

# Half Yearly Investor Report

## Magellan Core Infrastructure | December 2014

By Dennis Eagar, Portfolio Manager, Magellan Core Infrastructure

Dear Investor,

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

The objective 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.

The types of infrastructure assets in which the Strategy invests are generally natural monopolies that provide an essential service to the community. Infrastructure assets offer investors protection from the impacts of inflation, because their earnings generally have some direct linkage to it. 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 held by the Strategy comprises two main sectors:

- **Utilities:** Utilities comprise approximately 74% of the Strategy and include both regulated energy utilities and regulated water utilities. Utilities are typically subject to economic regulation. The terms of regulation typically require a utility to efficiently provide an essential service to the community and, in return, permit the utility to earn a fair rate of return on the capital it has invested in its operations. As a utility provides a basic necessity, e.g. energy or water, there is minimal fluctuation in demanded volumes in response to the

economic cycle, while the price charged for the utility service can be adjusted with limited impact upon demanded volumes. As a result, the earnings of regulated utilities have been, and are expected to continue to be, stable, irrespective of economic conditions.

- **Infrastructure:** Infrastructure includes airports, ports, toll roads and broadcast communications infrastructure. Regulation of infrastructure companies is generally less intensive than regulation of utilities and this allows companies to accrue the benefits of volume growth (i.e. the returns of infrastructure companies are linked to growth in passengers, vehicles or containers). As economies develop, grow and become more inter-dependent, 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.

### Performance Review

The Strategy returned +10.6%, before fees, for the six month period ending December 31, 2014. The Strategy's return outperformed the +6.2% return of the benchmark UBS Developed Infrastructure & Utilities Net Total Return Index (Hedged to AUD) by 4.4%. Note that both returns were negatively impacted by the strong US dollar, as well as the different currency exposures of the Strategy and index.

Eighty of the ninety one stocks in the Strategy generated positive shareholder returns in the period. Particularly strong returns were provided by Mexican airport company OMAB (Total Shareholder Return (TSR) of 34.8%), Zurich Airport (22.3%), Canadian electricity and gas distribution company Fortis (22.3%), oil and chemical tank storage company Vopak (20.7%) and UK water utility Pennon Group (20.6%).

All of sectors represented by investments held by the Strategy delivered positive returns for the period, with the Integrated Power sector providing a weighted average TSR of 14.7%, Water Utilities delivering 12.7%, Electricity Transmission & Distribution delivering 9.8% and Airports generating a 9.0%.

Geographically, the Strategy's US exposures generated a TSR of 14.3%, Australian/New Zealand stocks provided a TSR of 10.7%, UK stocks 9.8%, Canadian stocks 8.0% and European stocks 3.2%.

The performance of the benchmark was negatively impacted by stocks with a material exposure to oil prices, e.g. Australia's Origin Energy, which provided a TSR of -18.8% for the period, while utilities with substantial exposure to power generation again performed very poorly. Examples of the latter include the UK's Drax Group (TSR of -27.5%) and NRG Energy in the USA (-26.9%). Offsetting these losses was the strong performance of Japanese stocks, which delivered a weighted average TSR of 17.7% for the period.

## 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 Strategy 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.

Figure 1: Enbridge Pipeline Network. Source: Enbridge



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 western 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 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.

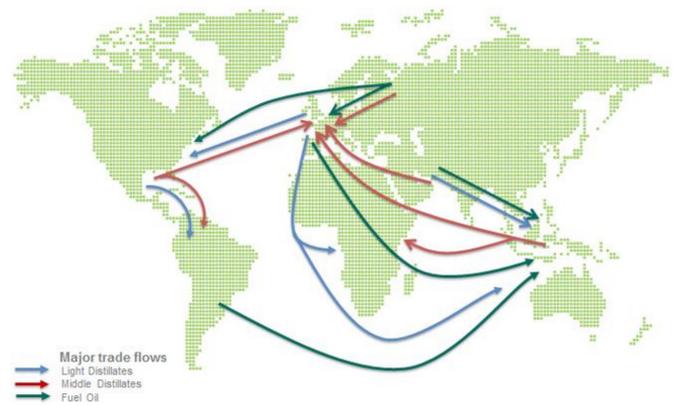
## Company in Focus - Vopak

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.

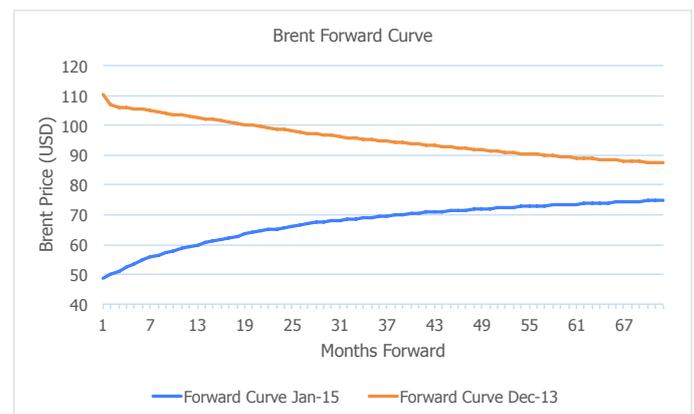
**Figure 2:** Major oil product trade flows. Source: Vopak Company Filings



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 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 chart below). 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.

**Figure 3:** Brent Forward Curve change December 2013 to January 2015. Source: Thomson Reuters



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.

## Portfolio Outlook and Strategy

The Magellan Core Infrastructure Strategy is designed to provide reliable returns over the medium to longer term. Excluding the impact of FX effects, Magellan expects the Strategy to provide a gross return of inflation plus 4% to 5% over the medium term.

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. An investment in listed infrastructure can be expected to reward patient investors within a three- to five-year timeframe.

Sincerely,



Dennis Eagar  
Portfolio Manager  
Magellan Core Infrastructure

## Contact Details

Level 7, 1 Castlereagh Street, Sydney, NSW 2000 Australia.

 +61 2 8114 1888

 [info@magellangroup.com.au](mailto:info@magellangroup.com.au)

### IMPORTANT NOTICE

This document is being furnished to you to provide summary information regarding Magellan Asset Management Limited ('Magellan') ABN 31 120 593 946, AFS Licence No 304 301 and an investment fund or investment Strategy ('Fund') managed by Magellan. This document is strictly confidential and is being provided to you solely for your information and must not be copied, reproduced, published, distributed, disclosed or passed to any other person at any time without the prior written consent of Magellan. No distribution of this document will be made in any jurisdiction where such distribution is not authorised or is unlawful. This document does not constitute an offer to sell or a solicitation of an offer to purchase any security or financial product or service. Any such offer or solicitation shall be made only pursuant to a Product Disclosure Statement, Information Memorandum or other offer document (collectively 'Offer Document') relating to the Fund or a Magellan financial product or service. A copy of any relevant Offer Document may be obtained by calling Magellan on +61 2 8114 1888 or by visiting [www.magellangroup.com.au](http://www.magellangroup.com.au). This document does not constitute a part of any Offer Document issued by Magellan, nor is it intended to constitute advertising or advice of any kind and you should not construe the contents of this document as legal, tax, investment or other advice.

The investment program of the Fund presented herein is speculative and may involve a high degree of risk. The Fund is not intended as a complete investment program and is suitable only for sophisticated investors who can bear the risk of loss. The Fund may lack diversification, which can increase the risk of loss to investors. The Fund's performance may be volatile. The past performance of the Fund is not necessarily indicative of future results and no person guarantees the performance of the Fund or the amount or timing of any return from it. There can be no assurance that the Fund will achieve any targeted returns, that asset allocations will be met or that the Fund will be able to implement its investment Strategy or achieve its investment objective. The management fees, incentive fees and allocation and other expenses of the Fund will reduce trading profits, if any, or increase losses. The Fund will have limited liquidity, no secondary market for interests in the Fund is expected to develop and there are restrictions on an investor's ability to withdraw and transfer interests in the Fund. In making an investment decision, you must rely on your own examination of any Offer Document relating to the Fund.

No representation or warranty, express or implied, is made with respect to the correctness, accuracy, reasonableness or completeness of any of the information contained in this document. This information is subject to change at any time and no person has any responsibility to update any of the information provided in this document. Magellan will not be responsible or liable for any losses, whether direct, indirect or consequential, including loss of profits, damages, costs, claims or expenses, relating to or arising from your use or reliance upon any part of the information contained in this document including trading losses, loss of opportunity or incidental or punitive damages.

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](mailto: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.