Market plunge adds to Challenger's bigger challenges

By **Chanticleer**
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The extraordinary sell-off in Challenger shares demonstrates how the company's past performance is brutally colliding with its future prospects.

The stock fell 17.1 per cent on Wednesday, closing near three-year lows at $7.80. In the space of 12 months, $3.9 billion or 42.3 per cent has been wiped off the value of Australia's biggest annuities provider.

The sell-off was sparked by a profit downgrade announced by new chief executive Richard Howes, who only joined the board on January 2.

David Rowe

His first public act as CEO was to tell investors that the savage beating equity markets took in the last quarter of 2018 will mean a $194 million hit to its investment portfolio in the six months to December.

The bulk of this ($117 million after tax) stems from lower equity markets, while there was a $34 million hit from wider credit spreads, as rates pushed higher during the half. A further $41 million hit came from the policy liabilities in the life business.

Challenger's statutory profit for the December half will be just $6 million, down from $195 million.

But as bad as that looks, the sheer size of the fall in Challenger's stock on Wednesday suggests investors have largely ignored the statutory profit fall.

The bigger concern was Howes' new guidance for normalised net profit in the full year. It has been cut from between $591 million and $613 million to

between $545 million and $565 million, a fall of 7.8 per cent at the mid points.

Strong volume growth

Normalised guidance, which strips out one-off items, has traditionally been fairly predictable at Challenger. The guidance cut has further jolted investors who were already wondering whether the company deserved to be priced a multiple well above the rest of the financial services sector.

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Under former chief executive Brian Benari, Challenger traded on a relatively high price to earnings ratio based on its ability to deliver strong volume growth – expanding its Australian business, pushing into Japan – while holding up its margins.

It achieved this by chasing higher investment returns from relatively riskier assets – a solid strategy when easy money was pushing asset prices higher.

But the process could only be taken so far, and Challenger has been steadily de-risking its portfolio by selling property assets in the last 18 months and moving more into fixed income, where asset prices are rising. It will reduce its exposure to property from a peak of 22 per cent of its life investment portfolio to 15 per cent by June 2019.

The impact of this shift, and the impact it has had on margins, has clearly been underestimated by the market.

Richard Howes (left) with his predecessor Brian Benari. The new man has a tough job. **Steven Siewert**

While Challenger's growth story might be relatively intact – it is, for example, well placed to capitalise on the Coalition government's MyRetirement reforms, which are designed to encourage more annuity-

style products in the market – investors have decided that falling margins mean Challenger's once-high multiple is no longer warranted.

After last August's disappointing full-year results – which sent shares down 7 per cent – analysts were divided on whether Challenger's multiple of about 16 times forward earnings was too high.

Following Wednesday's share price crash, that multiple sits at around 11.6 times.

No doubt Howes is wondering at what level will the stock start to find support again. One investor said the stock was now back to an appropriate multiple, but still a way off bargain territory.

The handover from Benari is also likely to created some nerves. Investors may also recall the six months after the last chief executive change back in early 2012, from Dominic Stevens to Benari. Over that period, Challenger's share price fell by more than 21 per cent.