MAGELLAN
ASSET MANAGEMENT LIMITED

Annual Investor Report

Magellan Infrastructure Fund | June 2014

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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 year ended 30 June 2014.

During the year, the Fund showed a positive return of 22.0%, which is 2.6% below the benchmark (the UBS Developed Infrastructure & Utilities Net TR Index Hedged to AUD). However, the Fund once again exhibited lower volatility than the benchmark (a standard deviation of returns of 6.2% against 7.3% for the benchmark).

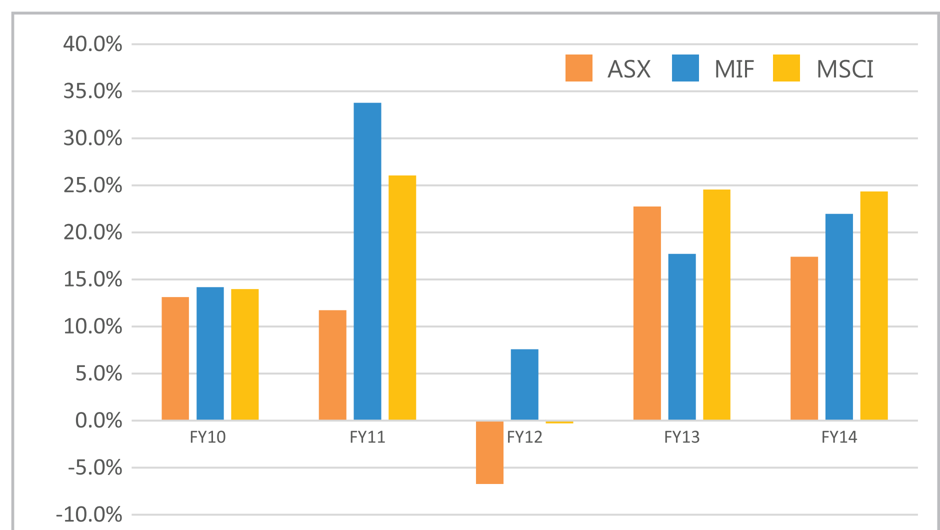
On 1 July 2013, we launched an unhedged version of the Fund. For the year ending 30 June 2014, the Magellan Infrastructure Fund (Unhedged) returned 22.0%, net of fees, which is 1.1% better than the benchmark (the UBS Developed Infrastructure and Utilities Net Total Return Index (AUD)).

In July 2014, the Fund paid a distribution of 1.95 cents per unit for the six months ending 30 June 2014. This takes the total distributions paid to unit holders in the Fund in respect of FY2014 to 2.86 cents per unit.

Our underlying investment philosophy has not changed since we launched the Fund in mid 2007. We seek to buy and hold an investment portfolio of what we regard as outstanding infrastructure companies. We aim to invest in infrastructure and utility companies that possess attractive fundamentals at prices that enable the Fund to achieve attractive risk adjusted returns over a three to five year period.

The five year return for the Fund to 30 June 2014 was 18.7% per annum, 4.9% better than the benchmark index. Perhaps just as importantly and as illustrated in Figure 1, the Fund's returns over the last five years have provided an effective counter-balance to the modest or negative returns provided by Australian equities (ASX200) and global equities (MSCI).

Figure 1: Annual Returns from MIF, the MSCI and the ASX 200



Portfolio Strategy

Generally, infrastructure assets are natural monopolies that provide an essential service to the community. Over time the stable, reliable earnings of infrastructure assets are expected to lead to a combination of income and capital growth for investors.

The universe of infrastructure assets that we consider for the Fund is made up of 2 main sectors:

- Utilities, including both regulated energy utilities and regulated water utilities. We estimate that utilities comprise more than 75% of the potential investment universe for the Fund. Utilities are typically regulated by a government sponsored entity. Such regulation requires the utility to efficiently provide an essential service to the community and, in return, authorises the utility to earn a fair rate of return on the capital it has invested; and
- Infrastructure, which includes airports, ports, toll roads, communications and energy infrastructure (oil & gas pipelines). Regulation of infrastructure companies is generally less intensive than for utilities and allows companies to accrue the benefits of volume growth. As economies develop, grow and become more inter-dependent, we expect the underlying levels of aviation, shipping and vehicle traffic to increase as will demand for all forms of communications and energy.

Both utilities and infrastructure companies provide an essential service while facing limited (if any) competition, and, because the service is essential, the price charged for the service can be adjusted with limited impact upon demanded volumes. As a consequence, earnings are more reliable than those for a typical industrial company and generally enjoy inherent inflation protection.

Portfolio Summary

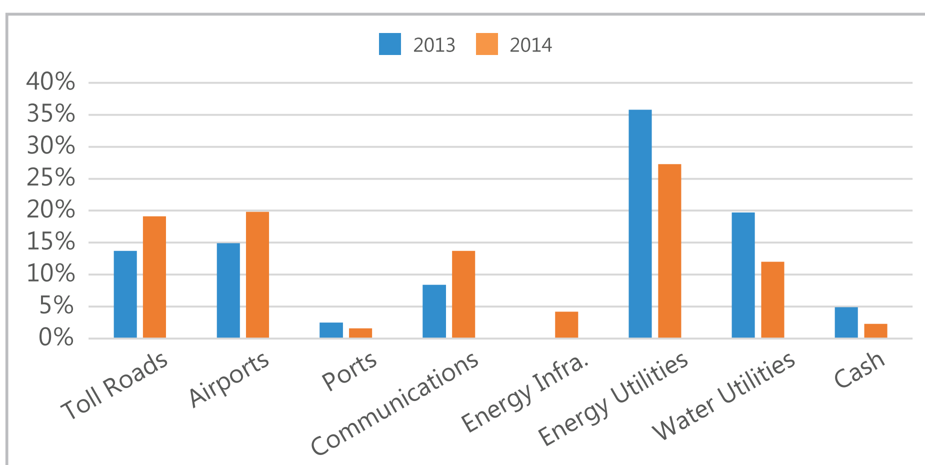
The Fund's investment portfolio has been constructed to reflect the most attractive investment opportunities that meet our qualitative criteria whilst also minimising the risk of permanent capital loss. As at 30 June 2014, the Fund's portfolio consisted of 30 investments (in comparison with 29 investments at 30 June 2013). The top ten investments represented 56.2% of the portfolio at 30 June 2014 compared with 51.5% at 30 June 2013.

The composition of the Fund by sector at 30 June 2013 and 30 June 2014 can be seen in Figure 2.

The major sector changes to portfolio composition during the period were the increases in the exposure to Airports and Toll Roads, the introduction of an Energy Infrastructure stock (Canadian oil & gas pipeline owner Enbridge) and a commensurate reduction in the regulated water and energy sectors.

As a result, regulated utilities made up 40.3% of the fund at the end of June 2014 compared to 55.5% a year earlier.

Figure 2: MIF Sector Exposures



While the holdings of stocks in the fund are primarily driven by Magellan's assessment of their valuation premium, i.e. the difference between Magellan's valuation and the share price, as a general rule we will hold a higher proportion of the fund in regulated utilities during uncertain times and a smaller proportion at other times.

The composition of the portfolio by geography at 30 June 2013 and 30 June 2014 is depicted in Figure 3.

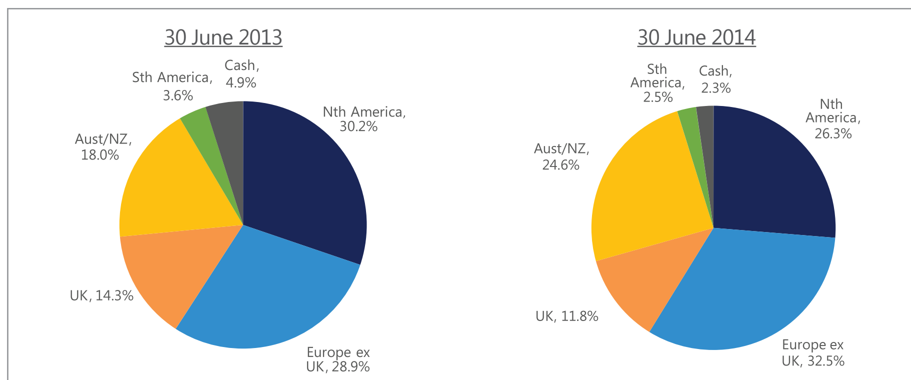
Over the course of the year we have found utilities in the better performing economies of the world, effectively the most defensive infrastructure investment opportunities, to have become progressively more expensive. Accordingly, we have reduced the exposure to regulated utilities in the USA and UK and increased our exposure to airports and communications infrastructure in Europe. Over the last two years we have reduced our exposure to the US market from 35% to 22%.

The best performing stocks in the Fund during the year were toll road stocks. Australia's Macquarie Atlas Roads generated a Total Shareholder Return (TSR) of 73.7% while Italian companies Atlantia and SIAS generated TSRs of 73.4% and 54.8% respectively. Pleasingly, only one stock held in the Fund generated a negative return in the past year. Dutch company Vopak, which owns oil and chemical tank storage facilities in strategically located ports around the world suffered from the crisis in Crimea. Fortunately, this was a <2% holding in the Fund.

The Importance of Definition

Those who follow our Fund closely will know that a key focus for us is the importance of definition, i.e. how you define the potential investment universe of infrastructure stocks. Magellan deliberately uses a very conservative definition because we believe it ensures that the resulting portfolio will deliver what investors want from an allocation to this asset class - robust performance though almost all market conditions with inherent inflation protection. The past year has seen some dramatic examples of the importance of this point.

Figure 3: Composition of the Portfolio by Geography



Example 1:
Energy Future Holdings

Magellan does not consider companies with a significant exposure to the unregulated power generation market, or to commodity prices generally, to be investment grade infrastructure. Any company that derives more than 25% of their earnings from these sources is excluded from our investment universe although there are many such companies in the commonly used benchmark indices.

In April 2014, Texas' largest power company, Energy Future Holdings, filed for bankruptcy. The company was burdened by debt stemming from its record 2007 leveraged buyout (LBO) of TXU Corp, led by private equity funds KKR, TPG and the private equity arm of Goldman Sachs. The equity investors contributed a combined $7bn to the takeover, equity that is now effectively worthless. Among the owners of its US$42bn in debt was none other than legendary investor Warren Buffett.

So what went wrong? Well this was a case of two key factors: too much debt combined with lower than forecast power prices – the same factors that resulted in Australian equity investors losing more than 90% of their equity in Victoria's Loy Yang A power station in the early part of the last decade. The LBO of TXU assumed that natural gas prices, which set the cost of electricity in Texas, would rise. Instead, prices have fallen more than 65 percent since July 2008. And with gearing levels as high as they were, there simply was not enough headroom to survive such a fall.

It is worth noting that relatively high gearing is only a problem when associated with uncertain cash flow. The gearing carried by Energy Future Holdings may very well have been sustainable if the company enjoyed the reliability of cash flows that characterises a regulated utility.

Example 2:
Boardwalk Pipeline Partners

Another recent example was the experience of US listed entity Boardwalk Pipeline Partners, the share price chart of which follows.

Boardwalk Pipeline Partners, LP (BWP) is a master limited partnership (MLP) that provides transportation, storage, gathering and processing of natural gas and liquids. BWP operates more than 14,000 miles of pipelines and underground storage caverns with an aggregate working gas capacity of approximately 201 Bcf and liquids capacity of roughly 18 million barrels.

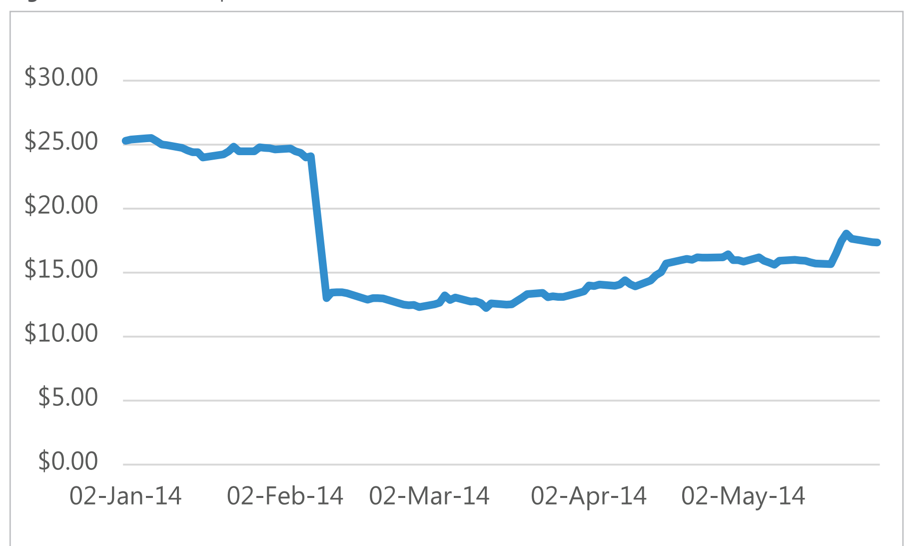
An MLP is a trust structure managed by a general partner. The MLP pays no corporate tax providing it pays out almost all of its free cash as dividends. The general partner is incentivised to maximise dividends through remuneration that is directly linked to dividend growth. Magellan has concerns about such structures and excludes MLPs from our investment universe.

So what went wrong here? In simple terms, the company was forced to significantly reduce dividends, and guidance for future dividends, because of low contract renewal rates with companies that have used the pipelines to ship gas or oil. And because it was already paying out the maximum available cash it had no room to accommodate a drop in revenues. Why were contracts not renewed? There were a number of factors but the most significant was that the energy market in the US went through such a fundamental change as a result of the fracking revolution that the strategic value of the pipelines was severely diminished. And because their pipelines did not enjoy the protection of a regulatory regime, the non-renewal of those contacts was highly material to the entity's earnings.

Example 3:
Hokkaido Electric Power Co

Hokkaido Electric Power's Total Shareholder Return for the year was -42.3%. HEP is a Japanese regulated electricity utility. Magellan does not include any of the Japanese electricity utilities in our investable universe because the regulatory process for Japanese electric utilities places asymmetric risks on shareholders, i.e.

Figure 4: Boardwalk Pipeline Partners Share Price



the regulatory process limits return upside without providing the normal downside return protections we see in regulatory regimes in other developed countries.

So what went wrong here? Like its peers, HEP was forced by the government to shut down its nuclear generators post the 2011 Fukushima disaster. The companies then had to rely on more costly fossil fuel generators but with no compensating tariff increase as the government forestalled electricity rate increases that could hinder the country's fragile economic recovery. After three years of losses, HEP announced that it was seeking a capital injunction from a state owned lender to remain in business. The share price graph below shows the market's reaction.

Transurban

In our 2014 half yearly report to investors we highlighted the strengths of Australian toll road company Transurban. Subsequently, we were pleased to participate in a large equity raising conducted by Transurban which was used to help fund a controlling interest in a consortium that acquired Queensland Motorways Limited (QML) for approximately A$7bn.

This was not a particularly value accretive acquisition – in fact the price paid was very much in line with our own valuation. But all toll roads, and particularly toll road networks such as QML, have inherent yet unquantifiable option value so we expect that, over time, the price paid for these assets will look relatively cheap.

That option value is on display in Transurban's existing toll road networks in Sydney & Melbourne where deals reached with local road authorities have seen the company investing capital to improve the capacity of its toll roads (and sometimes the surrounding road network) in return for toll increases and concession extensions that are significantly Net Present Value positive.

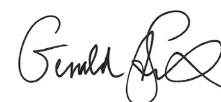
As a specific example, in 2010 Transurban reached agreement with the NSW Government to widen the M2 from two lanes in each direction to three as well as build additional access ramps. In return, the concession term was extended by four years and tolls were increased by approximately 8%. As a result our valuation of Transurban's equity in this asset increased by over 30%.

Figure 5: Hokkaido Electric Power Co Share Price

Outlook

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 are different from standard asset classes and offer investors valuable diversification when included in an investment portfolio. In the current uncertain economic and investment climate, the reliable financial performance of infrastructure investments makes them particularly attractive and an investment in listed infrastructure can be expected to reward patient investors with a three to five year timeframe.

As is clear from much of the content of this letter, Magellan has a quite conservative approach to the management of this Fund. This will not change regardless of market conditions as we strongly believe such a defensive posture reflects the role infrastructure should play in any portfolio. This may mean that we will under-perform the benchmark if markets continue to rise strongly, an outcome that would not cause us a moment's discomfort.



Gerald Stack
Lead Portfolio Manager

July 2014

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