this risk measure.
# Sectors are internally defined. Geographical exposures are by domicile of listing.

Fund Commentary

The portfolio recorded a negative return over the quarter. The stocks that contributed the most included the investments in Canadian Pacific Railway, Atlas Arteria and Crown Castle International. Canadian Pacific added 13% thanks to its better-than-expected result and operating outlook and on higher traffic numbers for North American railways. Atlas, which is listed in Australia but manages toll roads in France, Germany and the US, gained 10% as the Australian dollar weakened. Crown Castle added 4% after the US cell-tower operator reported higher-than-expected second-quarter earnings, due largely to site growth, and boosted full-year guidance.

The biggest detractor was Atlantia following the collapse of a bridge on a tolled road in Genoa. The bridge that collapsed was a tolled section of the A10 motorway that was operated under a concession contract by Autostrade per l'Italia, an 88% owned subsidiary of Atlantia of Italy. The newly formed left-right populist Italian government blamed Atlantia for being derelict in its duties to maintain the bridge. The government appears to have commenced a process that could lead to it revoking the single concession that governs Autostrade per l'Italia's toll-road network in Italy. We have removed Atlantia from the portfolio following internal analysis, including meetings with Italian legal and political experts, that led us to conclude that the range of financial outcomes that Atlantia faces is wide. Thus, we no longer believe the financial returns to shareholders are as reliable and predictable as we require of stocks held in the strategy given our central tenet of capital preservation.

Other stocks that lagged on a contributions basis included the investments in Transurban and Enbridge of Canada. Transurban shed 6.3% as it completed a capital raising to fund its acquisition of Westconnex. Enbridge lost 10% over a quarter during which the pipeline operator said it would issue c.US$7.1 billion of equity to buy shares it doesn't own in three North American units so as to simplify its corporate structure.

Key Stock in Focus – Atmos Energy

Atmos Energy: The natural gas company stands out because its high earnings growth is unusual for a utility.

The US sources just under 30% of energy needs from natural gas whose cheaper price and environmentally friendly traits are expected to increase demand for an energy source that comes out of the ground clean, ready to use and can be easily transported to customers presuming the network is up to standard.

Natural gas, as an essential service, is regulated. The 'regulatory compact' is that utilities are deemed the sole provider in an area and are assured of a reasonable return on their investments (termed the 'rate base' in industry jargon). As such, US regulators allow gas utilities to increase the price of connections in small steps over time to compensate for the money spent on equipment. To smooth their returns, regulators allows gas utilities to pass on costs. These costs include operational and maintenance expenses and, crucially, the cost of natural gas – thus, customers bear the cost if gas prices climb but gain the benefit when gas prices fall. (In Australia, gas utilities can't automatically pass on fluctuations in the gas price.) The certainty of returns makes US natural-gas utilities an attractive risk-reward proposition for investors.

But there's one major issue with natural gas in the US. The network needs upgrading. Most of the pipes that transport gas across the US are old. Parts of the network could prove dangerous because leaky gas is flammable. In 2010, a gas explosion in the San Francisco suburb of San Bruno sent flames more than 1,000 feet (300 metres) high and eight people died when their homes where engulfed in fire. Understandably, a nationwide push is underway in the US to upgrade old gas pipelines. But it takes time and money.

This is the industry context in which to place Atmos Energy, the US's largest fully regulated natural-gas-only distributor. The Dallas-headquartered company that earned US$1.2 billion (EBITDA) profit in fiscal 2017 distributes gas to more than three million homes and businesses in eight southern US states via a network that is 70,000 miles (115,000 kilometres) long. Most of Atmos's activity is centred in Texas, where the company is the largest gas distributor. In addition, the company operates one of the biggest intrastate gas transmission pipelines in Texas and manages storage assets.

Of prime importance is that Atmos is spending US$8 billion from 2018 to 2022, about 80% of which will be used to upgrade its pipelines. This means the company's rate base is expected to nearly double over that time and regulators will be more amenable to agree to higher prices on Atmos connections. Atmos's plan to eventually overhaul about 40% of its pipeline network make the company one of the most compelling long-term investment opportunities among utilities in our universe, which we limit to the most reliable of utility and infrastructure stocks.

The company does have its challenges. A low-risk stock with a steadily rising earnings outlook that offers income streams (a dividend stock) is more vulnerable to rising interest rates. Atmos estimates that 6,100 miles (9,800 kilometres) of its pipeline warrant immediate replacement. To emphasise the danger, leaks from the ageing pipelines earlier this year forced people in Dallas to evacuate their homes. Such incidents have fortunately been rare and serve to highlight why Atmos must make its ageing network safe and efficient. The company, which has exceptional safety record, can look forward to years of regulatory-sanctioned price increases on a larger rate base. The fact that Atmos is not exposed to shifts in gas prices or changes in demand (say, a warm winter that leads to lower heater use) makes the company a low-risk investment.

Old company, old pipelines

Atmos can trace its history back to 1906 in Texas, which holds significance for the age of its pipelines. The company estimates that 29,000 miles (47,000 kilometres), or 42%, of its network was built before 1970 when the US first passed regulations imposing minimum standards on gas pipelines.

About 13,000 miles (21,000 kilometres) of Atmos's pipelines were made before 1940.

The company operates as three arms: the regulated distribute division that delivers gas, the regulated pipeline segment the handles the transport and storage of gas, and the non-regulated division that services customers.

Atmos's plan to replace the ageing steel, cast iron and plastic pipelines is expected to lead to price increases that will ensure earnings growth of about 6% to 8% p.a. on a rate base that will nearly double in five years. We estimate that Atmos's 'rate base' will nearly double in value from US$6.6 billion in 2017 to US$11.8 billion in 2022 due to its investment program as it replaces about 750 to 1,125 miles (1,200 to 1,800 kilometres) of old pipelines each year over the next five years.

Even after about 6,000 miles (9,600 kilometres) of pipeline are upgraded over the next five years, that will still leave about 22,000 miles (35,000 kilometres) of network to be upgraded after 2022. This suggests that the company will keep spending money to upgrade its network and generate earnings growth for at least for the next 25 years. That means investors can look forward to steadily rising profits from a company that has proved reliable for investors in recent decades.

The company has delivered 34 consecutive years of higher dividends and 15 years of growth in earnings per share. It targets annual earnings growth of 6% to 8% and a dividend yield of about 2%. The popularity of natural gas and the company's capital expenditure are likely to add to Atmos's record of keeping happy its investors.

Sources: Company filings and website.