Aurora UK Alpha

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Monthly Factsheet

December 2024

Holdings >3% 31 December 2024	%
Castelnau Group Ltd	16.0
Frasers Group	14.8
Barratt Redrow	14.7
Lloyds Banking Group	8.8
Ryanair	7.8
Bellway	4.0
Others <3%	28.3
Cash & Cash Equivalents	5.6

Share Price: £2.27

Net Asset Value: £2.57

Discount: 11.7%

Market Cap: £260m

Data as of 31 December 2024

In December, the NAV was down 2.5% for the month, versus the FTSE All Share (incl. dividends), which was down 1.2%. This left the NAV down 3.6% for the year versus a 9.5% rise for the index.

The only significant share price move of note during December was Frasers, which fell 17% after it announced a modest downgrade in next year's earnings. Given Frasers' weight in the portfolio, this contributed largely to the overall December performance.

On an annual basis, Frasers and Barratt were the largest detractors on performance, with Castelnau Group, Netflix and Lloyds having the most positive impact on performance.

For investors who were previously shareholders in Artemis Alpha, it is our practice to report on holdings above a 3% weight. A process of portfolio amalgamation has been underway since the merger at the end of November and that is progressing.

We are conscious that the Trust is trading at a discount, and we will be doing all that we can in 2025 to eliminate that.

The following contains extracts from Gary Channon's year end thoughts to Phoenix Investors:

What we would like to do here is communicate confidence without arrogance. At the heart of the Phoenix investment framework is a system called DREAM where we score factors in three ways; a rating, a confidence in that rating and the depth of work that has been done on that factor. For many factors depth and confidence are correlated, but sometimes more depth reveals more uncertainty. The reason we use this method of separating is to reduce the instinct of a value focused analyst to give a lower score when confidence is lower, or where depth is shallow. This increases the chances of it being wrong, can lead to less clear thinking and raises the error rate. In DREAM we seek truth by the Socratic Method and recognise that ratings, confidence and depth are all different things.

So, the outcome of our assessed and valued holdings aggregates to an overall intrinsic value for the portfolio of circa £6.50 a share. There is uncertainty either side of that number, but it is less than you might expect, and it is less than it is for each individual holding because the negative scenarios are not the same for each holding and not strongly correlated. The 90% certainty range is around £5.50 to £7.65 (we own businesses with an upside skew to their expected values)

But we are big believers in Ben Graham's concept of Margin of Safety and apply it to the price we are willing to pay, which is no more than half that intrinsic value and no more than what we see as the worst-case outcome. That would be £3.26 a share. Such a big margin of safety protects us from our errors and negative future developments and sharply increases our overall confidence of making positive returns with your money. Applying it to a single investment gives a lot of confidence in a positive outcome but doing it across a portfolio really amplifies that margin of safety. If the probability that the actual value of our holdings is above £6.50 is around 50-60% then the chance that it is above £3.26 is approaching 100%.

So, when current share prices give a NAV of £2.57 you can see how that impacts our confidence that there is considerable upside to come, and our experience shows that when the gap is this wide, good things happen performance-wise in the following years. The present discount in Aurora adds an additional element to the valuation opportunity at this time.

Our confidence is increased by the depth of work we have done on what we own and how closely we are able to monitor them and their competitors. Dignity (held in Castlenau), Barratt Redrow, Frasers and Lloyds together account for about 54% of the portfolio and c.63% of the intrinsic value. They are the biggest and most attractive holdings (based on the difference between the current share price and the intrinsic value) in the portfolio. Phoenix has invested in Barratt for over 20 years and for Frasers and Lloyds it's 17 years. We have built a considerable depth of expertise in their industries and familiarity with their businesses and competitive landscapes. With Dignity our due diligence has been at an even greater level because we have been inside the business and acquired it.

One concern we often hear is that with our holdings being concentrated in the UK market it will be hard to perform if the UK remains in the doldrums. We look at it differently.

The lower the value of a business in the market, the more likely that its earnings progression will translate into an investment return. If a business is trading at the level of its net tangible assets and we expect it to make 15% on that capital, then some of that will come to us as dividend and the rest will go back into the business. Let's say it is evenly split, then we will receive a 7.5% dividend and its net assets will have grown by 7.5%. Even if it still trades at that net asset level, we will have received a 15% return. If money is used to buy back stock, then again dividing that net asset value by a lower number of shares will push it up on a per share basis and mean the same rating will deliver a price return. This doesn't mean that businesses can't derate further and get cheaper, in fact that is exactly what has been happening to us in 2024. Eventually though the cheapness entices value buyers and bidders and we have seen that across the UK market this year.

When you are valued very cheaply business success tends to show up in investment returns, whereas if you buy a highly rated share, then the business can be fundamentally successful but not the investment as it loses some of that rating. In the particular cases of Barratt and Frasers, we know from the past why they go through periods of being undervalued and how that has reversed; as we've described before, they have been the gifts that kept on giving.

The other thing we would point out is that we are not restricted to the UK listed market. We have the ability in the Trust to invest up to 20% of the portfolio in non-UK listed companies. We invest where we think our knowledge, insights and monitoring capability give us an edge. We also realised that some of the best businesses in the UK were not based or listed here. For example, we once owned ITV, which was the best commercial TV company at the time but that is now Netflix and instead, we own that.

The final point we would make about the UK market is that when you get so much negativity around something of value then it tends to precede a reversal. If how the reversal was going to happen was obvious then the current value wouldn't exist. It is always looks darkest before the dawn.

When we have so much upside value, limited downside with such confidence and depth it is not surprising that the portfolio hasn't changed much. We did make one new investment of note in 2024 which we mentioned in the September fact sheet and because it hadn't reached 3%, we didn't reveal it. However, after that report the holding was mentioned in a broker report regarding Aurora, and we can share it with you now. The new holding is in Burberry.

New Holding

We invested in Burberry in September 2024 at a price of around £2bn for the whole business (£5.72 per share). Although we have worked on the luxury goods sector for over a decade now, this is the first investment and so we limit ourselves to a 3% portfolio weight. The share price moved out of range before we got to 2%.

The investment in Burberry is premised on a number of key tenets. The overall demand for luxury is a function of the human condition and the rise in GDP per capita (that machine we covered in the 2022 Q4 report). The financial economics of luxury businesses are excellent because the prior investment in brand is not on the balance sheet, it's a sunk cost. The selling price of goods does not relate much to the cost of production because the brand has value to the customer. Some brands have accumulated large global awareness usually built on a heritage of past product excellence. Finally, luxury goods companies unlike restaurants or fashion retailers have enduring resilience to poor or mismanagement. In other words, they are more likely to be recoverable from failure no matter how bad or for how long.

Burberry was founded in 1856 by Thomas Burberry in Hampshire. He specialised in making outdoor clothing, which led him to invent gabardine, an innovative fabric that was both waterproof and light, and this was the essence of and still is what made Burberry a great success. Burberry's coats were worn by explorers like Amundsen to get to the South Pole, by Shackleton in his heroic efforts and by Mallory when he attempted Everest. Thomas Burberry was a commercial businessperson, not just a technical expert. He built the brand by raising its awareness and by getting his clothing worn by the celebrities of the day. The iconic trench coat was designed for use in the First World War trenches, but its fashion credentials come from Hollywood exposure, like Humphrey Bogart in Casablanca and Audrey Hepburn in Breakfast at Tiffany's.

We were able to invest in Burberry at such an attractive price because of the compounding of several negative factors. The overall luxury market is in retreat following an overexposing boom during Covid, particularly in China by far the largest market for luxury in the world. Burberry made some mistakes, the worst of which was raising prices significantly just as the market turned down, and finally it is listed in London, the bargain basement stock market of the world. The icing on the cake was its demotion from the FTSE 100 in September.

There are plenty of case studies for what Burberry needs to do and the new CEO, Josh Schulman, is well versed in them. The price we paid allows for him to get it wrong first time and there to be a second attempt (even another CEO) and a rights issue. Scoping out and getting comfort with the downside has been the hardest part of the investment. The upside is easy to see; before it stumbled annual Free Cashflow was £500m to £600m and its market valuation was £10bn. We have a mid-case intrinsic value of £4.8bn.

Mistake – Randall & Quilter

2024 was the year of our first zero, a holding that became worthless. This is the absolute worst thing that can happen to us with committed capital, and that is to lose it all. There is no way back from there. We do so much to avoid it, and this is the first in 120 investments and 26 years and it contains lessons. The company is Randall & Quilter.

Phoenix originally invested in 2007, and it was bought by the Trust soon after our appointment in early 2016. Our original investment premise backed Ken Randall and his approach to what is an extremely difficult and complicated business. Ken Randall retired in April 2021 and by June we decided that we didn't rate his successor, William Spiegel, and started to sell our holding which had reached 20% of the company. We had sold half the holding when an agreed bid was announced for the company in April 2022. The bid massively undervalued the company but as we were in the course of divesting, we accepted the bid. Then things went horribly wrong.

We were contacted by another major shareholder, a UK fund management company, and asked to help in resisting the bid and in an act which now seems obviously dumb, Gary agreed to help, and we reversed our position on the bid. Gary even managed to persuade the bidders to drop the bid and work together with us and the other investors to give the business the capital it needed so that we could ultimately get much better value. We did it though with one condition, and that was that Ken would come back as CEO, which was accepted by those involved who collectively spoke for enough of the equity for us to be confident that it would happen. But it didn't.

Ken did agree to come back, which was no small thing for someone who had retired after 30 years building his business and had had a recent health scare, but he cared about R&Q and was willing to come and help. The reason it failed was that those shareholders changed their mind on backing Ken and you can read the whole sorry saga in the public domain because in the end we called an EGM and put out a statement to explain our position and why it was essential that William Spiegel, the man running the business, was removed. We also offered to speak to shareholders, and we did speak to some.

The vote was lost, and we were trapped in a situation where for a lot of the time we were inside and unable to act, but essentially trapped in a situation that went from bad to worse. William Spiegel with the support of the board sold the crown jewel asset (Accredited) at a bargain price to a private equity firm with a condition that he went with it. That price was chipped again during the deal and so he is there now as CEO of Accredited being judged from the bargain price they paid for it and which he negotiated. This is absolutely the worst piece of corporate governance we have been exposed to and despite all we did to sound the alarm and give shareholders the chance to save the day, we failed and worst of all, the equity has ended up worthless in our estimation.

We started off by following a preciously learned piece of wisdom, which is to not have our capital in the hands of someone we don't trust. Where we went wrong was believing we could orchestrate a change against an unwilling executive and board. We had just won a vote at Dignity in the April of 2021, and that may have resulted in an overinflated view of our ability to win a proxy battle like this. Our first instinct, which was to say no, was the right one, and what followed was an example of misguided overconfidence that missed that simple point, we put your money in the hands of people we had no reason to trust for a period in the expectation that it was temporary.

We won't do that again, and we are deeply sorry for this. It is worth noting that this was not a failure of analysis. Much worse, the analysis was correct, it was a failure of judgement and execution by Gary (we write this report in the third person, which gets slightly weird when I, Gary, am doing the writing!).

Artificial Intelligence

We could talk about macro factors like the recession the UK has taken itself into on sentiment alone, or how to think about and scenarioise Donald Trump's return but when we look back 5 years from now though, we think the most significant factor impacting business value and economic development will have been AI. It's a freight train heading down the tracks and we've just scratched the surface on its potential impact. Our early estimation is that enormous productivity gains are coming initially at the cost of employment. We are grateful to have a front row seat through Iona Star and our partnership with Frasers Group, we are not sure if the future is dystopian or utopian yet, but it's certainly risk and opportunity for businesses.

UK Housebuilding

It wouldn't be a Phoenix report if we didn't say something about UK housebuilding to which we are highly exposed. The UK housing market attracts more attention than any other sector in which we invest and so much of the commentary is poor and often misleading.

Much has been made of the low output of new houses in 2024 and then related to events in 2024 and yet the 2024 output is a reflection of land and building decisions made in 2022/3. Interest rates rose quite sharply from 0% at the beginning of 2022 to 5% by the middle of 2023, which had an immediate impact on mortgage rates, availability, and expected house prices. The Autumn of 2022 was when Liz Truss' first and only budget nearly blew up the gilt market and so it is no surprise that housing executives at that time were cautious about their likely 2024 output, stopped buying land and slowed down the rate of future site openings.

Given the stability that returned in 2023/4, we expect that housing output will be up next year and given the level of demand, so will revenue. The land going through the books by then for those with shorter landbanks like Barratt Redrow will have increasingly improved margins so this will show up in the reported earnings.

The sector had a bad fourth quarter share price wise and as loath as we are to try to attach fundamentals to share price movements, there were some news stories that did seem to cause the weakness, none of which we think have an impact on the value of our holdings:

Vistry made a series of profit warnings, which they said relate to underestimating building cost, which means they overpaid for land. The way land buyers get land purchases through finance committees without breaking hurdles is to underestimate the costs of the idiosyncratic elements of site development like infrastructure. It was known in the land market in 2022 that Vistry was overpaying because they were trying to grow quickly, and when you put pressure on land buyers to buy land, they find a way to buy land. Vistry's issues are specific to them and shouldn't impact the sector negatively.

Persimmon complained about the cost of the new Building Safety Levy. This is to pay for remediation of past construction where the original developers are not available to pay for the repair. In total it is aiming to raise £3bn over 10 years. It is likely to be levied on buildings of over 10 units and so Barratt can be expecting to pay 10% to 12% of it. This is on top of the Residential Property Developer Tax, which is 4% on all profits over £25m per annum. There is a big difference though. The tax falls on shareholders and so we include it in our intrinsic value estimations but the Building Safety Levy is something that a developer will include in their build cost estimation when they buy land, and so it will fall upon the value of land and be borne by landowners. This is something acknowledged and intended in the government consultations with the sector, which have been going on since 2021 and are in the public domain. Land bought before 2021 will not have had this factored in and so shareholders will bear the cost of this, but most of the costs and soon all of the cost is going to fall on land prices. The levy is due to start in September 2025. Again, Barratt's relatively short landbank will benefit.

So more misunderstood news, lower prices but that is all just gratification postponed. Our monitoring programme picked up a significant uptick in Barratt sales at the end of October, which has persisted.

Summary

Your money is invested in businesses that we know well, are in the hands of good management and from which we expect good results. Their current values are so low that we have an expectation of high returns in the fullness of time.

Aurora Track Record

	NAV Return %	Share Price Total Return %**	FTSE All-Share Total Return Index %**	Relative NAV to ASX %
2024 (to 31 December)	-3.6	-5.7	9.5	-13.1
2023	33.2	28.8	7.9	25.3
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
Cumulative*	78.6	65.4	80.2	-1.6

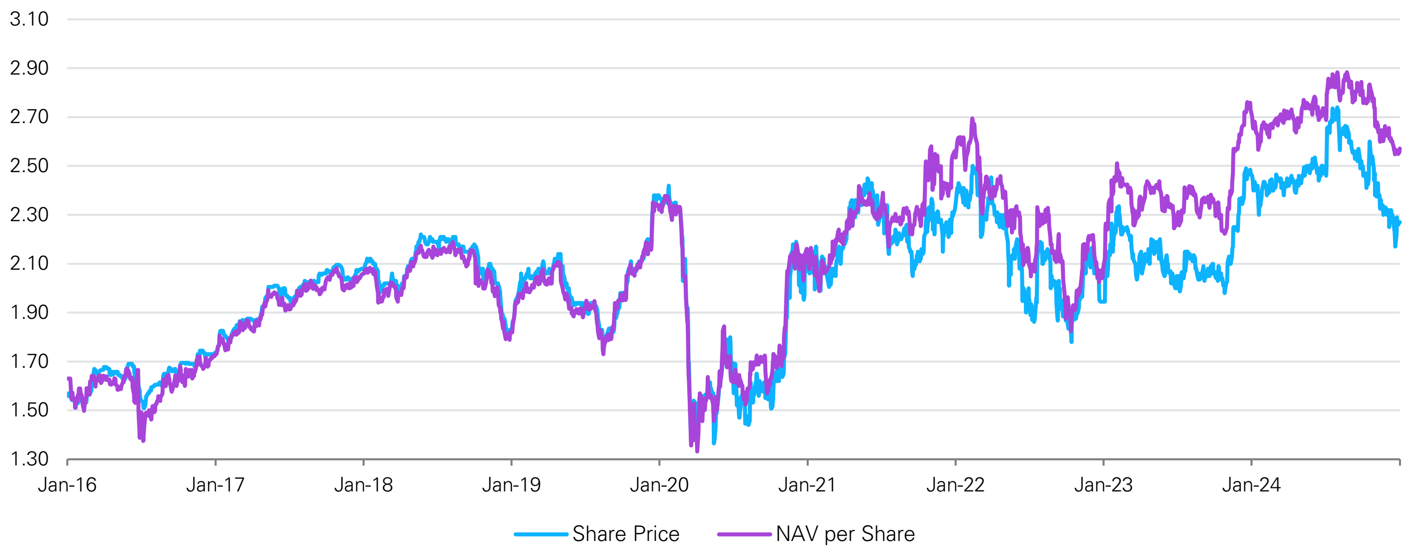
* Since 1 January 2016

**Share price return with dividends reinvested; FTSE All Share Total Return Index with dividends reinvested.

Past performance is not a reliable indicator of future performance.

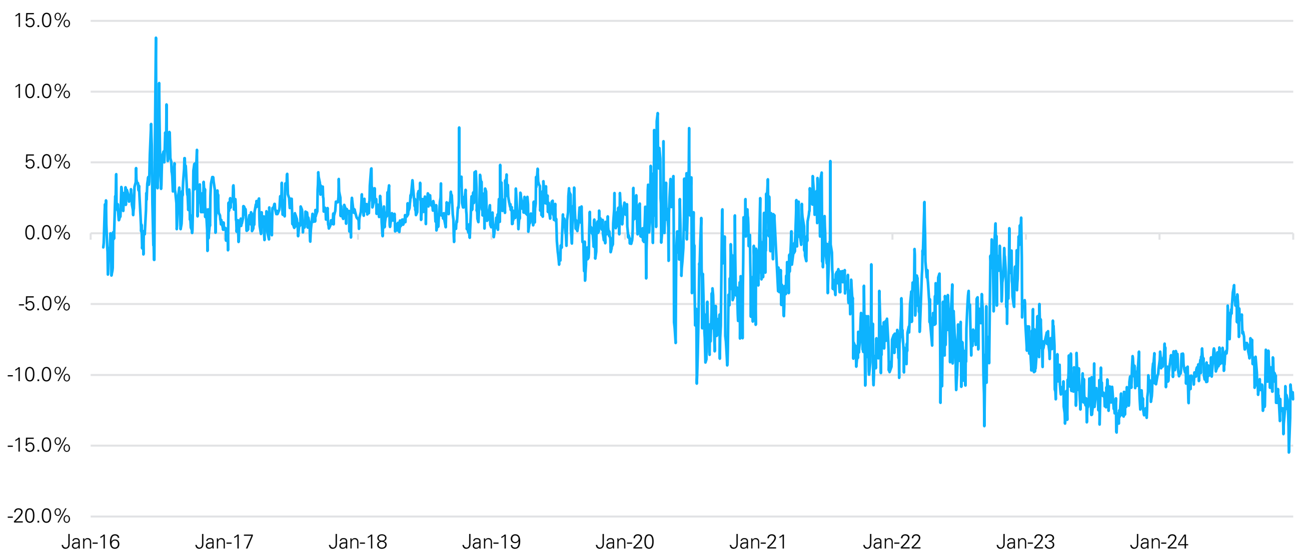
Aurora shares are eligible to be invested in an ISA or SIPP. Neither Aurora UK Alpha nor Phoenix Asset Management Partners run such a scheme. You should consult a financial adviser regarding a suitable self-select ISA or SIPP provider.

Aurora Share Price & NAV per Share – 31 December 2024



Past performance is not a reliable indicator of future performance.

Aurora Premium / (Discount) – 31 December 2024



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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.

Target Market

Aurora UK Alpha 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.

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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