December 2014

Investment market update

Though global share markets were generally positive in November, Australian shares were unable to benefit from these gains and fell significantly. This underperformance was due to weakness in Australia's two dominant sectors—banks and resources. Against the backdrop of a very weak overall market, some companies' stocks were able to withstand the sell-off and even achieve small gains in some cases. One such company was APA Group (APA) and this month's update focuses on UniSuper's significant investment in the company.

Performance of key markets

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	-3.2	0.3	4.0	13.4	6.8
US Shares (S&P 500) in US Dollars	2.7	6.4	16.9	20.9	16.0
US Shares (S&P 500) in Australian Dollars	5.7	17.6	25.1	28.6	17.6
Asian Shares (MSCI Asia)	1.6	2.8	5.6	9.0	4.7
Australian Dollar (AUD/USD)	-2.9	-9.5	-6.6	-6.0	-1.4
Australian Fixed Interest (UBSA Composite)	1.3	3.2	8.6	6.1	6.9
Cash (UBSA Bank Bill)	0.2	1.1	2.7	3.2	3.9
Balanced (MySuper) option*	**0.4**	**4.1**	**9.8**	**13.3**	**8.8**

Returns are for periods to 28 November 2014. Past performance is not an indication of future performance.

** Returns relate to our Accumulation (not Pension) investment options and are published after fund taxes and investment expenses, other than account-based fees.*

See performance information for all options

Australia underperforms in November

One of the defining themes in financial markets over the past 18 months has been the concern about the potential negative impact on asset prices once the US Federal Reserve brought their quantitative easing (QE) program to a close. As it happened, the end of the US QE cycle was not as detrimental to markets as some feared, partly because it was offset by additional easing in both China and Japan over the past month and increased speculation that Europe will soon follow suit. Overall global share markets were generally positive in November.

Unfortunately Australian shares didn't benefit from these gains. The -3.2% return in the month was one of the weakest outcomes globally. Speculation that Australian banks (which make up more than 30% of the index) may face higher capital charges pursuant to the Financial System Inquiry underpinned a 4% fall in the sector. Meanwhile, further weakness in commodity prices saw resource stocks (16% of the index) fall 9%.

Stock highlight - APA Group

Much has been said and written about the domestic liquefied natural gas (LNG) boom that will likely see Australia become the largest exporter of LNG in the world by 2020. A major player in Australia's gas industry is APA, a top 50 company with a market capitalisation of around $6.7 billion. UniSuper is currently the largest shareholder with $560 million (8.4%) of the company.

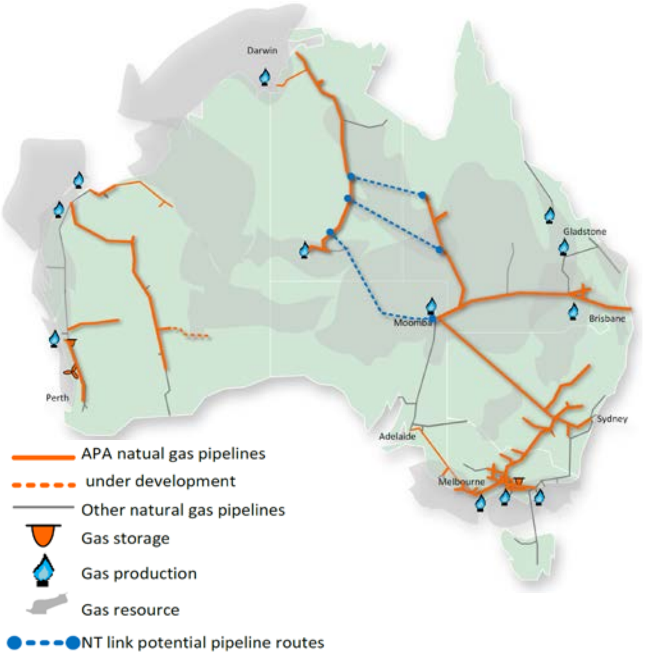
APA's 'Fortress Asset' qualities

Previous market updates have discussed our strong desire to build a portfolio of fortress assets. These are assets which, due to their dominant position in an industry or region, are able to generate sustainable earnings and dividends streams with a lower risk profile than the overall market. Examples of such assets that we have previously discussed include Sydney Airport, Transurban, and high quality property trusts like Scentre Group and Novion Property, which own Australia's best retail shopping centres. APA is another such asset underpinned by the following characteristics:

Strong market position: APA owns a national gas pipeline network of over 14,000km, connecting gas from source to end user. As is the case with most infrastructure assets, the economics of competing usually don't stack up. As the analogy implies, a fortress asset is typically protected with high barriers to entry and lack of substitutes.

Network economies also work in APA's favour as they have steadily built and bought an interconnected web of pipelines around Australia. The economics of adding to an installed network can be lucrative assuming disciplined capital outlay.

Figure 1: APA's pipeline network



Source: APA Group

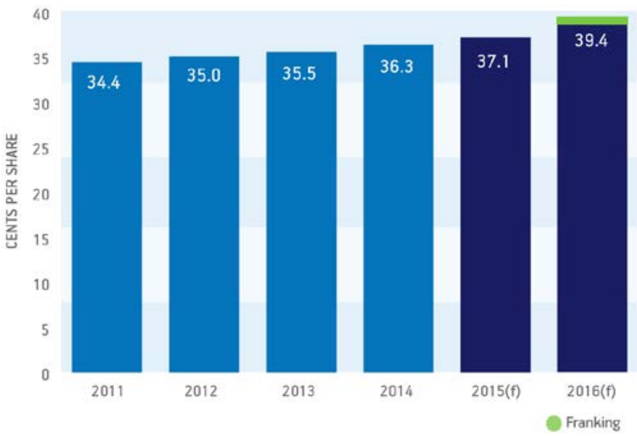
Inflation protection: About three quarters of APA's asset base is unregulated which allows them to price their services to earn attractive returns. Pricing power is of course the key to inflation protection. Further enhancing this part of the story is the fact that over 70% of Group revenue is secured by long term 'take-or-pay' contracts, whereby APA's customers pay for access to pipelines regardless of whether they are actually used. This also provides some downside protection in the event of economic slumps.

Simple business model, and positive industry dynamics = sustainable dividends

APA is a 'pure play' gas infrastructure in Australia (i.e. *only* focuses on gas infrastructure), so it doesn't suffer from the risks involved in running complex businesses across different industries and countries. As well as the benefits of scale and network economies, APA will also benefit from participating in an industry with secular growth prospects. Being a cleaner fuel than coal, gas is expected to take a substantial amount of market share from coal as the world looks to reduce carbon emissions.

Most importantly however, is APA management's commitment to convert the company's competitive advantages in a favourable industry into shareholder returns. APA's long-term CEO Mick McCormack takes great pride in the fact that APA has never cut its dividend. Presumably he'll be determined to keep that record intact.

Chart 1: APA: dividends per share



Source: Bloomberg, Macquarie Research
Past performance is not an indication of future performance.

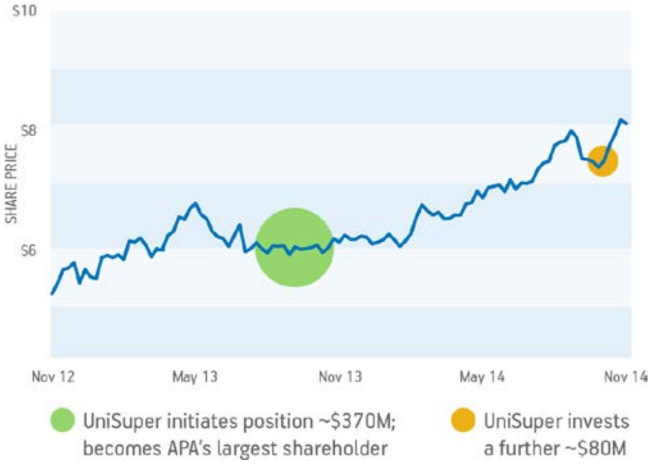
UniSuper's investment in APA

When considering such large 'single stock' investments, we first look at the macro dynamics of an industry, then at company specifics. It's often the case that infrastructure assets exhibit favourable macro and company-specific characteristics, but the available liquidity is too small for UniSuper to take a significant stake in. APA ticked all of our boxes, so it was a matter of timing our entry into the market.

Our initial significant investment in APA was in July 2013 when the shares were trading at c. $5.90 providing a dividend yield of about 6%. Since that time the stock has returned approximately 45% (which compares favourably to the ASX 300 return of 19%). We made an additional investment on some share price weakness in October 2014.

With the benefit of hindsight we should have invested earlier.

Chart 2: UniSuper's positioning in APA



Source: Bloomberg
Past performance is not an indication of future performance.

Our initial significant investment in Transurban was in March 2012 and it was around this time that we were also scouting the broader infrastructure sector. At the time however, we were more cautious on APA as it was in the throes of a bidding war for Hastings Diversified Utilities Trust and later Envestra (owner of much of Australia's local / residential gas distribution pipelines). Our concern was that APA would overpay for these companies. As it turned out, they showed strong discipline. Indeed APA actually sold its shareholding in Envestra to an offshore buyer that was willing to pay a high price. We should have backed management to do the right thing from the outset and invested earlier; patience is not always rewarded!

Risks

With a current yield of 4.6% and the prospect of steadily rising dividends, the APA story looks almost too good to be true in the context of a market in which 10-year government bonds are yielding just over 3%. While our position obviously reflects our optimistic outlook for the company, it doesn't come without risks, as is the case with all equity investments, which include:

1. **Valuation:** As a high quality 'yield' stock, APA (currently trading at $8.15) has had an excellent run over the past couple of years. There is a school of thought that we are now in a 'yield bubble' which will undoubtedly bust when rates rise. Our view is that firstly, rates are likely to stay low for a long time and / or secondly, a rising rate environment would be driven by a stronger economy, and APA is very well placed to benefit from that scenario.
2. **Management error:** Acquisitions present a particular risk. APA management is currently bidding for BG Group's LNG's pipeline infrastructure in Queensland. APA has a natural bidding advantage given the network and scale economies that would not be available to other bidders. However, there is a risk that APA management will overbid to win the asset. We trust that APA Management will exercise the same discipline recently displayed in relation to the Envestra deal.
3. **Regulatory:** Some of APA's pipeline infrastructure is regulated by various Australian government authorities. There is a risk that rising utility bills could encourage a populist response from government and regulatory authorities (e.g. capping bills at an uneconomic level). This risk is somewhat mitigated by the fact that only around one-quarter of APA's revenues are regulated. Furthermore, Australian regulators have generally proven to be reliable and objective. A sound regulatory framework is one reason why our utilities do not have any problems raising capital.
4. **General economy:** Gas demand does benefit from a general trend towards cleaner forms of energy and residential demand is also reasonably defensive. However higher prices and general economic conditions can have a negative impact through lower electricity generation and industrial gas demand (e.g. brick manufacturing, chemicals manufacturing). This risk is mitigated by the nature of APA's long term take or pay contracts and its diversified network.

In summary, despite the sharp rally that we have seen in APA since our initial investment, we remain confident of the future prospects. Accordingly, we intend to be a holder at current prices and an accumulator at lower prices. This also applies to our other fortress assets like Transurban and Sydney Airport.

Of course this overview shouldn't be taken as advice or a recommendation to buy any of the stocks mentioned, as your personal circumstances may differ from our risk-return considerations.

Want to learn more about our investments? Find out more **here**.

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