Aurora Investment Trust – June 2023

Share Price: £2.00 Net Asset Value: £2.29 Discount: 12.7%

Market Cap: £152m

Data as of 30 June 2023

Holdings >3% on 30 June 2023	(%)
Frasers Group	20.3
Castelnau Group Ltd	15.7
Barratt Developments	14.1
Ryanair	8.0
Netflix	6.8
easyJet	6.5
Lloyds Banking Group	5.0
RHI Magnesita	4.0
Bellway	3.6
AO World	3.0
Others <3%	12.8
Cash & Cash Equivalents	0.2

In June, the NAV was down 0.9% for the month, versus the FTSE All Share (incl. dividends), which was up 1%.

The strongest performer during the month was AO World, which rose 22.5%. Other double-digit growth came from Netflix, which was up 11.5%

Falls of note were Bellway -12.0%, and Barratt Development -10.7%.

We are delighted to announce that Aurora will be hosting an Aurora Investor Event on Tuesday, 10th of October 2023. The event will be held at the Queen Elizabeth II Centre in London, and is designed for both existing and prospective Aurora investors. Gary Channon and the team will be reflecting on performance and updates on the holdings across the portfolio. If you would like to attend the event, please contact maraki@pamp.co.uk for further details.

The following contains extracts from Gary Channon's quarter-end thoughts to Phoenix investors:

Outlook

Housebuilding

Concern about interest rates is driving opinions and price moves in housebuilder shares, which always act as a proxy for the market's views on house prices. This is because lower selling prices immediately reduce housebuilders' accounting profits as the cost of land and building have already been set. Analysts forecast earnings, and when house prices decline, so do earnings. However, as we have pointed out many times before, in cash terms the drop in house prices is largely recovered in the replacement cost of land, and as housebuilders slow their growth, they need less land replacement. The net effect is that they generate cash. Bellway's trading statement on 13th June is a great illustration where they expect slightly lower output, lower selling prices and therefore lower profits, but an increase in cash even though they are buying back their shares.

Cash is value and accounting earnings is not, and eventually the market ends up recognising its mistake, but for now, it makes for very depressed valuations and wonderful investments.

An Anatomy of a UK House Price Crash

There are peculiarities of the UK housing market that cause it to correct in a certain way. As it is not possible to walk away from a mortgage in the UK even if the house is worth less than the loan, and as banks are very reluctant to repossess properties and in fact are under all sorts of regulatory and political pressure not to do so, it means that there are very few forced sellers in the market.

Price adjustments happen slowly because when told that they need to reduce the price of their house substantially to sell it, most decide not to sell and even not to move. Volumes decline.

Price does adjust down gradually though. There is an imprecision about house values but, if we were to think of them like shares, then the bid to ask price is around 10%. In a strong market where buyers outnumber sellers, houses transact on average at the offer side. In a weak market, buyers expect a discount and place lower bids and, within reason, sellers accept those bids. Houses that were transacting for £300k decline to £270k, but only very slowly.

The biggest modern-day crash in UK house prices occurred from 1989 to 1995 and was in total 23%. However, only 9% of that came through price; the rest was from inflation. It was an absolute -9% but in real terms, -23%. The fall in 2008 was even less because inflation was lower.

So far in this adjustment prices have barely budged off their highs; they've stopped rising at a time of high inflation and so in real terms they have fallen c.6% from their peak. Given all the prevailing conditions that are likely to persist, this will cause housebuilders' profits to fall and their cash generation to rise.

Higher rates are painful for those seeking a mortgage, but a tightly supplied housing market means that there are always occupiers for houses built and we can see that rents are rising rapidly. Housebuilders are now selling more of their product to landlords.

Dignity

We are now in a much less restricted position to talk to you about Dignity. We have nearly 99% of the equity, have delisted it and are in the process of mandatorily purchasing the remainder.

A new governance structure is in place and new appointments have been made to the executive leadership. For the first time in 3 years, Dignity has a permanent CFO. The new leadership team is moving quickly to accelerate the transformation of Dignity and capture the benefits of being delisted. Sir Peter Wood's team is now fully engaged. New boards have been formed and regular meetings with the shareholders, SPWOne and Castelnau are held.

We can now talk more openly about valuations. There are many ways in which to tackle this, but we can start with one that is familiar to you, that is a Phoenix Intrinsic Value and on that basis, we value Dignity at a little over £30 per share, versus the £5.50 acquisition price. This is not to underplay the huge amount of work to be done in order to deliver the performance that earns that valuation.

Another important valuation consideration is downside, and for Dignity the base downside can be calculated using a breakup or liquidation value. Selling the portfolio of crematoria and repaying the debt, we think, would generate more net proceeds than the acquisition price of the whole business (£286m). There are many valuable funeral businesses in the Dignity portfolio but even setting that aside and assuming you wind it all down without any disposal proceeds, it still leaves c.400 commercial freeholds mainly in residential areas with planning gain potential, as well as over 200 residential freeholds. These are valued at c.£150m on an existing use basis and it's too early to give an accurate number for planning gain potential but it's very material. As for the funeral plan trusts, they have a surplus above the regulatory requirement of c.£200m.

Taking that all together, assuming successful execution and even allowing for tax, gives a value over twice the acquisition price. Unlike the bottom of the range worst case scenarios that we calculate as arm's length fund managers, this is one that we have the authority to deliver if warranted. Having control doesn't just unleash the upside, it more importantly protects the downside.

The value creation at Dignity comes from that Lollapalooza effect we talked about in 2020 when we publicly sought a strategy change. Seize the opportunity provided by the regulation of funeral plans to grow the market and lead it, thereby building up an investment float that can be prudently compounded until needed to provide funerals. More plans mean more funerals and more funerals will increase the volume of cremations we handle at our crematoria.

It is a merit-based strategy. We aim to be the best provider in all three areas and to cultivate a culture that delivers excellent service, a great place to work and outstanding economics.

As we discussed during the acquisition, it is our intention in the medium term to seek a way of crystallising the value being created in Dignity, so that those holding stakes that wish to realise some of that value are able to do so. Before that, Castelnau will produce a monthly valuation of the business that will be independently verified; for a period following the acquisition the acquisition price is considered the value because there is a recent public transaction at that level. We plan to report to you as transparently as is commercially sensible, and being a private company will make that a lot easier than when it was as a public company.

AI

When we started in 1998, the market was getting distorted by the arrival of the internet. A bubble was building in technology and telecoms company valuations in anticipation of the huge potential rewards that would accrue to the winners. Other businesses were left behind and became extremely undervalued in what turned out to be one of the greatest value investing windows we have seen.

The internet has had a huge effect, both creative and destructive; great fortunes have been made and others wiped out. There has been no single bigger factor impacting businesses since. We generally adopted a more cautionary and wary attitude trying to avoid those businesses that were likely to be hurt and investing where we thought it would have either no effect or a positive one.

25 years later, markets are once again undergoing a technology led distortion and this time it is Artificial Intelligence doing it. It looks like it will have as profound of an impact on business and society as the internet has. No investment can be considered without thinking through the implications of AI, but just as it was in 1998, it's too early to know what will happen and what the ramifications will be. We need to be vigilant.

In Castelnau we started a data science company of our own two years ago with Gerry Buggy to find ways of applying AI to our businesses, because at the time we couldn't find an equivalent business to work with. That company, Ocula Technologies, has now taken the products developed with the help of Castelnau Group companies and is signing up external companies. We are learning a lot in watching that happen. If you have a business that might benefit from the actionable AI technology in Ocula, let us connect you with the co-founders, Tom McKenna (ThomasM@ocula.tech) and Greg Fletcher (Gregoryf@ocula.tech).

In one of our Castelnau companies we are trying to practically apply AI to improve productivity and from early indications the results will be significant. These learnings help us with our assessment of portfolio companies and potential investments. Our analysts are now augmenting their work with the help of ChatGPT and others.

There is a storm coming; like with the internet the market will over think it, overreact and thereby create opportunities for the prepared mind. We are doing all we can to equip ourselves for it.

There has been a deluge of publications on the topic, most not that useful, in fact ChatGPT4 is probably the best teacher right now. The book we found the most useful in thinking through the likely implications and creating a way to put those in an economic context is *Prediction Machines, Updated and Expanded: The Simple Economics of Artificial Intelligence* (the 2022 version) by Agrawal, Gans and Goldfarb. This comes out of the University of Toronto, which has been the originator of much of the latest breakthroughs in AI.

UK

The UK is, in so many ways, mired in its own gloom. Anyone visiting even with a neutral perspective will soon find themselves infected by the negativity that pervades life in the UK. Although there are plenty of negative things occurring, and some of them have been big, like the implications of Brexit, when one thinks about it in the context of what the future holds for the world, there is reason to be particularly optimistic.

Take technology; Charles Babbage is considered to have built the first computer, Ada Lovelace to have written the first computer programme, Alan Turing is the founding father of modern computing and Artificial Intelligence, Tim Berners-Lee is the person who started what became the internet we know today, Geoffrey Hinton who recently stepped down from Google and is considered the father of AI and Demis Hassibis the new head of AI at Google is the co-founder of Deep Mind that has made great breakthroughs in AI. These people are all from the UK and were actually all born in London. This is not coincidence, the British, although they rarely acknowledge it themselves, have a culture that produces creative and inventive people, and we are in an era when that will be highly valued.

The best-selling writer of all time is Shakespeare, but in the modern era it is JK Rowling. In fact, 3 of the 5 best-selling books of all time were written in the UK. The same goes for music where 4 of the top 8 selling artists of all time are from the UK. We could go on but the picture is the same, the UK is unusually creative in a way that has global appeal.

Machines reduced the manpower needed in food production and robots and AI are doing the same in manufacturing, logistics and administration. As people work less they put more time and money into leisure and entertainment. That is having a big impact in games and sports and once again, the UK is uniquely placed.

Football is the world's most watched sport with the English Premier League the most watched and most valued in the world. Next it is cricket. The most valuable sport according to Forbes is Formula One, which also originated in the UK and 70% of the teams are based here. As we write another game originated in the UK, Tennis, the most watched single person match sport in the world, is having its annual tournament in Wimbledon, SW London.

This creative and playful inventiveness is not just an intrinsic cultural characteristic, it is also the product of an education system that encourages individuality. Again, the UK has four universities ranked in the Top 10 in the world, the same number as the US, a country with 5 times the population.

Brexit may impact where companies decide to locate their factories, but there is a reason why Apple and Google have recently opened such big HQs in London.

Conclusion

The past 25 years has been a miserable one for investors in the UK stock market when compared to their global peers. Some of this has been justified but a lot has been due to the devaluing of businesses listed here. As we write, the value of Apple now exceeds the whole of the FTSE 100.

These are the moments when value investors retire, get fired or alternatively double down, maximise their upside value and wait. Buffett says that when it is raining gold put out a bucket not a thimble. We think we've being doing that, and no more clearly illustrated by our seizing the opportunity to buy all of Dignity. In 1999, in our first full year, we lagged the market by 25%, and value investing felt like a lonely place to be as everyone was enjoying bumper returns in the market. What we learned then and have again and again, is that in the end value wins, it can be a long wait, but ultimately value shines through.

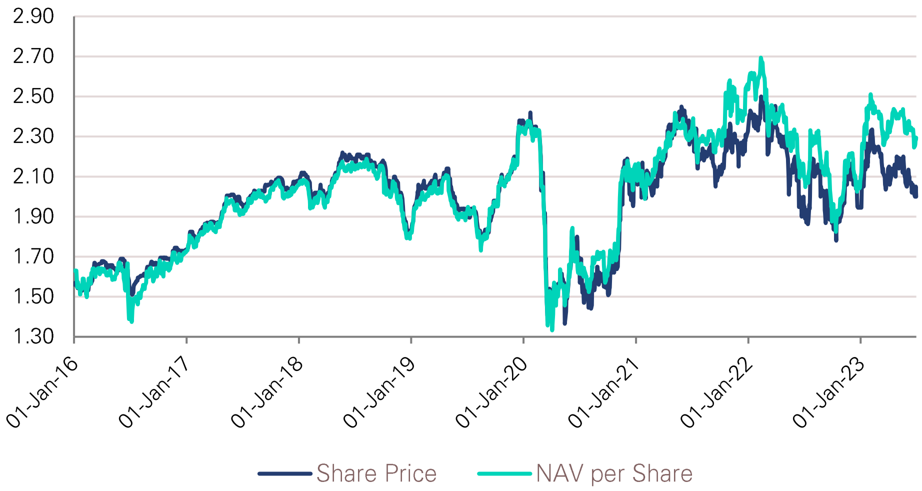
Aurora Track Record

Performance	NAV Return %	Share Price Total Return** %	All-Share Index %**	Relative NAV to ASX %
2023 (to 30 June)	11.9	4.3	2.5	9.4
2022	-17.4	-16.3	0.3	-17.7
2021	19.1	13.5	18.3	0.8
2020	-5.5	-10.0	-9.7	4.2
2019	29.7	31.9	19.1	10.6
2018	-10.3	-10.9	-9.5	-0.9
Cumulative*	55.6	42.0	56.5	-0.9

* Since 1 January 2016
**Share price return with dividends reinvested; All Share Index returns with dividends reinvested.
Past performance is not a reliable indicator of future performance.

Aurora shares are eligible to be invested in an ISA or SIPP. Neither the Aurora Investment Trust nor Phoenix Asset Management Partners run such a scheme. You should consult a financial adviser regarding a suitable self-select ISA or SIPP provider.

Aurora Share Price & NAV per Share – 30 June 2023



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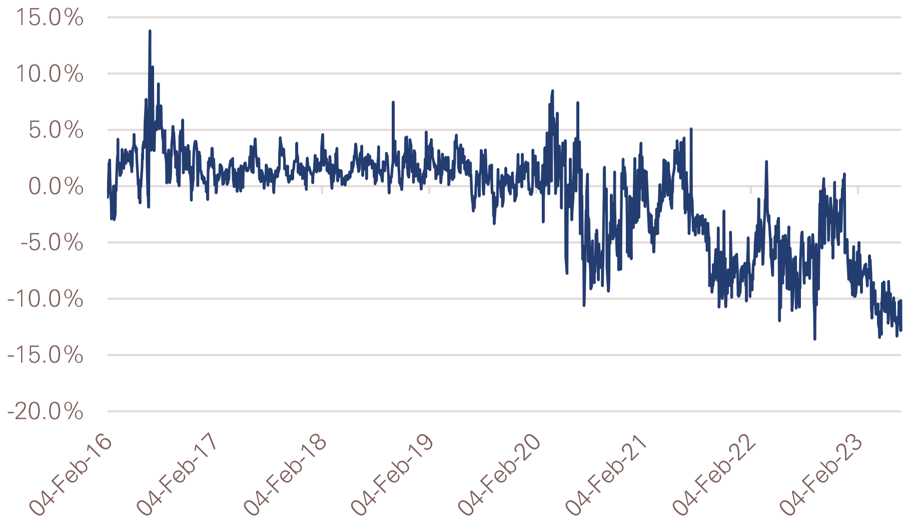
Aurora Premium / (Discount) – 30 June 2023



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Investment Objective

We seek to achieve long-term returns by investing in UK-listed equities using a value-based philosophy inspired by the teachings of Warren Buffett, Charlie Munger, Benjamin Graham and Phillip Fisher. Our approach, combined with thorough research, invests in high quality businesses run by honest and competent management purchased at prices that, even with low expectations, will deliver excellent returns.

Contact

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Fund Manager since 28 January 2016

Portfolio Manager: Gary Channon
Listing: London Stock Exchange
Inception Date: 13 March 1997
ISIN: GB0000633262
Bloomberg: ARR

Fees

Management: None
Performance: One third of returns in excess of the market

Regulatory Notice: