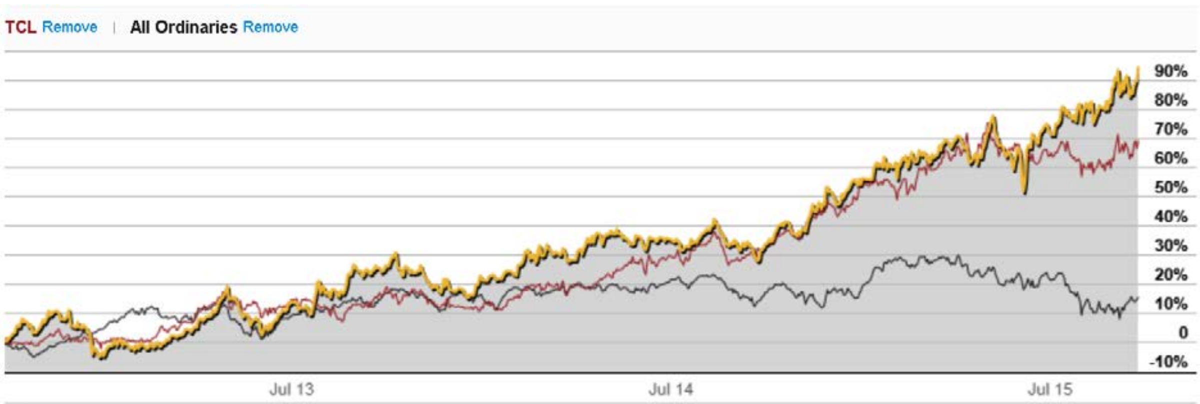
Dear Investors, 19th Oct 2015

I promised myself that if SYD ever got to $6 a share, I would write a short article about it. With SYD shares closing at $6.23 on 16/10/15 the time has come to fulfil the commitment.

As you probably know, global markets have been obsessed with yield stocks ever since governments and central banks opened up their money taps. At first, it started as a reasonable reaction by investors to redeploy capital from bank deposits with falling yields into higher yielding equities, which, ideally, were backed by high quality assets with defensive characteristics. Sydney Airport (SYD) and other infrastructure stocks like Transurban (TCL), Macquarie Atlas (MQA) and Spark Infrastructure (SKI) were amongst the better quality options available to investors seeking a few percentage points extra return over a term deposit.

Falling rates fuelled a strong capital flow, which created tremendous momentum for these stocks thereby compressing yields and increasing investor's risk as the chart below shows.



Source: Commsec. Yellow – SYD, Black – All Ords, Red - TCL

People who jumped on the yield bandwagon early have made very respectable returns over the last 3-4 years and have been joined by an army of cheerful followers. Market valuations have swelled and the yield stocks are now perceived as the elite of the ASX. The general market recently had a savage pullback and yet SYD and other yield plays remained firm or even advanced. Without elaborating further, **the market is well and truly in love with yield stocks.**

And when the market is in love with something, you know what to expect next – silly valuations and eventually a bust.

A colleague of mine once shared with me an old broker's secret that any successful market roll up story required just one large client at the end of the chain, who was effectively a "disposable" for everybody else to feed on. And at the moment, anyone buying SYD, TCL or similarly priced yield stocks may suddenly find themselves falling into the "disposable" camp.

<u>Why?</u>

Well in the case of SYD, let's look at the valuation and compare it to the underlying earnings power of the airport.

Year	Jun FY2003	Jun FY2004	Jun FY2005	Jun FY2006	Jun FY2007	July - Dec 2007	Dec FY2008	Dec FY2009	Dec FY2010	Dec FY2011	Dec FY2012	Dec FY2013	Dec FY2014	Dec14 - Jun15	
Operating Cash	362,952	413,463	474,641	520,228	588,461	291,310	650,639	658,721	775,192	784,200	858,700	894,100	976,600	474,400	
- Debt/lease related cash costs	-452,095	-311,961	-421,823	-309,085	-399,507	-178,787	-427,509	-366,269	-375,013	-406,900	-420,300	-409,300	-419,000	-215,900	
- Tax	-33,306	0	0	0	0	0	0	0	0	0	0	0	0	0	
- Maintenance Capex (=depreciation)	-91,368	-85,952	-100,418	-110,889	-130,239	-88,327	-119,177	-165,050	-172,318	-164,600	-168,300	-174,500	-216,300	-95,600	12Y total
= Cash flow available to SYD securityholders	**-213,817**	**15,550**	**-47,600**	**100,254**	**58,715**	**24,196**	**103,953**	**127,402**	**227,861**	**212,700**	**270,100**	**310,300**	**341,300**	**162,900**	**1,907,631**
- Growth Capex	-4,460,788	-7,072	-27,553	-107,703	-44,024	1,600	-261,050	-140,539	37,577	-1,400	-34,300	-51,700	-37,300	-42,700	-716,164
- Dividends & RPS Distrib	-84,332	-135,224	-374,746	-272,144	-545,960	-508,393	-466,263	-300,884	-399,494	-383,900	-450,100	-472,800	-522,800	-279,800	**-5,112,508**
= Cash surplus / (deficit)	**-4,758,937**	**-126,746**	**-449,899**	**-279,593**	**-531,269**	**-482,597**	**-623,360**	**-314,021**	**-134,056**	**-172,600**	**-214,300**	**-214,200**	**-218,800**	**-159,600**	-3,921,041
From / (to) other Creditors	3,241,740	89,700	267,000	213,745	1,107,228	278,986	215,600	-871,623	90,227	811,900	-440,600	222,700	245,600	190,300	**2,420,763**
From Shareholders	2,000,000	0	0	0	0	0	394,400	987,697	0	0	0	0	0	0	**1,382,097**
Decrease / (increase) in cash account	-482,803	37,046	182,899	65,848	-575,959	203,611	13,360	197,947	43,829	-639,300	654,900	-8,500	-26,800	-30,700	118,181
= Funding of deficit / (surplus)	**4,758,937**	**126,746**	**449,899**	**279,593**	**531,269**	**482,597**	**623,360**	**314,021**	**134,056**	**172,600**	**214,300**	**214,200**	**218,800**	**159,600**	

Source: SCACH annual reports, all numbers in $000s

The above table is a compilation of cash flow statements reported by SCACH (the holding company for Sydney Airport) since privatisation. The key takeaway is that: Over the last 12 years, the company has paid $5.1bn in distributions. Of this, only $1.9bn (or 35%) was generated[1] by the business itself (see the table above in yellow). The remaining $3.2bn was funded by debt and (surprise!surprise!) equity raisings.

As an example, in 1HY15 the airport only generated about $163m of free cash after maintenance capex[1], whereas the actual distribution paid was $279m. The shortfall was funded by debt. And SCACH has been running this capital reshuffling exercise for more than a decade (paying about $275m in debt establishment costs in the process)!!!

Is this sustainable?

Well, Sydney airport is indeed one incredible asset. It has been consistently delivering EBITDA growth for more than a decade. This allowed the management to supercharge the available cash earnings by borrowing against the future expected growth in these earnings and returning the borrowed funds immediately to the unitholders. When the debt levels got too high, SCACH simply hosed it with an equity injection.

At $6.23 a unit, SYD's stock is valued at $13.9bn. **This is more than 40 times FY14 underlying cash earnings or a 2.46% FY14 cash earnings yield.** Obviously, nobody cares about this at the moment. The company will keep boosting these modest earnings by up to 80-90% each year by piling up the debt and giving investors their craved 4.5% dividend yield. **However, it is likely that the outlook for EBITDA growth will deteriorate materially when construction of the second Sydney airport begins.** The second airport will not only set the shareholders back a few billion dollars (if SYD exercises its right to develop it), but it will forever change the long-term growth outlook for the (currently monopolistic) Kingsford-Smith airport. With that in mind, there is no doubt that sooner or later this capital shuffling circus will have to stop and there will be a whole lot of people finding themselves in the "disposable" camp.

SYD is not unique

The story is similar if you look at MQA or TCL. Unlike SYD with its many decades left in concession, both MQA and TCL hold concessions with weighted average remaining life of about 18 and 24 years respectively (Do investors realise that they don't actually own these assets in perpetuity?). Obviously, this means that some of their distributions are always going to be capital returns rather than earnings. And in the case of TCL trading at $10 a unit, it is difficult to see how the unitholders will receive anything beyond their money back over the remaining life of the concessions. **So you can forget about generating any meaningful real return unless you are lucky enough to offload your units to another "disposable" down the chain.**

Good investing,

Max Shramchenko

[1] Based on an assumption that the required maintenance capital expenditure has been roughly equal to depreciation.

Note: Harness Asset Management Small Companies Value Fund (the Fund) does not own shares in the stocks mentioned above as at 20 Oct 2015. The above is in no way intended as financial advice, nor any recommendation by the manager of the fund.