Strategy Update: 30 September 2016

Magellan Core Infrastructure

Key Facts

Portfolio Manager	Dennis Eagar & Gerald Stack
Strategy Inception Date	17 December 2009
Total Infrastructure Assets[1]	AUD $6,942.9 million
Total Strategy Assets	AUD $4,199.4 million

AUD Hedged Performance[2]

	Composite (Gross)	Composite (Net)[3]	Index[4]	Excess Return
3 Months	-1.4	-1.6	2.6	-4.0
6 Months	4.3	4.0	8.8	-4.5
1 Year	17.5	16.7	14.0	3.5
3 Years (% p.a.)	17.9	17.1	11.7	6.2
5 Years (% p.a.)	17.7	16.8	12.8	4.9
Since Inception (% p.a.)	17.0	16.1	10.2	6.8

	Composite (Gross)	Composite (Net)[3]	Index[4]	Excess Return
2009*	1.9	1.8	0.9	1.0
2010	15.9	15.1	5.7	10.2
2011	15.6	14.8	4.7	10.9
2012	16.3	15.5	9.1	7.2
2013	16.7	15.8	18.5	-1.8
2014	28.0	27.1	22.9	5.2
2015	7.9	7.2	-5.4	13.3
2016 (CYTD)	13.1	12.6	15.4	-2.3

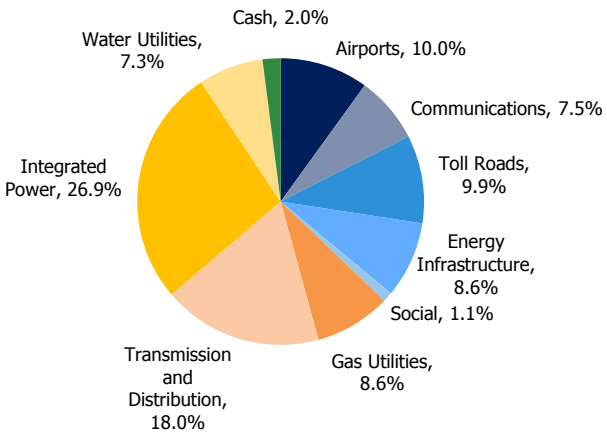
AUD Hedged 5 Year Risk Measures[5]

	Against Benchmark[4]	Against Global Equities[5]
Upside Capture	1.0	0.6
Downside Capture	0.6	-0.2
Beta	0.8	0.3
Correlation	0.8	0.4

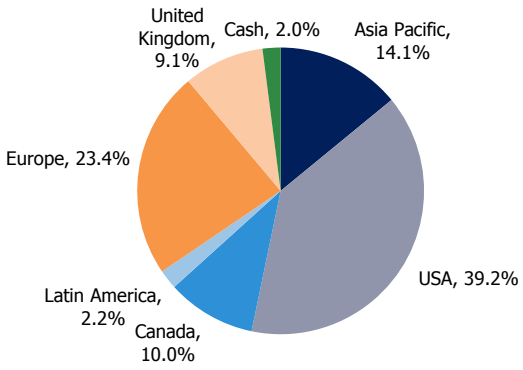
Top 10 Holdings[6]

	Sector	%
Enbridge Inc	Energy Infrastructure	3.1
TransCanada Corp	Energy Infrastructure	3.1
National Grid PLC	Transmission and Distribution	3.0
Transurban Group	Toll Roads	3.0
Power Assets Holdings	Integrated Power	2.9
Snam Rete Gas SpA	Gas Utilities	2.8
Sydney Airports	Airports	2.7
Aena SA	Airports	2.5
Abertis Infraestructuras	Toll Roads	2.4
Atlantia SpA	Toll Roads	2.4
	TOTAL:	27.9

Industry Exposure[6]



Geographical Exposure[6]



1 Comprised of all Infrastructure strategies.
2 Returns are for the Global Core Infrastructure Hedged in AUD Composite and denoted in AUD. Performance would vary if returns were denominated in a currency other than AUD. Refer to the GIPS Disclosure section at the end of this document for further information.
3 Composite (Net) returns are net of fees charged to clients and have been reduced by the amount of the highest fee charged to any client employing that strategy during the period under consideration. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. Fees are available upon request.
4 S&P Global Infrastructure Index Net Total Return (hedged to AUD) 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 March 2015, it was replaced on 1 January 2015 with the S&P Global Infrastructure Index Net Total Return (hedged to AUD).
5 Risk measures are for the Global Core Infrastructure Composite hedged to AUD. The Global Equity Index is the MSCI World Net Total Return AUD hedged.
6 Representative portfolio. The exposures are by domicile of listing.

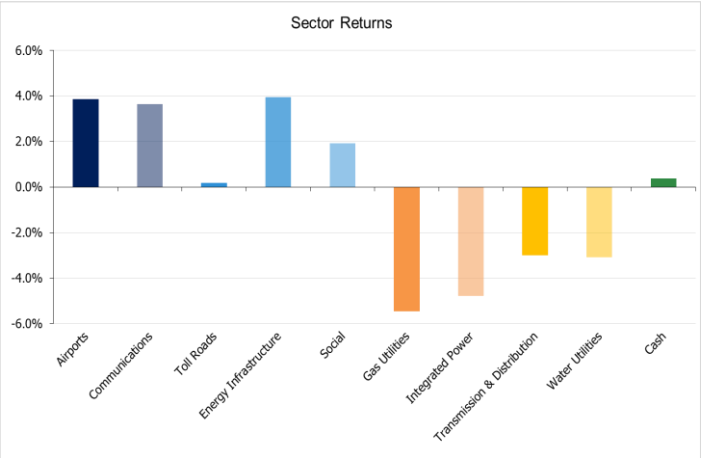
Performance

During the September 2016 quarter, the Core Infrastructure Strategy (AUD hedged) returned -1.4% before fees. This was 4.0% worse than the +2.6% return of the benchmark S&P Global Infrastructure Index (AUD Hedged). The 12-month return for the Strategy was +17.5%. This was 3.5% better than the benchmark return of +14.0%.

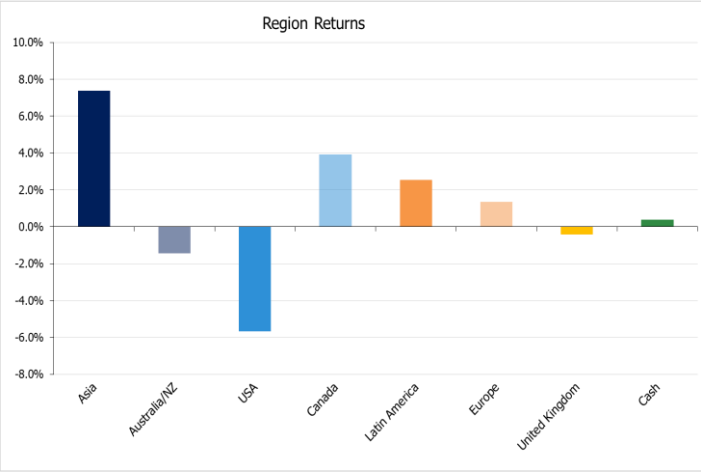
The quarter was dominated by a heavy sell-off of US utilities which made up 27 of the 30 worst performing stocks in the strategy. US stocks declined by an average 5.7% for the quarter, led by Aqua America (Total Shareholder Return of -14.0%), American Water Works (-11.0%) and Southwest Gas (-10.7%). This was offset by relatively strong performances by Canadian stocks (+3.9%) and European stocks (+1.9%). In total, Infrastructure stocks held in the Fund were up an average 3.3% for the quarter while utility stocks were down an average 4.1%.

In regard to stocks excluded from the Magellan investment universe but included in commonly used benchmarks, the September 2016 quarter saw oil & gas pipeline companies increase by an average of 21.5% for the quarter while US/Canadian rail companies rose by over 14%. Japanese regulated utilities declined by 2.1% for the quarter.

The Strategy's returns for the quarter by sector and region are shown in the following graphs:



Source: Magellan Asset Management Limited.



Source: Magellan Asset Management Limited.

Strategy

The strategy remains consistent with previous periods and is not expected to change over the long term.

The Strategy seeks to provide investors with attractive risk-adjusted returns from the infrastructure asset class. It does this by investing in a portfolio of listed infrastructure companies that meet our strict definition of infrastructure at discounts to their assessed intrinsic value. We expect the Strategy to provide investors with real returns of approximately 5% to 6% over the longer term.

We believe that infrastructure assets, with requisite earnings reliability and a linkage of earnings to inflation, offer attractive, long-term investment propositions. Furthermore, given the predictable nature of earnings and the structural linkage of those earnings to inflation, 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.

Topic in Focus - What's a toll road worth?

Given the recent strength in toll roads and the broader infrastructure sector, a number of market commentators have suggested share prices for these stocks have run too hard. From our observations though, it appears that many of these conclusions are underpinned by crude valuation measures that fail to account for the unique characteristics of these assets.

In this brief note, we talk about our approach to valuing toll roads and how it differs from approaches that are often applied to valuing equities.

Introduction

Toll roads are a key segment of the global infrastructure market. However, these assets also have some rather unique characteristics. This means that shorthand valuation measures/metrics (eg. PE ratios and EV/EBITDA) can generate misleading outcomes. This paper aims to provide clarification of why this is the case.

Key characteristics that have an impact on valuing toll roads

The key characteristics to consider when valuing a toll road are as follows:

- Toll roads operate under a concession agreement (or contract) with a government that, among other things, sets out two critical factors:
  - The date at which the concession agreement terminates; and
  - The basis on which the tolls will increase.
- When the concession actually terminates, the asset is handed back to the government, i.e. unlike most other enterprises, there is no terminal value.
- Toll roads operate on relatively high EBITDA margins (EBITDA being revenue minus expenses before depreciation, interest and tax), typically around 80%-

90% for urban toll roads and 70% for inter-urban roads. This means that, for a typical urban toll road, only 10%-20% of revenue is used to run the toll road, including regular maintenance.

- Toll roads involve significant upfront build costs and accounting standards dictate that an asset must be depreciated over its useful life to reflect expected maintenance or replacement expenditure. However, in the case of a road, maintenance is a relatively small proportion of revenue (say 2% p.a.), and is generally expensed rather than capitalised. This means that the depreciation entry for accounting purposes significantly overstates the actual expenditure needed to maintain the road. An example of this is Australian toll road company, Transurban, which incurred an accounting depreciation expense of A$550 million but had a cash maintenance cost of only A$55 million.

PE ratios are meaningless when looking at toll roads. Not only is the cashflow generated by the business almost always higher than the published earnings, but the ratio also ignores the fundamental nature of toll roads – that they are limited life assets.

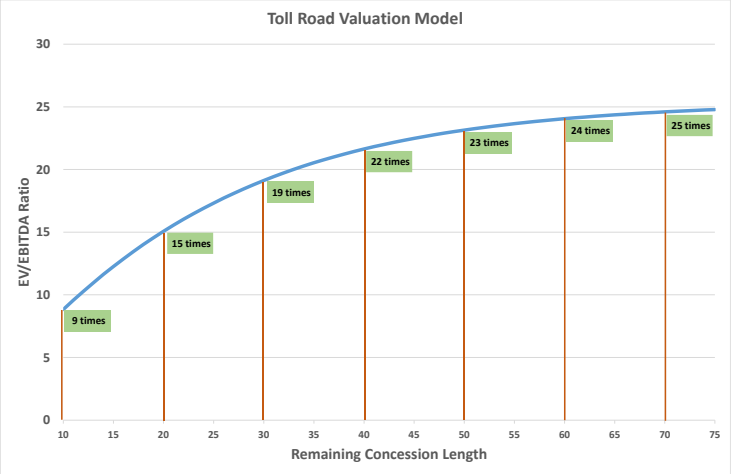
- For most normal industrial companies, depreciation is a good proxy for the maintenance costs needed to keep a business operating competitively. However, for toll roads, given the disparity between accounting depreciation and the real cost of maintaining toll roads, accounting earnings can significantly understate the underlying position of the business and the free cash it generates.
- This disparity has another indirect benefit to the underlying value of the business. Accounting earnings are lower and hence so is the tax that the business will have to pay, thus actual post-tax cashflow is higher.
- PE is a proxy for the net present value of the cashflow from the earnings of a business, however for toll roads, the valuation needs to be based on the underlying free cashflow generation.

Is an EV to EBITDA multiple a good measure when valuing toll roads?

Another short hand measure often used when valuing normal industrial companies is the Enterprise Value (EV) to EBITDA ratio. To determine the EV in each case we use a discounted cashflow methodology to value the toll road by forecasting the cash flows generated by the toll road under the assumptions set out below[1].

The following graph is based on a standard toll road model where the key assumptions are as follows:

- Traffic in Year 1 grows at 2% with the growth rate reducing by 0.1% per annum.
- The EBITDA margin is 75% in year 1, growing each year by 0.5% to a maximum 90%.
- Tolls increase with inflation of 2% p.a.

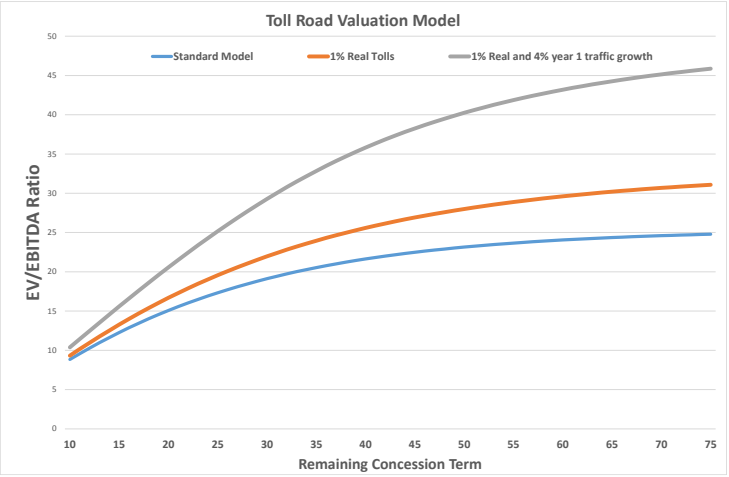


Source: Magellan Asset Management Limited.

As the graph highlights, the EV/EBITDA ratio appropriate to the valuation of this hypothetical toll road increases with the concession length, so a rational investor would value the toll road at 15 times current EBITDA if there were only 20 years remaining on the concession but would be prepared to pay 22 times if there were 40 years remaining and almost 25 times if there were 70 years remaining.

But concession length isn't the only important variable in valuing a toll road. Given that toll roads have a largely fixed cost base, the rate of growth of revenues can clearly be a critical factor in a toll road's worth. The following graph shows the shape of the above curve under two additional scenarios:

- Scenario 2: As per the standard model shown above but with tolls increasing by 1% in real terms instead of inflation; and
- Scenario 3: as per Scenario 2 but with traffic growth starting at 4% growth instead of 2% in year 1 (and also fading at 0.1% p.a).



Source: Magellan Asset Management Limited.

As this graph highlights, a rational investor would be prepared to pay approximately 15 times EBITDA for a standard toll road with 20 years remaining in the concession period but as high as 45 times Year 1 EBITDA if it was a scenario 3 toll road with 70 years remaining on the concession.

Every aspect of the toll road's earnings in the three scenarios in Year 1 is identical, i.e. they all have the same revenue, EBITDA and earnings. Yet the actual NPV of each asset's future cash flows varies enormously.

Thus EV/EBITDA is also not useful for valuing and comparing toll roads as a fair multiple will be determined by the length of the concession, expected traffic and price growth, none of which are reflected in the current EBITDA of the toll road under analysis.

Concluding comments

The conclusion is clear. Any use of current year financial results such as PEs or EV/EBITDA ratios as a means to determine the value of a toll road is problematic at best and most likely misleading. The corollary is that there is only one way to effectively value a toll road business – model each asset over its entire concession period and aggregate the sum of those assets. On that basis, our analysis suggests that a number of the world's highest quality toll roads remain attractively priced.

[1] Valuing the future cash flows of the road using a Weighted Average Cost of Capital of 6.8% based on a Nominal Cost of Equity of 7.0%, a nominal Cost of Debt of 6.0% and assuming 40% gearing. For simplicity the hypothetical toll road Enterprise Value is determined pre-tax and interest costs.

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The Global Infrastructure Benchmark is comprised of the following: from inception to 31 December 2014 the benchmark is UBS Developed Infrastructure & Utilities Index Net Total Return (AUD Hedged) and from 1 January 2015 the benchmark is S&P Global Infrastructure Net Total Return Index (AUD Hedged). The benchmark changed because UBS discontinued their index series.
The UBS Developed Infrastructure & Utilities Index Net Total Return (AUD Hedged) 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.
The S&P Global Infrastructure Net Total Return Index (AUD Hedged) is a market capitalisation weighted index that is designed to track 75 companies from around the world diversified across three infrastructure sectors energy, transportation and utilities. 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.

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The Global Core Infrastructure composite is a global strategy investing in strictly defined or "pure" infrastructure companies (typically 80-120). The filtered investment universe is comprised of stocks that 1. generate reliable income streams, 2. benefit from inflation protection and have an appropriate capital structure. The investment objective of the strategy is to minimise the risk of permanent capital loss; and achieve superior risk adjusted investment returns over the medium to long-term. The composite is hedged to Australian dollars with Forward contracts. The composite was created in December 2011.

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 selection 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.