AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive — 31st August 2016

Reporting Season Snakes and Ladders

During the months of February and August, the majority of Australian listed companies reveal their profit results and most provide guidance as to how they expect their businesses to perform in the upcoming year. Whilst we regularly meet with companies between reporting periods to gauge how their businesses are performing, during reporting season companies open up their car bonnets to enable investors to have a detailed look at their company's financials. Until this happens, investors don't know for certain whether smoke is going to pour out (and receive a scornful look from the girl in red below) or find out that the growth engine is humming along.

Today marks the final day of the August 2016 reporting season and companies have until the end of the day to report their financials. In this piece we are going to run through the key themes that have emerged over the last four weeks.

Minimal Growth

Last August, it was the miners and energy sectors dragging down aggregate earnings, but this was offset by earnings growth from financials sector and the free kick that offshore earners received from a falling AUD. In August 2016, the aggregate net underlying profit[1] growth for the ASX 200 was a paltry +0.2% with banks (0%) and industrials (-3%) being offset by growth from cyclicals(+2%) and most surprisingly resources (+7%) which were not as bad as had been feared led by the ***Big Australian BHP*** (share price +5% in August).

The overall ASX 200 return for the month of August is only slightly below the overall aggregate profit growth reported. Whilst this suggests a benign and boring reporting season for investors, the overall ASX200 return masks the dispersion in results, with the defensive sectors of utilities, telecoms and healthcare down 3-6% and energy, miners and the previously unloved consumer staples retailers up by a similar amount.

Give me my Money Back!

Capital management was again a prevalent in the recent reporting season and was understandably popular with investors, though it was less of a feature this reporting season than it has been in the past. ***Telstra***, ***Qantas***, ***IAG*** and ***CSL*** announced new share buy-back plans. Across the industrial companies the dividend payout ratio has remained very high and is now

[1] In calculating underlying profit one-off events and non-cash items such as asset write downs are removed from the statutory profit in the attempt to gain a picture of how a company's core business is performing.

approaching 80%. Whilst rising dividends plays to the "*search for yield*" investment theme and currently boosts share prices, in the longer term companies do need retain cash to reinvest in their operations in order to grow earnings in the future without adding to debt.

Gearing and the cost of debt declines

The de-gearing we have seen amongst corporate Australia sets the scene for this excess capital to be used in either a spate of acquisitions or returned to shareholders at the next reporting season. From meetings with management teams over the past few weeks, capital management appears to be the preferred course of action, though global and domestic political instability has made many management teams quite cautious to open their cheque books.

Additionally companies are paying much less for the debt they have, primarily by accessing the offshore debt markets. Falling debt costs has delivered profit growth in an environment where revenue growth has been hard to achieve. A range of portfolio companies such as ***Investa Office Trust*** have reported that the margin cost of their debt is in the 3.5-3.8% range.

One of the questions we have posed to management teams that we have met with over the last 4 weeks is "***Given the low current cost of debt and the long tenor of debt available, does it not make sense to look at increasing gearing rather than paying down debt? ".*** The responses from CEOs have been either a) "*if I was running a private company I would increase our gearing from 30% to 50%, but fund managers like you won't let me*" or b) "*the assets that I wanted to buy two to three years ago are no longer available at reasonable prices".*

Cost cutting

In the absence of revenue growth, Australian companies are clearly holding onto their wallets and delaying or halting significant investment spending. The large diversified miners were again very vocal about their focus on shareholder returns and their reductions in capital expenditure. In the cost cutting department ***BHP*** was a highlight for me, with a 16% reduction in unit costs delivering a higher than expected profit. This outweighed in the minds of investors the 76% cut in the dividend and the prospects of falling commodity prices especially iron ore over the second half of 2016.

Best and worst results

Over the month the best results were from the domestic housing-exposed cyclicals and companies that were expected to deliver disappointing results but surprised on the upside. Results from housing related companies ***Mirvac***, ***Stockland*** and ***Lend Lease*** showcased the continuing strength of the Australian housing cycle and ***JB Hi-Fi*** and ***Harvey*** both showed b+12% profit growth and margin expansion despite heavy discounting from Dick Smith's receivers trying to shift stock. In the better than feared category is ***Ansell*** which came in ahead of the market's low expectations after a poor first half result in February. Similarly ***Computershare*** and ***Woolworths*** performed well after bettering low expectations.

On the negative side of the ledger the bottom performers were companies that did not deliver bad results per se, but rather high price to earnings companies that had results below lofty market expectations. ***CSL***'s guidance of 11% net profit growth for FY17 and a $500 million buy-back disappointed the lofty expectations of sell side analysts, though we note that over the last few years CSL has tended to fall around results and then recover over the next month. ***Medibank Private*** delivered 46% growth in earnings and expanded margins, but the stock price fell on concerns about slowing growth due to publicity issues and poor customer service. The market darling of 2015, ***Blackmores*** continues to have a tough 2016 despite reporting a 14th consecutive year of sales growth after management warned that sales in 2017 are likely to be lower as Australian retailers and pharmacy chains had been de-stocking vitamins after buying extra stocks in 2016 to cater for entrepreneurs who had been cleaning out there shelves and on-selling their products online in China.

Another theme amongst the poor performers this August has been companies in the 2014 IPO vintage, significantly missing guidance in their second year as listed companies. Market commenters far more cynical and jaded than I have pointed that this has occurred after the end of the escrow period had ended for the shares held by their former private equity owners. Aged care provider ***Estia Health***, ***Spotless*** and personal care and tissue manufacturer ***Asaleo*** all had a rough reporting season.

How have we done?

The August reporting season has been a tale of two halves for the Dividend Income Trust, but we are expecting to perform just ahead of the ASX 200. The fund underperformed in the first two weeks along with most income style fun, as the higher yield utilities, financials and telco sectors have been the worst performing sectors down -5%.

The second two weeks of August have been kinder assisted by longs in Macquarie (+9%), Amcor (+6%), Lend Lease (+5%), Magellan (+6%), as well as retailers Super Cheap (+12%), JB Hi-Fi (+16%) and Harvey Norman (+12%). On the short side positions we were pleased to have identified companies with earnings risk such as Spotless (-12%), Seven West (-24%) and Iluka (-7%), though some of these gains were off-set by relief rallies in Worley (+11%) and Ansell (+17%).

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Aurora is the issuer of the:

- **Aurora Dividend Income Trust (Managed Fund) (ASX code: AOD)**
- **Aurora Absolute Return Fund (ASX code: ABW)**
- **Aurora Fortitude Absolute Return Fund**
- **Aurora Global Income Trust (ASX code: AIB)**
- **Aurora Property Buy-Write Income Trust (ASX code: AUP)**
- **HHY Fund (ASX code: HHY)**

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