Magellan Infrastructure Fund (Currency Hedged) (Managed Fund)

TICKER: MICH | ARSN: 612 467 580

MAGELLAN ASSET MANAGEMENT

AS AT 31 MARCH 2024

PORTFOLIO MANAGER GERALD STACK

INVESTMENT PHILOSOPHY	OBJECTIVES	PORTFOLIO CONSTRUCTION	INVESMENT RISKS
To prudently invest in outstanding infrastructure and utilities companies at attractive prices that exhibit highly predictable cashflows.	To achieve attractive risk-adjusted returns over the medium to long term; while reducing the risk of permanent capital loss.	Relatively concentrated portfolio of typically 20 to 40 investments. Typical cash and cash equivalents exposure between 0 - 20%.	All investments carry risk. While it is not possible to identify every risk relevant to an investment in the fund, we have provided details of risks in the Product Disclosure Statement. You can view the PDS for the fund on Magellan's website www.magellangroup.com.au.

MAGELLAN INFRASTRUCTURE FUND (CURRENCY HEDGED) (MANAGED FUND): KEY PORTFOLIO INFORMATION

TICKER	FUND SIZE	BUY/SELL SPREAD	MANAGEMENT AND PERFORMANCE FEES[1]	INCEPTION DATE
MICH	AUD $664.3 million	Nil	1.06%, and performance fee of 10% of dual hurdle excess return^	19 July 2016

^ 10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (S&P Global Infrastructure Index A$ Hedged Net Total Return) and the Absolute Return Hurdle (the yield of 10-year Australian Government Bonds). Additionally, the Performance Fees are subject to a high water mark.

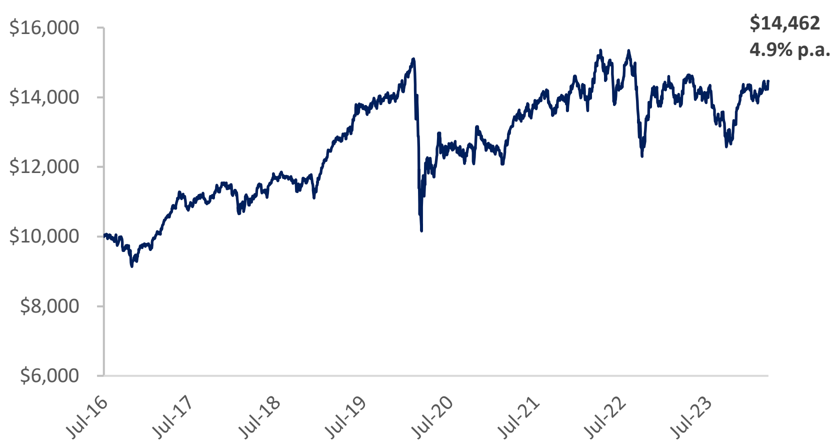
PERFORMANCE[2]

	1 MONTH (%)	3 MONTHS (%)	1 YEAR (%)	3 YEARS (% p.a.)	5 YEARS (% p.a.)	7 YEARS (% p.a.)	Since Inception (% p.a.)	OUTPERFORMANCE CONSISTENCY[+]
MICH	2.1	1.5	1.9	3.5	2.4	4.7	4.9	53%
S&P Global Infrastructure Index A$ Hedged Net Total Return	4.6	2.6	2.7	5.5	3.4	4.3	4.8	-
Excess	-2.5	-1.1	-0.8	-2.0	-1.0	0.4	0.1	-

CALENDAR YEAR RETURNS	CYTD (%)	2023 (%)	2022 (%)	2021 (%)	2020 (%)	2019 (%)	2018 (%)	2017 (%)	2016 (part year)
MICH	1.5	3.7	-6.0	15.2	-11.2	25.5	-0.4	17.5	-2.8
S&P Global Infrastructure Index A$ Hedged Net Total Return	2.6	3.4	1.3	13.7	-11.9	25.3	-6.7	14.4	-0.4
Excess	-1.1	0.3	-7.3	1.5	0.7	0.2	6.3	3.1	-2.4

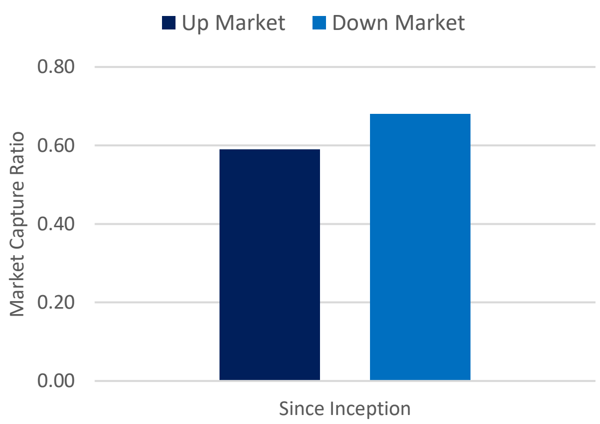
Past performance is not a reliable indicator of future performance.

PERFORMANCE CHART GROWTH OF AUD $10,000[2]



Past performance is not a reliable indicator of future performance.

MARKET CAPTURE[3]



[1] Transaction costs may also apply – refer to the Product Disclosure Statement. All fees are inclusive of the net effect of GST.

[2] Calculations are based on NAV prices with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Returns denoted in AUD.

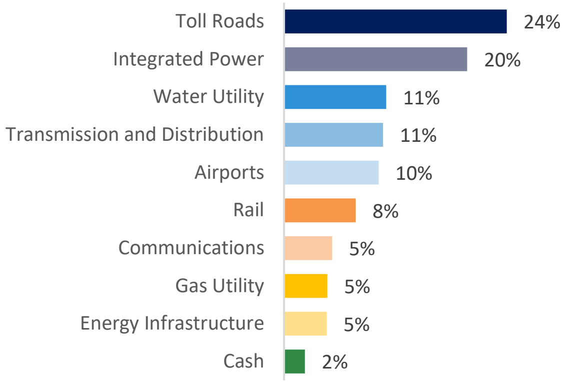
[3] Market Capture is calculated after fees measured against the monthly return of the MSCI World Net Total Return Index (A$ Hedged). Up market capture shows how the fund performed relative to the index while the market is rising. Down market capture shows how the fund performed relative to the index while the market is falling. All MSCI data used is the property of MSCI. No use or distribution without written consent. Data provided "as is" without any warranties. MSCI and its affiliates assume no liability for or in connection with the data. Please see complete disclaimer in www.magellangroup.com.au/funds/benchmark-information/

[+] Outperformance consistency indicates the percentage of positive excess returns for rolling 3 year returns since inception.

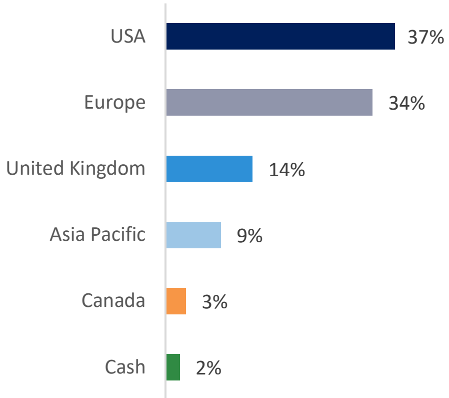
TOP 10 HOLDINGS

STOCK	SECTOR[4]	%
Aena SME SA	Airports	7.0
Ferrovial SE	Toll Roads	6.8
Vinci SA	Toll Roads	6.5
Transurban Group	Toll Roads	5.4
Severn Trent	Water Utility	5.2
National Grid Plc	Transmission and Distribution	4.6
Dominion Energy Inc	Integrated Power	4.3
United Utilities Group Plc	Water Utility	4.3
Sempra Energy	Integrated Power	4.2
Norfolk Southern Corporation	Rail	4.2
	TOTAL:	52.5

SECTOR EXPOSURE[4]



GEOGRAPHICAL EXPOSURE[4]



TOP CONTRIBUTORS/DETRACTORS 1 YEAR[5]

TOP 3 CONTRIBUTORS	CONTRIBUTION TO RETURN (%)
Ferrovial	2.2
Aena SME SA	1.7
Vinci SA	1.3
TOP 3 DETRACTORS	**CONTRIBUTION TO RETURN (%)**
Evergy Inc	-0.5
Eversource Energy	-0.5
Xcel Energy Inc	-0.5

[4] Sectors are internally defined. Geographical exposures are by domicile of listing. Exposures may not sum to 100% due to rounding.
[5] Shows how much the stock has contributed to the fund's gross return for the period in AUD. Excludes non-disclosed positions established in the latest quarter.

Less than a month later, Leigh Day, a law firm, announced that it was commencing group litigation proceedings against Thames Water and five other water and sewage companies, claiming that they had systematically underreported pollution incidents, thereby allowing them to overcharge customers.[5]

The stream of negative headlines with regards to Thames Water weighed heavily on the performance of Magellan Infrastructure strategy holdings, Severn Trent and United Utilities, in the third quarter of 2023, a period during which the Magellan Select Infrastructure strategies maintained moderate positions in each of these names. Compounded by sharp rises in yields on UK Government bonds, the enterprise value of both United Utilities and Severn Trent's regulated businesses declined to a level broadly commensurate with the book value of their regulatory assets, a phenomenon last observed in the run-up to the 2018 general election in which Jeremy Corbyn campaigned for Labour on a platform of re-nationalising the UK's privatised water industry.

In the market's indiscriminate reaction to the Thames Water crisis, we perceived opportunity. Beyond their common sector and geographic exposures, Severn Trent and United Utilities bear little resemblance to Thames Water. The characteristics that distinguish Severn Trent and United Utilities on the one hand, and Thames, on the other, are reflected in their gearing, their achieved returns, and their environmental record:

- Gearing: as at 30 September 2023, Thames Water's £20.6 billion regulated asset base was geared to ~80%,[6] with the company perilously close to being placed into a [illegible] lock-up under the terms of its regulatory [illegible] ratio [illegible]%. By contrast, Severn Trent and United Utilities are, in our view, prudently financed, with debt funding ~61%[7] and 59%[8] of their adjusted regulatory capital values, respectively, in-line with the notional capital structure assumed by Ofwat in setting the cost of capital for the sector.

- Achieved returns: Over the first three years of the AMP7 regulatory period, persistent regulatory penalties have seen Thames deliver its shareholders a mere real return on regulatory equity (RoRE) of [illegible]% approximately half the level of the company's baseline return allowance. By contrast, Severn Trent and United Utilities are among only five companies in the sector that have outperformed their baseline return allowance in AMP7, delivering cumulative RoRE of [illegible]% and [illegible]%, respectively.[9]

- Environmental record: Thames' chequered environmental record has also seen it ranked amongst the worst-performing companies in the sector in the Environment Agency Environmental Performance Assessments (EPA) in the last two years. The businesses we hold in the Magellan Select Infrastructure strategies, by contrast, have among the best environmental credentials in the sector: United Utilities has secured the best possible four-star rating in two of the last three years, while Severn Trent achieved a sector record by securing its fourth consecutive four-star rating in the EPA's most recent assessment.[10]

Indeed, while Thames Water sank deeper into financial distress during the second half of 2023, we judge that United Utilities and Severn Trent's fundamental prospects improved. Our view reflects United Utilities and Severn Trent's accelerating growth outlook, the likelihood of an increased baseline return allowance in AMP8, and expectations of sustained regulatory outperformance:

- An accelerating growth outlook: United Utilities and Severn Trent's AMP8 business plans propose record levels of investment, supporting projections that growth in their regulatory capital value will accelerate from an anaemic low-single-digit real annualised rate in the current regulatory period to ~5.5–6.5% per annum, in real terms, in AMP8. Our conviction that Ofwat will approve the vast majority of spending proposed in these ambitious business plans reflects the legislative mandates that underpin the proposed spend: ~82% of the enhancement investment proposed by Severn Trent in its business plan is required to meet 2030 statutory requirements introduced during the current regulatory period, while [illegible]% of United Utilities' proposed spend is driven by legislative obligations.[11] Significantly, regulators and policy makers appear to accept the need for this investment, with public pronouncements from Ofwat, the government, and the Labour opposition repeatedly acknowledging the need for a dramatic increase in investment in the next regulatory period.

  The likelihood of an increased baseline return allowance: Ofwat's early view of the cost of capital for AMP8, struck at ~3.29% in real terms, reflected prevailing market parameters during September 2022. Sustained increases in real yields on UK Government bonds since September 2022 suggest that AMP8 draft determinations, expected in June, will embed an increased weighted average cost of capital. Our analysis of bond markets suggests a ~1.25% increase to Ofwat's early view of the real risk-free rate if prevailing bond rates persist.

[5] Leigh Day, First Environmental Collective Action Claim Launched on Behalf of Millions of Customers Overcharged by Water Companies, 9 August 2023, https://www.leighday.co.uk/news/news/2023-news/first-environmental-collective-action-claim-launched-on-behalf-of-millions-of-customers-overcharged-by-water-companies/

[6] Thames Water, Interim Results for the Six Months Ended 30 September 2023, 5 December 2023, https://www.thameswater.co.uk/media-library/home/about-us/investors/our-results/interim-2023-24/TWUL-Interim-Report-HY24.pdf

[7] Severn Trent, Fiscal 2024 Interim Results Presentation, 22 November 2023, https://www.severntrent.com/content/dam/stw-plc/homepage/severn-trent-results-presentation.pdf

[8] United Utilities, Fiscal 2024 Interim Results Presentation, 16 November 2023,

[9] Ofwat, Monitoring Financial Resilience Report 2022-23, 19 October 2023, https://www.ofwat.gov.uk/wp-content/uploads/2023/10/The-Monitoring-Financial-Resilience-Report-2022-23.pdf

[10] Environment Agency, Water and Sewerage Companies in England: Environmental Performance Report 2022, 12 July 2023, https://www.gov.uk/government/publications/water-and-sewerage-companies-in-england-environmental-performance-report-2022/water-and-sewerage-companies-in-england-environmental-performance-report-2022

[11] [illegible]

We note that customary cross-checks undertaken by Ofwat also support a higher return, with depressed prevailing trading multiples on the sector's listed players consistent with higher implied discount rates. Pragmatically, we also note that the imperative for Ofwat to attract unprecedented levels of capital to the sector to deliver legislatively mandated environmental improvements creates a compelling incentive for the regulator to 'aim up' when selecting point estimates from the ranges derived from their econometric analysis.

- Expectations of sustained regulatory outperformance: Under Ofwat's regulatory framework, there are three primary levers through which water companies can achieve realised returns in excess of their authorised return allowance.
    - financing – achieving a weighted average interest rate on their debt portfolio below the regulator's cost of debt allowance;
    - outcome delivery incentives (ODIs) – delivering operational and customer service improvements that exceed performance commitments agreed in the company's regulatory determination, giving rise to incentive rewards; and
    - totex – delivering the scope of work agreed in the company's regulatory determination at a lower total cost than the cost allowance provided by the regulator.

  On the financing limb, United Utilities and Severn Trent's continued outperformance of Ofwat's cost of debt allowance in AMP8 is virtually assured. With structurally superior credit quality to most of their peers, Severn Trent and United Utilities are, in our view, almost certain to continue outperforming the regulator's embedded cost of debt assumption, which is struck by reference to sector-average debt costs. Moreover, their ability to better Ofwat's assumed cost of new debt in the next AMP reflects their regulatory halo and credit quality that is superior to the blended average of the bond index the regulator uses to set the allowance.

  Similarly, on ODIs, we observe that Severn Trent and United Utilities are the only two companies in the sector that have achieved cumulative net rewards in the current AMP. While the increased emphasis on ODIs that are commonly defined and applied across the water sector in the next AMP has the potential to alter relative rankings, we note that both Severn Trent and United Utilities have consistently met or exceeded nearly 80% of their performance commitments in the current regulatory period, suggesting that their outperformance is likely to persist.

  On totex, the record levels of investment expected in AMP8 create uncertainty as to the scope for meaningful outperformance. We note, however, that Severn Trent and United Utilities have secured authorisation to accelerate certain AMP8 investments into the current regulatory period. This early start, coupled with the extensive preparations both companies have made with their supply chain should position them well to deliver their scopes of work efficiently and in full.

While we perceive that this is a compelling opportunity, it should be acknowledged that the investment case for Severn Trent and United Utilities is not without risks.

Alongside the rest of the sector, Severn Trent and United Utilities remain subject to ongoing investigations by both Ofwat and the Environment Agency into the compliance of their wastewater treatment works with environmental permits.[12] We note, however, that Ofwat has initiated enforcement cases against six of Severn Trent and United Utilities' peers, has already notified three of the implicated companies of their provisional findings and expects to issue a proposed decision in respect of these companies imminently.[13] In this context, the probability of Ofwat launching an enforcement case against either Severn Trent or United Utilities, more than two years after starting their investigation, appears to us to be remote.

A lack of public disclosure on the progression of the Environment Agency's investigation renders the risk of adverse findings harder to handicap. We note, however, that United Utilities and Severn Trent's environmental credentials are unrivalled amongst their peers, and the management teams of both companies have expressed confidence in their compliance with environmental permits, suggesting that adverse findings are a tail risk. Should this tail event be realised, Severn Trent and United Utilities risk facing criminal prosecution and, if found guilty, could incur uncapped fines and civil penalties. In the final instance, however, the fines and penalties imposed on water companies in respect of environmental breaches are adjudged by the courts, having regard to the same sentencing guidelines that have historically given rise to fines that, in all but a few instances, have proved financially immaterial.

Severn Trent and United Utilities were also among the six companies named as defendants in the group litigation proceedings brought by the law firm, Leigh Day. We note, however, that the management teams of both Severn Trent and United Utilities are adamant the claims are entirely without merit, conflating 'combined sewer overflows' and 'pollution incidents' in a manner that is contrary to the express terms of the regulation.

Yet recent events suggest that the most significant near-term risk to our investment case arises from the prospect of further negative headlines with regards to Thames Water.

In December 2023, Ofwat challenged a dividend payment made by Thames to the Group's unregulated captive financing entity, Kemble Water Finance Limited (KWFL). The distribution, Thames said, was required to fund interest costs on debt issued by KWFL, an entity whose only source of cash flow is dividends from Thames Water. As KWFL is already in a precarious financial position, Ofwat's intercession virtually guarantees that KWFL will default on a debt payment due at the end of April 2024, and calls into question the solvency of the Kemble Group. Bonds issued by Kemble fell sharply in response, trading at deep discounts to their face value. Frenzied negotiations between Thames, Ofwat and the Government ensued.

[12] Ofwat, Investigation into Sewage Treatment Works, https://www.ofwat.gov.uk/investigation-into-sewage-treatment-works/

[13] Ibid.

On 28 March 2024, having reached an impasse in their negotiations, the shareholders of Thames Water issued a press release announcing that the regulatory arrangements expected to apply to the company in AMP8 rendered their business plan uninvestible. Having concluded that the conditions that underpinned their July 2023 commitment to provide £750 million of equity support during the current regulatory period had not been satisfied, Thames' shareholders announced that the £500 million equity contribution due by 31 March 2024 would not be provided.[14]

The announcement leaves Thames teetering on the brink. While the company noted it has £2.4 billion of available liquidity,[15] absent an equity injection, it is only a matter of time before the United Kingdom's largest water company breaches its debt covenants. A multi-notch credit rating downgrade, not inconceivable in the circumstances, would see the company breach the licence condition that requires it to maintain an investment-grade rating, creating a trigger for the government to put Thames into special administration. Press reports suggest that Thames remains locked in furious negotiations with the government, with options including a debt-for-equity swap and injection of equity by new shareholders being canvassed as potential solutions to the crisis. It seems clear, however, that the crisis will not revive proposals to renationalise the country's water industry. The Conservatives oppose such a move on ideological grounds. Moreover, Sir Keir Starmer, Leader of a Labour Party widely tipped to form government in the forthcoming general election, dropped the nationalisation of the water industry from Labour's policy platform in 2022, and in a January 2024 interview with the Reading Chronicle, reiterated his position, noting that "I don't think nationalisation is the answer".[16]

Despite any obvious direct implications for Severn Trent and United Utilities, the announcement from Thames Water's shareholders on 28 March saw the stock of both companies lurch lower. While further news regarding Thames may drive increased volatility in the near-term, patient long-term investors should seize the opportunities that arise when markets price risks indiscriminately, taking comfort in the possibility of outsized future returns.

[14] Thames Water Shareholder Funding Update, 28 March 2024, https://www.thameswater.co.uk/news/shareholder-update
[15] Ibid.

[16] The Reading Chronicle, Sir Keir Starmer Speaks Out after Thames Water Supply Chaos, 27 January 2024, https://www.readingchronicle.co.uk/news/24078516.sir-keir-starmer-speaks-thames-water-supply-chaos/