# AURORA FUNDS MANAGEMENT THE ALTERNATIVE VIEW

By Hugh Dive 10th June 2016

## Heart Racing, Feeling Sick …. It's Confession Season

Since the GFC one of most unpleasant feelings for an analyst or fund manager is when a company held in their portfolio posts a notice on the ASX of a "*Trading Update*". Since 2008, this has almost always been a downgrade of a company's expected profits, which then results in a sharp price fall, gnashing of teeth and tears from the analyst responsible for recommending the stock. A recent example of this came from ***Flight Centre*** who warned two weeks ago that they were unlikely to meet their targeted profit growth due to consumer confidence over the Australian election and the Brexit referendum in the UK. The company's share price fell by 17% wiping $627 million off the travel company's market capitalisation based on a change in expected profit in 2016 of only $30 million! In this week's piece we are going to look at downgrades and next week I am going to follow up with a piece on *earnings shenanigans*, or what a company can do to dress up their earnings.

**Confession Season**

The months leading up to the end of each reporting season are known as "Confession Season", which is usually May/June and November/ December of each year as the companies become aware that they are not going to meet profit expectations and then "confess" their sins. These expectations are either as a result of explicit forecasts given by the management team at the previous result or the post financial year Annual General Meeting, or as a result of the consensus expectation of the investment bank analysts that cover the company.

Australian Securities and Investments Commission (ASIC) imposes continuous disclosure obligations on listed companies, which require that companies keep the market informed of any market sensitive information that would materially impact the company's stock price. In the case of profit results this is "10 to 5 percent materially different from guidance or expectations. This is done to maintain market integrity and prevent situations where some investors could trade on market sensitive information to the detriment of others, as potentially may have happened in the ***Newcrest*** debacle in 2013. What the company is trying to do is guide sell-side analyst expectations closer to what the actual result will be to avoid precipitous movements in the stock price on the day that the results are released. Additionally continuous disclosure aims not only to reduce information asymmetry between company managers and investors, but also between institutional and retail investors.

Earlier on in my career as an analyst, especially when I was covering small capitalisation companies, it seemed that management teams had a different attitude towards their continuous disclosure obligations due to lesser scrutiny and penalties from ASIC[1]. Results days were wildly exciting affairs as companies reported results both significantly higher and lower than expectations which often resulted in share prices up and down of 20-30% in a day.

**No Benefit of the doubt for New IPOs**

When it comes to earnings downgrades the harshest treatment in terms of price falls is always meted out to recently listed companies. This occurs for two reasons; one the company will only have a short record of being listed so investors are unable to look back and see how the business and its management team responded to adverse circumstances. Secondly and more powerfully is the feeling generated that investors were misled by the forecasts in the initial public offering documents and the siren song of the pitch from the sponsoring investment banks.

A recent example of this was ***Spotless***' downgrade in December 2015 which saw the company's share price fall 50% in two trading days. Whilst the quantum of Spotless' downgrade was not *prima facie* disastrous, the newly listed company is not afforded the same latitude by the market that say an equivalent downgrade from ***CSL*** would have enjoyed. Meat exporter ***Wellard*** has seen its share price fall by over 60% since listing six months ago (including 14% today) after the company has downgrade profit forecasts twice in its short life as a listed company.

When ***Medibank*** posted an update in January 2016, this fund manager automatically assumed the worst, but was pleasantly surprised by a $100 million profit upgrade to the 2016 results based on better than expected claims expense outcome.

**Management Incentives**

The average tenure of the CEO of an ASX 200 listed company has declined from 5.7 years in 2006 to 4.2 years in 2013, however if you remove the outliers (CEOs with greater than 15 year in the job) this declines to a mere 3.2 years. With most management teams on three year short term incentive packages and the market often punishing companies that don't make the guidance, company management teams have very strong incentives to hit their profit guidance (often by hook or by crook). This can lead to short term behaviour such as aggressive accounting policies or borrowing earnings from future years. A recent example of this can be seen in ***Woolworths*** alleged behaviours in their "mind the gap" scheme that was purported by the ACCC to extract $60 million late last year from 821 Tier 2 suppliers to plug an earnings hole. Similarly in April ***Wesfarmers*** subsidiary discount department store Target admitted to using rebate payments from suppliers to inflate their 1st half 2016 earnings by $21 million.

**How have we fared?**

As we are currently still in confession season (which is unlikely to conclude before the first week of July), it would be an almighty act of hubris to declare that the portfolios have passed through unscathed, but we have been short a few of the companies that have downgraded. In 2016 we were short the downgrading ***Flight Centre***, ***Ansell***, ***Orica***, ***Spotless*** and ***ALS***. With the last company on this list ALS; we were very pleased in May that our process identified that this was a company with material risk to earnings and it fell 14% over the month and 27% over the past year as our suspicions were confirmed by management. Unfortunately the decline in ALS' share price stimulated a bid by a private equity consortium in early June, which undid some of our good work as we thought that it was prudent to close out the short.

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[1] ASIC only obtained enforcement options in 2004 such as civil penalty proceedings with a maximum fine of $1 million, criminal penalty proceedings, enforceable undertakings and the use of infringement notices.

Worrying about what can go wrong is something we spend more time on than, dreaming about blue-sky possibilities for a company. This is a function of the importance of the role that the Quality Filter (QFM) plays in our investment process and as such we seek to add value by being selectively short companies with earnings risk. Though sadly when these companies downgrade their earnings, one always feels that the portfolio should have had a much larger short position.

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