Aurora Investment Trust – September 2023

Share Price: £2.07 Net Asset Value: £2.36 Discount: 12.4%

Market Cap: £157m

Data as of 30 September 2023

Holdings >3% on 30 September 2023	(%)
Frasers Group	22.6
Barratt Developments	14.6
Castelnau Group Ltd	14.4
Ryanair	7.2
Netflix	5.9
easyJet	5.6
Lloyds Banking Group	4.9
RHI Magnesita	4.1
Bellway	4.0
AO World	3.1
Others <3%	12.5
Cash & Cash Equivalents	1.1

In September, the NAV was up 0.2% for the month, versus the FTSE All Share (incl. dividends), which was up 1.7%.

The only individual stock move of note was a 13% fall in Netflix after general negative sentiment in the US markets in recent weeks.

In his quarter end comments to Phoenix & Aurora investors, Gary Channon outlines the following thoughts on the portfolio and uses Lloyds Bank as an example of our investment approach in action:

From an investment activity perspective, this was the quietest quarter we have ever had; there were no changes to the portfolio. Low activity is not unusual for us, we have long practised the art of doing nothing. In human endeavour, doing nothing is usually associated with rest and yet that is the opposite of what we seek to achieve when we do nothing. That is because your capital is not really with us, it is deployed within the businesses we own and there we certainly don't expect it to be doing nothing.

We deploy capital in businesses where it is unusually productive and value creating. We are drawn to a particular type of business model. Although there is much written about investment values and metrics, there isn't much on the topic of business models and yet they are so crucial to the outcome for a long-term investor.

There are six key things you need to know about a business model to value it:

i) How much capital does it need? By that we mean real capital as per the Phoenix definition of Core Capital, it's the capital needed to replicate the business.

ii) What sustainable return is earned on that capital?

iii) How much capital will need to be retained versus returned to shareholders?

iv) What is the sustainable return on marginal capital retained?

v) How long into the future can we reasonably estimate (points ii-iv)?

vi) How will those who are managing the model act?

Our long-term investment returns are a function of these factors combined with the price we pay in relation to the core capital.

Let's illustrate with a holding, Lloyds Bank. We are now going to simplify and summarise some Lloyds data, but it is important to note that at Phoenix, our route to simplification is via depth and detail. Going straight to the simple is a recipe for mistakes, especially so with banks. We have been working on Lloyds in some considerable detail for over 15 years.

Lloyds has a business model which makes a 15% return on its capital, it doesn't need much of that to be retained for its organic growth and so it pays out about a third of its net return as dividend and has been doing some large share buybacks.

Lloyds trades in the market at a value of £28bn, which is less than the value of its tangible capital of £29bn (this number is itself an underrepresentation which we won't go into here but relates to the impact the introduction of IFRS17 on the way the accounts are presented). We think a better measure of the tangible core capital is about £32bn or 50p a share.

So in other words, at the current share price you can purchase £1 of Lloyds capital for 87.5p. That capital is earning 15%, so that's a 17% return versus the share price. When we say return, we mean real return, free and clear of taxes and needs in the business. Lloyds expresses itself in terms of how much its capital ratio would improve if it didn't distribute the returns. Lloyds needs 13.5% of capital (it has over 14%), and if it did nothing this would grow by about 2% a year (i.e., 13.5% produces 2% a year of distributable cash).

When Lloyds buys back shares at the current price, and they have bought £2bn worth this year, they are re-investing money at 17% because of the discounted share price. This does wonderful things for investors who don't sell. Whatever the share price does, we are getting richer at a rate of approximately 17% per annum.

On the current run rate, Lloyds will generate its whole market value in after tax and free and distributable cash in the next 5 years. At those kinds of values, one of the hardest parts of valuation (part V above), which is how far into the future we can see, becomes much less of a risk.

The share price by which we report performance does not move in line with that value creation, except over the very long term. Lloyds for this quarter did move almost exactly in line with its underlying value creation, it rose 3.9%. However, that was just a fluke because for the year, it is down over 2% including the dividends paid!

What is a business model like this worth? Well, we can simplify valuation into what we should pay for a business's capital in order to achieve the return we seek. If we are looking for a 15% after tax return, then we should pay the capital value of a 15% return business. It does not matter whether it distributes or retains earnings if that capital going back in is earning 15%. But capital markets don't price equities to yield 15%. We have always used a long-term discount rate of 7.5% premised on a long-term government bond rate of c.5% and what is called an "equity risk premium" of 2.5%. The risk referred to is volatility and we don't think of volatility as risk, but for someone choosing equities over government bonds, then the extra volatility is a risk, so much that when you come to access your money, there is a risk that it is trading at a discount because of that volatility. So, it could be called the Equity Inconvenience Premium.

Using 7.5%, if a business, like Lloyds, makes a 15% return on its capital and could never grow so it distributed all profits as dividend, then it would be worth twice its capital (i.e., 15/200 = 7.5%). If a business could sustainably retain and deploy half of its earnings, then it becomes worth more than 4 times its capital (you will have to take our word for these numbers otherwise we will turn this into a very dull piece but please do write if there is some underlying information or verification you would like).

Lloyds buying back shares is like retaining capital for re-investment and at these rates very value creating. If it stays cheap and they keep doing this then it is worth more than 4 times its capital, over 200p per share. We don't have that level of assumption in our core Intrinsic Value of 110p a share as we don't assume future buybacks, but you can see how the value is building. Meanwhile the shares languish at 44p. Every time they retain a £1 of capital and invest it at something worth more than twice what they pay, then it pushes up intrinsic value and if that doesn't cause the shares to move, then that invisible elastic between price and value gets stretched a notch further.

While we are in the business of simplifying Lloyds, here is the whole economics in a form that you can always use to do mental maths IVs without even a calculator.

- Lloyds makes its money by earning a spread between its depositors and its borrowers. Those are almost in balance at £450bn. They have been pricing business for decades to a model that in normal conditions would earn towards 3.5%. It's less than that at the moment in part because of the lag as their book adapts to higher rates (called the structural hedge). Anyway, let's use 3%.
- 3% x £450bn is equal to £13.5bn (This is their Net Interest revenue which is currently running at about £14bn).
- On top of that they have Other Income which is all the fees and commissions they earn from doing banking business and is steadily growing but is currently about £5bn.
- So, total Revenue of £18.5bn
- They lose money on some loans and a short cut through the cycle number to use is 0.40% of the assets, in other words £450bn x 0.4% = £1.8bn
- Lloyds has the best cost to income ratio of its peers at just under 50% and they have more cost efficiencies to come but let's use 50% which gets costs at £9.25bn (50% x £18.5bn)
- So when we take those two costs off the revenue we get profits before tax of £7.45bn.
- Tax for banks is 3% above everyone else and so it's 28% for a charge of £2.1bn.
- So Lloyds Net Profit after Tax is £5.35bn on £32bn of capital
- There are 63.5bn shares in issue making Earnings Per Share: 8.4p on 50.4p of capital.

This is our cleaned up, noise aside, simplification of the Lloyds business model, which is making over 16% return on its capital by our calculations.

Investing in exceptional business models means that the value creation machine works while you wait. The biggest two risks to the models' assumptions are the sustainability of those high returns on capital and management actions. Our investment team is devoted to monitoring those for signs of a deviation away from our assumptions.

Sustainable high returns on capital are a product of what Buffett calls a "moat", i.e., a protective gap between what it costs a business to produce a product and service, and the value a customer puts on it. The investment team analysts spend lots of their time watching, even wading in, our moats. The same goes for management, we are looking to see how they act and allocate capital and what motivates them. We scan the competitive horizon in a paranoid search for competitive disruption.

Every holding in the portfolio can be evaluated with the same business model framework. Our business models vary but they all have at their heart high returns. It's unusual for high return businesses to trade at a discount to their capital but it is a phenomenon of the current UK equity market. It is true of Lloyds and Barratt Developments, even though they are both FTSE 100 companies, they are hardly obscure. The numbers aren't hard to find either, this is not 2009 where the published figures were ugly and it took some work to estimate value, these days it is in plain sight, you don't have to read all 361 pages of the Lloyds Annual Report to figure it out.

Some might dislike the use of a bank to demonstrate the point and it is a fair challenge usually. If we went to the FCA or PRA and said we had a new business idea we wanted them to authorise and it involved taking in money that was instantly redeemable and then lending that out for 25 years to someone buying a house, we would probably be laughed out of the room. That's before we mention that we want them and the government to guarantee those deposits! This is essentially the Achilles Heel of almost all banks; from a theoretical liquidity point of view, they are always insolvent and occasionally when their credibility is impacted, then theory becomes practice through a bank run. Lloyds though is exceptional in that it could repay all its depositors instantly because of a little discussed facility put in place by the Bank of England in 2009 that allows banks to pledge mortgage assets at the central bank in return for cash with a modest haircut. Lloyds has over £300bn of mortgages and over £100bn cash and liquidity.

One common factor in almost all bank failures is growth, rapid growth. In no industry does rapid growth imperil a business like it does with banking. Because of Lloyds' size, it has around a quarter of most of the UK retail banking market, it has little room to grow and for shareholders that is a good thing. It means most of the value generated will come back to us or be used to repurchase shares. It protects shareholders against management misallocations of capital, and risk creeping into the balance sheet faster than we can spot it.

A holder of Lloyds equity is getting richer at the rate of 16% to 17% a year even if the shares don't move, and then if they do one day attract a better valuation, then that return comes on top.

In Castelnau Group, we are building and creating our own engines along the same lines to generate high actual and marginal returns on capital.

We are happy with the engines of value creation in the portfolio. Your capital is deployed where it is earning high returns, the market is currently attributing a low value to that capital and at some point, we expect that to change and thereby turbo charge those underlying returns. When that will happen, we honestly have no idea.

Aurora Track Record

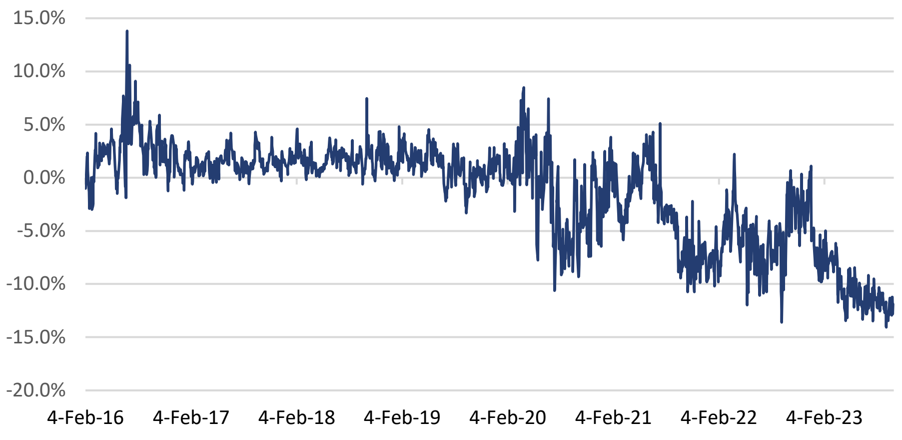
Performance	NAV Return %	Share Price Total Return** %	All-Share Index %**	Relative NAV to ASX %
2023 (to 30 September)	15.2	8.0	4.2	11.0
2022	-17.4	-16.3	0.3	-17.7
2021	19.1	13.5	18.3	0.8
2020	-5.5	-10.0	-9.7	4.2
2019	29.7	31.9	19.1	10.6
2018	-10.3	-10.9	-9.5	-0.9
Cumulative*	60.3	47.0	59.4	0.9

* 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 Share Price & NAV per Share – 30 September 2023

Past performance is not a reliable indicator of future performance.

Aurora Premium / (Discount) – 30 September 2023



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.

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.

Target Market

The Aurora Investment Trust is a long-term investment vehicle, appropriate for those making investments with at least a three year time horizon. It is aimed at investors looking for a manager with a business and value orientated approach, achieved through investments in predominantly UK companies demonstrating a high return on capital and control over their profitability through the strength of their business franchise. Aurora's portfolio is typically concentrated in a small number of deeply researched stocks, which can result in above average volatility. An investment in Aurora may be best suited to investors with at least an underlying knowledge of equity investments. The Trust is measured against a benchmark but does not follow the benchmark in its portfolio construction. It is intended for investors looking for capital appreciation rather than income, and while it does distribute a dividend, this is not the strategic aim of its investment approach.

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: