MAGELLAN
ASSET MANAGEMENT LIMITED

Annual Investor Report

Magellan Core Infrastructure | June 2014

By Dennis Eagar, Portfolio Manager, Magellan Core Infrastructure

Dear Investor,

The objective of the Magellan Core Infrastructure Strategy ("Strategy") is to provide investors with reliable, inflation linked returns through all stages of the economic cycle.

The universe of infrastructure assets that are held by the Strategy is made up of two main sectors:

- **Utilities:** Including both regulated energy utilities and regulated water utilities. Utilities comprise approximately 75% of the Strategy. Utilities are typically subject to economic regulation. This 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, there is minimal fluctuation in demanded volumes in response to the economic cycle and the price charged for the utility service can be adjusted with limited impact upon demand volumes. As a result, the earnings of regulated utilities have been, and are expected to continue to be, stable irrespective of economic conditions; and

- **Infrastructure:** Which includes airports, toll roads, broadcast communications infrastructure and ports. Regulation of infrastructure companies is generally done through contracts that regulate the prices the company can charge (rather than the earnings) and allows companies to accrue the benefits of volume growth i.e. the returns of infrastructure companies are linked to growth in passengers, vehicles, spectrum usage or containers. As a result, the revenues and earnings derived by infrastructure assets are expected to grow over time.

Performance

The Strategy returned +24.0%, before fees, for the year ending June 30, 2014. The Strategy's return under-performed the +24.6% return of its benchmark, the UBS Developed Markets Infrastructure & Utilities NTR Hedged to AUD Index by 0.6%. While under-performance may be seen as disappointing, it was not surprising given the very strong rise in the benchmark for the year. As discussed below, the investment strategy results in a much lower beta than the benchmark and the return for risk of the Strategy was materially better than the benchmark for the year.

Most sectors held in the Strategy performed positively during the year with Toll Roads generating a Total Shareholder Return in local currency (TSR) of 43%, Airports a TSR of 29%, and Water & Gas Utilities TSRs of 26% and 25% respectively. The ports sector was the worst performing sector held by the Stragegy, and the only one not generating a positive return, generating a TSR of -13% for the year.

Geographically, European stocks were the strongest performers providing a TSR of 38% for the year while the USA and Canada were at the lower end with TSRs of 19% and 14% respectively.

The best performing stocks in the Strategy during the year were Italian toll road companies Atlantia and SIAS (TSR of 59% respectively), Spanish utility Red Electrica (67%), Vienna Airport (58%), and Australian utility Envestra, which is the subject of a takeover (45%). Pleasingly, only one stock of the 90 in the portfolio generated a negative TSR for the year. Dutch company Vopak, which owns oil & chemical tank facilities in key strategically located ports around the world, was impacted by the backwardation of the oil curve and the troubles in Crimea resulting in a TSR of -19%.

In terms of the stocks included in the benchmark index but excluded from the Strategy because they do not meet MFG's stringent definition of investment grade infrastructure, Japanese electrical utilities (which were up over 60% on average in the previous year) fell sharply producing TSRs ranging from -6% to -42%. These stocks had also been very poor performers in previous years. In contrast, large, vertically integrated power companies in Europe with significant exposure to unregulated power generation and which had performed poorly for a number of years finally rewarded their shareholders with some decent returns. For instance, Italian utility Enel SpA delivered a TSR of 82%, Spanish utility Iberdrola a TSR of 47%, French utility GDF Suez 45% and German utility, RWE 33%.

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.

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 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 even the best can sometimes not fully understand the risks involved!).

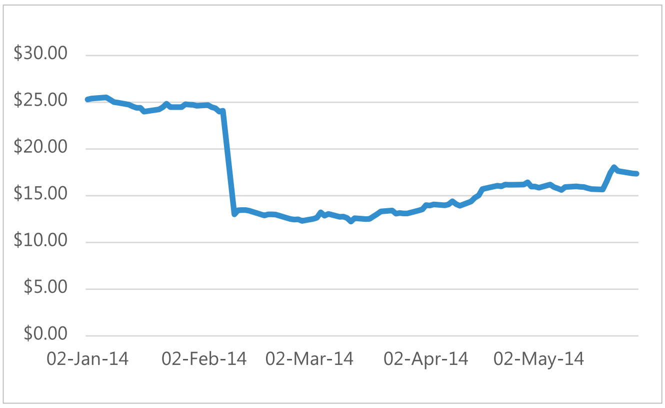
So what went wrong? Well this was a classic case of two key factors: too much debt combined with lower than forecast power prices – the same factors that resulted in Australian equity investors losing more than 90% of their equity in Victoria's Loy Yang A power station in the early part of the last decade. 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.

Figure 1: Boardwalk Pipeline Partners Share Price



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 ('HEP') Total Shareholder Return for the year was -43%. 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 places asymmetric risks on shareholders, i.e. 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.

Figure 2: Hokkaido Electric Power Co Share Price

Outlook and Strategy

The Strategy is designed to provide reliable returns in all but the most extreme market conditions. Excluding the impact of FX effects, Magellan expects the strategy to provide a gross return of inflation plus 5% to 6% over the medium term. The Strategy exceeded that expectation during the last year, partly reflecting the continued recovery of stocks held by the Strategy that had been over-sold in previous years. We now see the utilities market as broadly in equilibrium while infrastructure stocks, particularly those in Europe, remain cheap.

Magellan believes that infrastructure and utility 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.

Sincerely,

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IMPORTANT NOTICE

Performance is compared to the UBS Developed Infrastructure & Utilities Net Total Return Index (Hedged to AUD) which is a market capitalisation weighted index that is designed to measure the equity performance of listed Infrastructure and Utility stocks. Index results assume the reinvestment of all distributions of capital gain and net investment income using a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. The index is hedged to Australian dollars.

*Returns presented are for the Strategy's composite – the Magellan Core Infrastructure Strategy. Other numerical data such as weights, stock returns and contributions are based on a representative portfolio of the composite. Please refer to the disclaimer below for further details.

GIPS® DISCLOSURE

Magellan claims compliance with the Global Investment Performance Standards (GIPS®).

For the purpose of complying with GIPS, the Firm is defined as all discretionary portfolios managed by Magellan.

The Magellan Global Core Infrastructure composite is a global Strategy investing in strictly defined or "pure" infrastructure companies (typically 80-120). The composite is hedged to Australian dollars with Forward contracts.

To achieve investment objectives, the composite may also use derivative financial instruments including, but not limited to, options, swaps, futures and forwards. Derivatives are subject to the risk of changes in the market price of the underlying securities instruments, and the risk of the loss due to changes in interest rates. The use of certain derivatives may have a leveraging effect, which may increase the volatility of the composite and may reduce its returns.

A list of composites and descriptions, as well as policies for valuing investments, calculating performance, and preparing compliant presentations are available upon request by emailing data@magellangroup.com.au

The representative portfolio is an account in the composite that closely reflects the portfolio management style of the Strategy. Performance is not a consideration in the selections of the representative portfolio. The characteristics of the representative portfolio may differ from those of the composite and of the other accounts in the composite. Information regarding the representative portfolio and the other accounts in the composite is available upon request.

Industry and Geographical Exposures are calculated on a look through basis based on underlying revenue exposure of individual companies held within the representative portfolio.