MAGELLAN ASSET MANAGEMENT LIMITED

Half Yearly Investor Report

Select Infrastructure Strategy | December 2015

Gerald Stack
Head of Investments and Portfolio Manager

Dear Investor

I am pleased to write to you as an investor in the Magellan Select Infrastructure Strategy (the 'Strategy') for the six months ended 31 December 2015.

During the six months to 31 December 2015, the Strategy delivered a +8.4% return, in Australian dollar terms, before fees. This was 14.9% better than the benchmark[1] return of -6.5%. The Strategy also outperformed global equity markets with the MSCI World NTR (AUD Hedged) Index down 1.3% and the local equity market (the S&P/ASX200 Total Return Index was down 0.5% for the period).

For the year ended 31 December 2015, the Strategy generated a before fee return of +12.6%, outperforming the benchmark return of -5.4% by 18.0%. Since inception on 1 July 2007, the Strategy has delivered a gross annualised return of +9.2%, 5.1% p.a. better than the return of the benchmark index over the period.

Although returns in recent years have been pleasing, we judge infrastructure (when properly defined) to be a low-risk asset class that should provide investors with long-term returns in the order of inflation plus 4-5% per annum (as we have commented in previous investor reports). Infrastructure assets were oversold during the global financial crisis ('GFC') and the returns they have achieved over the last three years (Strategy +18.5%, market benchmark +11.2% p.a. before fees) reflect the market re-focusing on the asset class's attractive, conservative fundamentals.

Our underlying investment philosophy has not changed since we launched the Strategy 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 Strategy to achieve superior risk adjusted returns over a three to five year period.

[1]The Global Infrastructure benchmark is comprised of the following: from inception to 31 December 2014 the benchmark is UBS Developed Infrastructure & Utilities NTR Index hedged to AUD and from 1 January 2015 onwards, the benchmark is the S&P Global Infrastructure NTR Index hedged to AUD.

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 Strategy is made up of two main sectors:

- **Utilities,** including both regulated Energy Utilities and Regulated Water Utilities. We estimate that utilities comprise more than 60% of the potential investment universe for the Strategy. 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, earn a fair rate of return on the capital it has invested; and

- **Infrastructure,** which includes Airports, Ports, Toll Roads, Communications Assets 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.

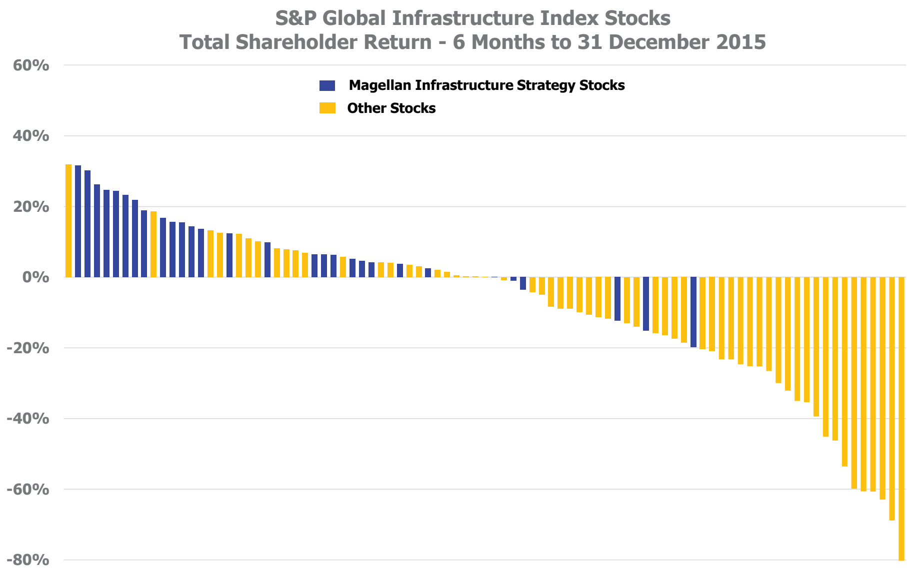
Both utilities and infrastructure companies provide an essential service while facing limited (if any) competition, and, because the service is essential, the price charged for the service can be adjusted with limited impact upon demand volumes. As a consequence, earnings are more reliable than those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

Performance Summary

The last six month period has provided a clear demonstration of the importance of how a global listed infrastructure investor defines their investment universe. As we have noted in previous investor letters, Magellan applies a conservative definition of the infrastructure investment universe that is designed to provide investors with predictable, through the cycle, inflation linked returns. This means that Magellan excludes those stocks from the investable universe whose earnings are materially impacted by competition, sovereign risk and, importantly in the last year, changes in commodity prices. Outperformance over listed infrastructure and global equities benchmarks reflects the limited exposure of the Strategy to stocks impacted by falling energy prices and, to a lesser extent, emerging markets.

To illustrate this point, Figure 1 shows the Total Shareholder Return (TSR) in local currency of the constituent stocks in the benchmark S&P Global Infrastructure Index for the six month period ended 31 December 2015 as well as the stocks held in the Strategy over the same period.

Figure 1: S&P Global Infrastructure Index Stocks.

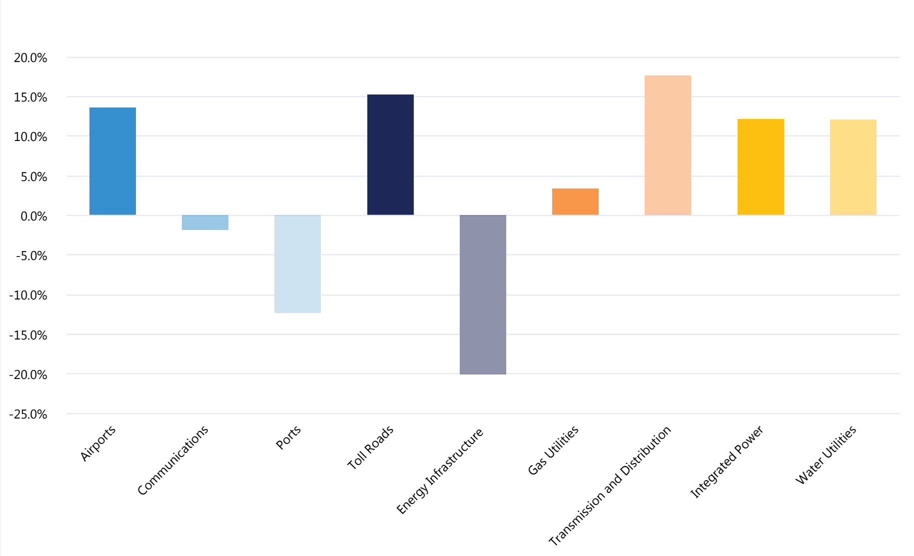


Source: Magellan Asset Management Limited

The graph shows that the Strategy outperformed over the period because the portfolio held stocks that performed well over the period but, perhaps more importantly, it avoided stocks that performed poorly.

The common themes affecting the worst performing stocks in the index were the impact of falling commodity prices and the impacts of the competitive environment. The definition applied by Magellan to infrastructure specifically excludes companies with material exposure to these themes from the potential investable universe. We apply this approach because we believe companies whose earnings and cash flows have material exposure to these themes do not derive predictable investment returns and we believe the expectation of predictable investment returns over the medium term is a key reason investors invest in infrastructure. Limiting exposure to commodity price variability and competition has been a major cause of outperformance of the Strategy compared to the benchmark over the period.

Figure 2: Returns by Sector.



Source: Magellan Asset Management Limited

The Strategy's returns for the six month period are shown by sector and region in Figure 2 and 3.

Over the six months to 31 December 2015, the three investments with the strongest returns in local currency were Macquarie Atlas Roads (+31.6%), Sydney Airport (+30.1%) and US utility Westar (+26.3%) while the investments with the weakest returns were Canadian pipeline company Enbridge (-19.8%), French satellite company SES (-15.1%) and Dutch oil & chemical tank storage company Vopak (-12.4%). On an absolute basis, the three largest contributors, in local currency, were Australian toll road company, Transurban, US water utility American Water Works and UK electricity transmission company, National Grid which added +1.4%, +1.1% and +1.1%, respectively.

Portfolio Summary

On 31 December 2015, the Strategy held investments in 29 companies (compared to 28 at 30 June 2015). The top 10 investments represented 52.0% of the Strategy, while they represented 57.6% at 30 June 2015.

Over the past six months, we have made the following material changes to the Strategy:

• We added new positions in Sempra Energy and Aeroports de Paris.

• We exited the position in Southwest Gas.

The top 10 holdings in the Strategy at 31 December 2015 were as shown in Figure 4.

The composition of the Strategy by sector and geography at 31 December 2015 can be seen in Figure 5.

Over the past six months, the key changes we have made to the Strategy are as follows:

• We have increased the weight of energy utilities in the Strategy by 8.6% and of water utilities by 1.9%. The total weight of utilities in the Strategy was 39.2% at 31 December 2015.

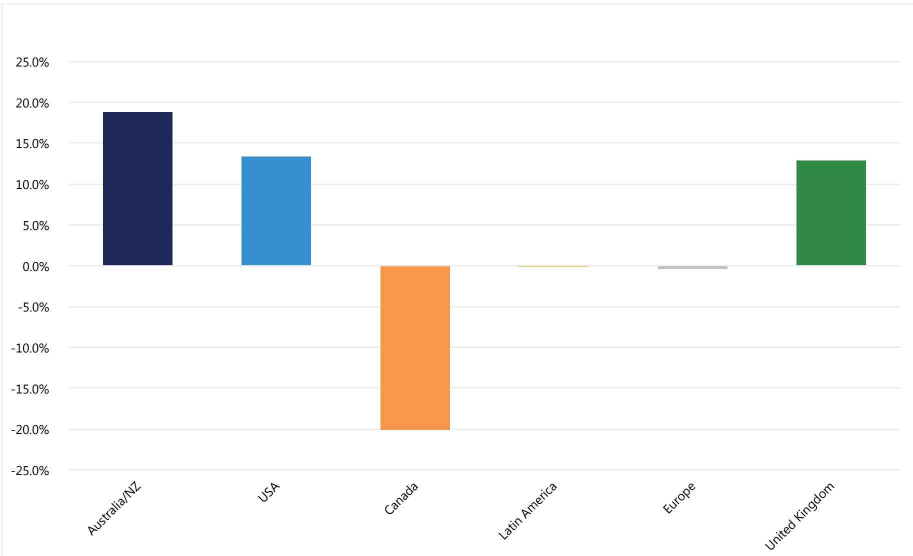
• We have reduced the weight of infrastructure segments by 7.7%. This reduction has been spread across the different infrastructure segments ie toll roads, airports, communications and energy infrastructure. The total weight of infrastructure stocks was 53.1% at 31 December 2015.

• We have reduced the cash weighting by 2.6% to 7.7% at 31 December 2015.

We seek to manage the Strategy to provide exposure to infrastructure companies that we assess as high quality and good value. At the end of June the Strategy's investment in utilities was low by the historical standards of the Strategy, reflecting our analysis that the best value investment opportunities in our defined investment universe were in the infrastructure segments rather than the Utilities segments. Since June the weight of utilities stocks in the portfolio has been increased as we identified investments that we considered good value.

The investment portfolio currently includes a relatively high level of cash reflecting our cautious view about the short term impacts of a

Figure 3: Returns by Region.



Source: Magellan Asset Management Limited

Figure 4: Top 10 holdings in the Strategy at 31 December 2015:

Stock	Sector	Weights (%)
Transurban Group	Toll Roads	9.1
Crown Castle	Communications	6.6
National Grid	Elect. Transmission. & Distribution	6.4
Atlantia	Toll Roads	4.8
SES	Communications	4.6
ITC Holdings	Elect. Transmission. & Distribution	4.5
American Water Works	Water Utility	4.5
Auckland International Airport	Airports	4.2
Zurich Airport	Airports	3.7
Sydney Airport	Airports	3.6

Source: Magellan Asset Management Limited

potential increase in the level of underlying interest rates. We expect to invest the bulk of this cash over the medium term.

Risk factors in the current environment, including interest rates

During the period, we've seen an environment of lower growth in China, uncertainty in equity markets, continuing downward pressure on the prices of resources, the start of a Federal Reserve ('Fed') tightening cycle and signs of a potential high yield credit squeeze and repricing. These are all cause for us to reflect on our approach to risk.

Magellan seeks to take a holistic view of infrastructure which considers various risk factors in whether an asset meets our definition and standards for investing. The stability of earnings are determined by more than an asset's competitive position; there is a range of other risk factors which will influence earnings streams.

We assess many risk factors, but the past few months highlights a few worth considering:

- **Sovereign risk:** We avoid countries where political decisions can easily be made which undermine the contractual position or potential earnings of a company. Additionally, we only invest in countries where the judicial system and law is sound so that contractual positions can be enforced in need;

- **Regulatory risk:** we avoid regulatory jurisdictions where regulatory processes are opaque or inconsistently applied;

- **Commodity price risk:** we do not invest in businesses which are materially reliant on the price of the product which they transport e.g. many pipeline businesses and MLPs in the US are excluded from our universe for this reason; and

- **Leverage risk:** we avoid businesses with high leverage or where their ability to service their debt is tight relative to their earnings.

Interest rates, debt and leverage

We expect global monetary conditions to experience further tightening over the medium term and, consequently, for longer tenor rates to increase.

There are two key areas we focus on when considering interest rates:

1. Impact on the businesses in which we invest; and

2. Impact on valuations and on debt and equity markets.

Impact on the businesses in which we invest

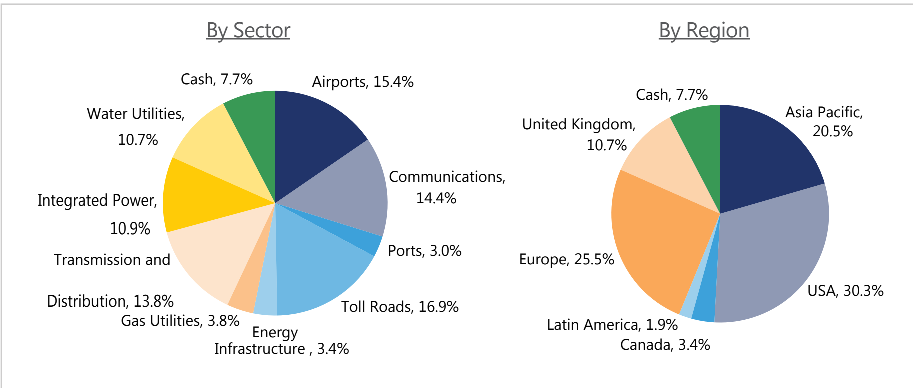
We are confident that the underlying businesses in which we invest are in good shape, have strong capital management and are well placed to manage successfully any inevitable increases in base lending rates. Strong capital management is critical and means these businesses largely have:

- Solid investment grade credit ratings, which are important to ensure they have access to multiple credit markets at all times regardless of credit cycles;

- Strong credit metrics i.e. they have a level of leverage that underlying earnings can comfortably support, and have strong debt service ratios. We estimate that, on average, the companies in our investment portfolio generate free cash to service debt of more than four times their annual debt service, which we view that as a strong buffer particularly given the stability of the underlying earnings;

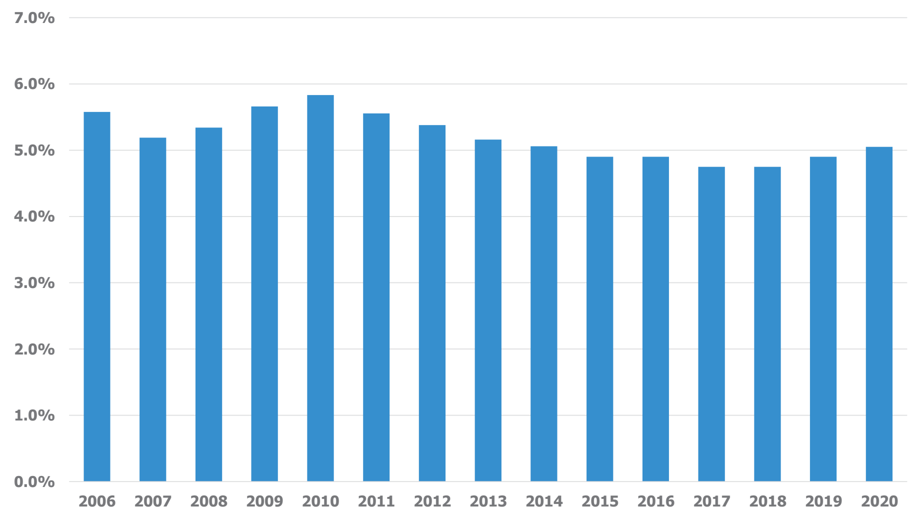
- Access to various debt markets (e.g. US, Europe, Canada, Australia),

Figure 5: Composition of the Strategy as at 31 December 2015:



Source: Magellan Asset Management Limited

Figure 6: Westar Energy Inc Average cost of debt:



Source: Magellan Asset Management Limited

meaning they are not reliant on any single market;

• Improved their credit ratings over time as their earnings and credit metrics have improved;

• Available liquidity and credit facilities to expansion or liquidity requirements;

• Lengthened and de-risked their debt maturity profiles so that the average repayment term dates are typically 8 to 10 years out, and repayments of debt in any single year is not excessive relative to the total debt burden;

• Managed interest rate exposure by undertaking material interest rate hedging or issuing fixed rate bonds to ensure earnings remain stable over the longer term;

• Reduced the cost of their borrowings throughout 2010 to 2015 by taking advantage of cheaper credit (lower base rates and margins), but also have further opportunity to reduce debt costs over the medium term by replacing more expensive "old" debt which is becoming due for repayment over the next few years.

It is important to note this last point. While interest rates are very likely to increase in the US in the next few years, the average cost of debt of the US stocks in our Strategy is likely to continue to fall as maturing debt is replaced with cheaper debt. As an illustration, Figure 6 (above) shows consensus forecasts for the average cost of debt for Kansas based power utility Westar Energy Inc showing the average cost of debt declining until 2018.

So overall, we remain confident that these businesses are well placed to continue to meet our investment expectations over the medium term and through a period of rising rates.

Impact on valuations and on equity markets

An increase in interest rates can be expected to lead to a higher cost of debt and an increase in long term discount rates. Our forecasts and valuations take these factors into account in our investment analysis. However, the history of financial markets leads us to expect increasing uncertainty as a consequence of a rising rate environment.

Stocks which are regarded as "defensive", including infrastructure and utilities, are often subject to negative sentiment during periods of interest rate increases as investors switch to higher growth sectors. However, it is our experience that, provided the businesses have solid fundamentals, their stock prices can be expected to revert to trend reflecting their underlying earnings profiles.

Notwithstanding equity market volatility we expect that underlying earnings of infrastructure and utilities companies in Magellan's defined investable universe should continue to be robust and reflect solid growth.

Ultimately the value of the companies in our investment portfolio reflects the future cash flows they are expected to generate and the risks associated with those cash flows. Magellan believes that, at the current time, investment markets are not pricing assets at the prevailing interest rate levels but rather, are pricing in a higher, more "normal" level of interest rates in assessing the risks associated with future cash flows. This means that if interest rates increase over the medium term we can expect the impact on asset prices to be somewhat muted because investors have already allowed for some level of increase.

Outlook and Strategy

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 Magellan's strict definition of infrastructure at discounts to their assessed intrinsic values. We expect that the Strategy should 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, 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.

Yours sincerely

Gerald Stack

Head of Investments and Portfolio Manager

IMPORTANT NOTICE

Performance is compared to the Global Infrastructure Benchmark which comprises of the following: from inception to 31 December 2014 the benchmark is UBS Developed Infrastructure & Utilities Index NTR Index (Hedged to AUD) and from 1 January 2015 onwards, the benchmark is the S&P Global Infrastructure NTR Index (Hedged to AUD). Both indices are market capitalisation weighted indices that are designed to measure the 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. Both indices are hedged to Australian dollars.

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 Select Infrastructure composite is a concentrated global Strategy investing in strictly defined or "pure" infrastructure companies (typically 20-40). 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. Industry and Geographical Exposures are calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio.

Contact Details

Magellan Asset Management Limited ABN 31 120 593 946, AFS Licence No. 304301
Level 7, 1 Castlereagh Street, Sydney, NSW 2000 Australia.
www.magellangroup.com.au

+61 2 8114 1888
info@magellangroup.com.au