



# QV Equities: Portfolio Manager Update

Equities Ltd. 17 May 2019

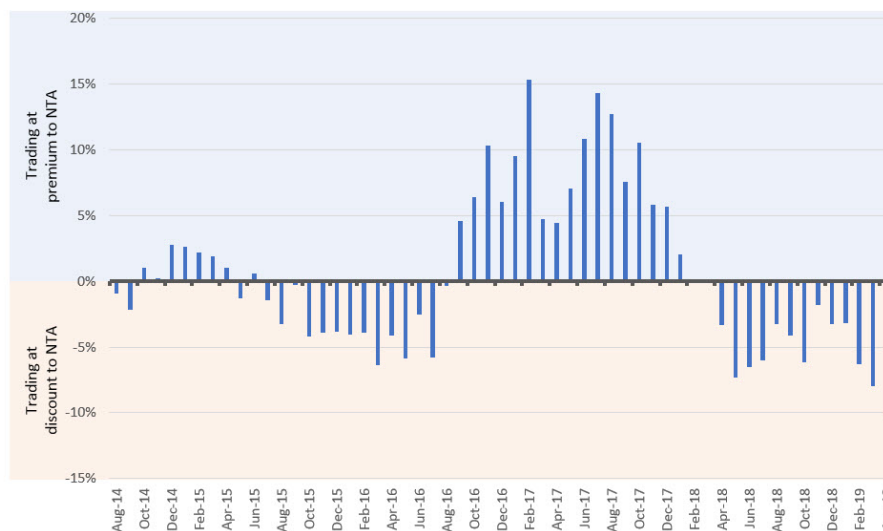
## QVE: a diversified portfolio of well-established, profitable companies

Please find attached an article written by **Anton Tagliaferro** and **Simon Conn** with their thoughts on the current sharemarket which explains the reasoning behind how the QVE portfolio is currently positioned. They also outline the investment case and reasoning for investing in QVE's top 10 holdings.

*"QVE's shares are backed by a portfolio of good quality companies that will continue to provide franked dividends for years to come. At the moment this portfolio of companies is being priced at a discount to its NTA when one compares it to the current share price. For me, this is an attractive opportunity and I recently topped up my already large investment in QVE shares for my own portfolio."*

**Anton Tagliaferro**, Co-Portfolio Manager of QV Equities

QVE's share price vs its underlying Net Tangible Assets (NTA)



Source: IML; as at 30 April 2019

# QV Equities: a diversified portfolio of well-established, profitable companies



**Anton Tagliaferro and Simon Conn**

**Co-Portfolio Managers**

**QV Equities**

May 2019

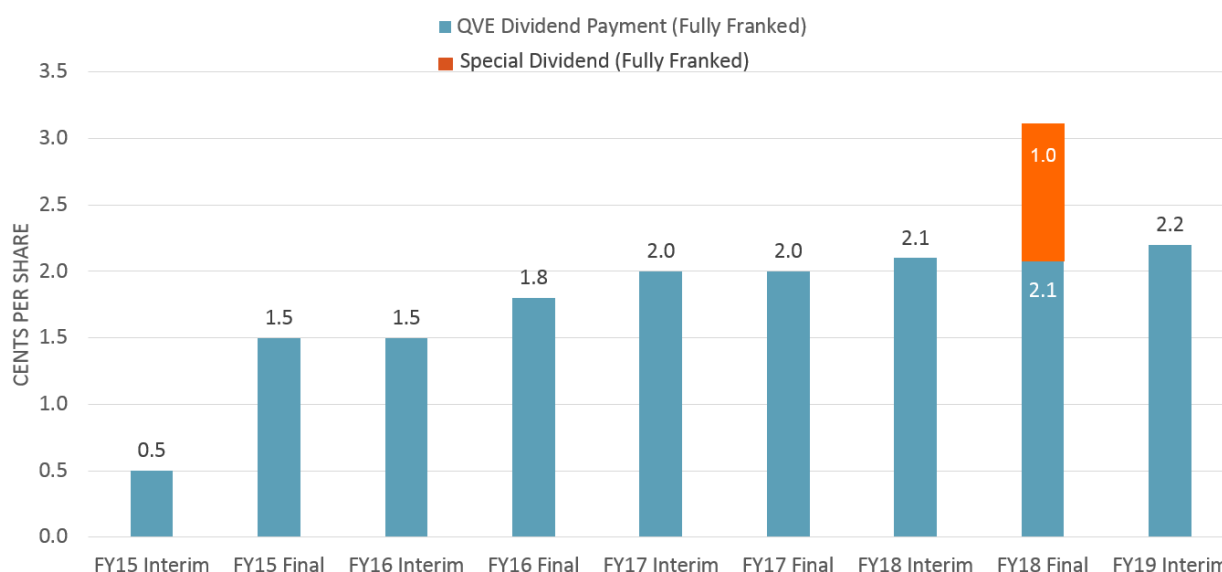
QV Equities (ASX:QVE) was launched in 2014 with the objective of providing shareholders with a portfolio of companies that sit outside the top 20 of the Australian Stock Exchange, selected by Investors Mutual (IML), a well-established value fund manager based in Sydney.

Given the large concentration of the top 20 in Australia to sectors such as the Banks and Resources, QVE seeks to provide investors with diversification outside these two sectors and to add value over time by investing in a carefully selected portfolio of quality companies.

The QVE portfolio thus aims to deliver consistent returns to investors over time through the growth of the underlying net tangible assets (NTA) of the company and through the provision of a consistent and growing fully franked dividend over time.

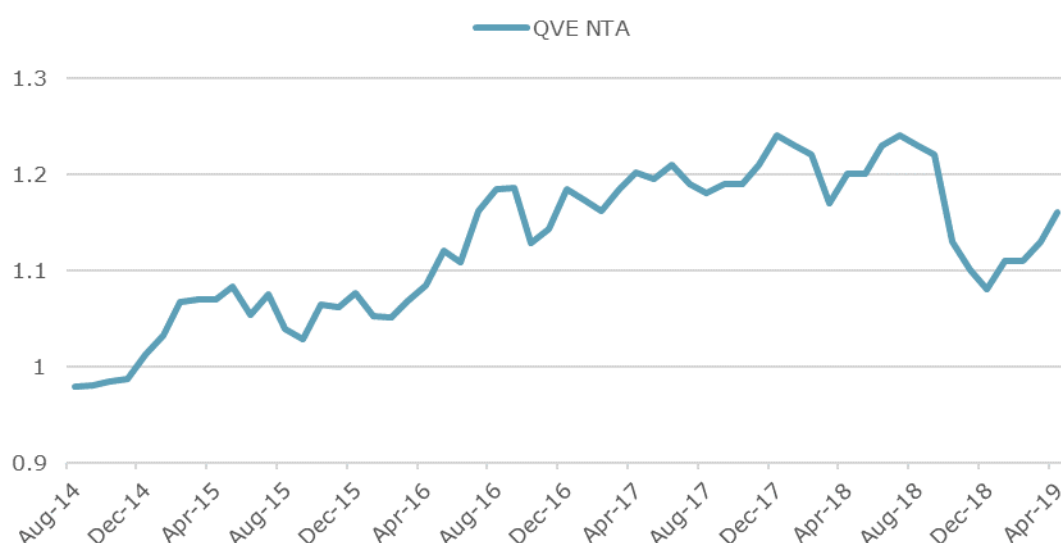
By and large QVE has achieved these investor outcomes as can be shown by the charts below which show the dividends paid to investors in chart 1 as well as the growth in the NTA since QVE's inception almost 5 years ago in chart 2.

**Chart 1: Historical dividends to QVE shareholders**



Source: QV Equities HY results to 31 December 2019 and Interim Dividend announcement; 14 February 2019;

**Chart 2: QVE Net Tangible Asset growth since inception**



Source: QV Equities; 31 August 2014-30 April 2019

IML has a long track record of investing in mid cap and smaller companies. Sharemarkets may gyrate through highs and lows, and many short-term investors will chase the latest trends. IML believes that our job is to select well-established companies, that are growing their long-term value, which will ultimately be seen in sustainable earnings and dividends over time and which in IML's view represent very sound, long-term value at the time of purchase.

Over the last 5 years, the QVE portfolio has managed to produce the outcomes above in what has been quite a challenging period for many investors who buy value stocks. The environment has tended to favour investors that are prepared to chase short-term trends and to invest in the sectors of the market which look fairly risky such as the Resources and Technology sectors.

While Australia boasts many of the world's best Resource companies with long life reserves, such as BHP, Woodside and RIO, these stocks can be extremely cyclical in nature given the unpredictability and volatility of the prices of the underlying commodities that they sell. In addition, Resource stocks outside the top 20 stocks in Australia tend to be of lesser quality and many are in fact highly speculative. For this reason, the QVE portfolio has only had a minimal exposure to this sector and will likely do so until we are sure that the downside risks are fully captured in the valuation of the Resource stocks we purchase.

Our caution towards the Technology sector requires further explanation as this sector continues to grab the limelight amongst many sharemarket investors and commentators.

While the US technology sector currently boasts several hugely profitable, cashed up, global technology leaders such as Microsoft, Apple, Google and Facebook, the truth is that the choice of good quality technology stocks in Australia is extremely limited. In fact, the majority of popular IT stocks in Australia are in our opinion very risky, either because they are loss making or because their business models are yet unproven.

Thus, if we look at the profitability of what are now referred to in Australia as the WAAAX stocks (Wisetech, Appen, Afterpay, Altium, Xero), you will see from the table below that not only do these companies not make a lot of money, but their valuations are, in our view, at an extreme level.

	Market Cap	FY19 EBITDA (\$m)	NPAT (\$m)	FY19 P/E (x)
Wisetech	\$7.3bn	105	55	129.2
Appen*	\$2.7bn	78.3	45.4	53.2
Afterpay	\$5.0bn	22.1	-12.4	n/a
Altium	\$4.2bn	94.5	78.4	53.3
Xero^	\$6.8bn	78.4	-4.6	n/a

Source: FactSet, IML; As at 31 March 2019 \*Adjusted for Dec yr-end ^Mar-19 yr-end

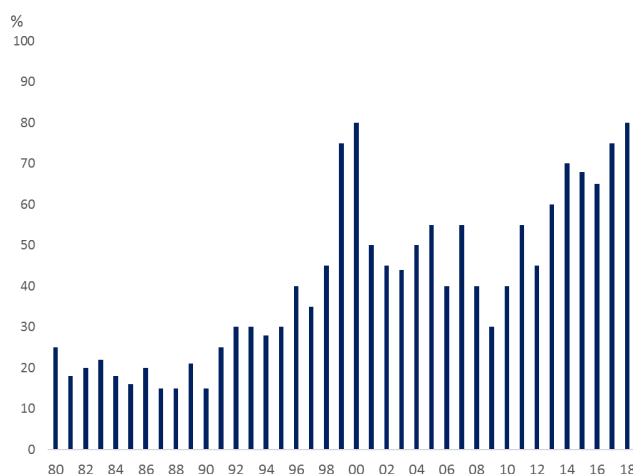
Many today are arguing that all of these companies have an extremely bright future because the world is changing so quickly that the valuation one pays for them is irrelevant. However, we would point out that this perceived rosy future appears to be more than captured in these companies' current share prices and valuations.

It is well proven that when buying any shares on the stockmarket that the price and valuation for the company is always relevant to the ultimate long-term returns that an investor can achieve on the stockmarket. For those investors who believe that this not the case should remember Sir John Templeton's famous quote:

*'The four most costly words in investment are: **this time it's different**'.*

The boom, and chase by investors, of the IT sector can also be demonstrated in the chart below which shows the trend in new floats in the US where loss making 'new age' companies like UBER are currently being floated at huge valuations - despite losing billions of dollars. The chart below shows that almost 80% of all new floats of companies (mainly IT companies) in the US in 2018 have been floated off despite being unprofitable. This sort of percentage hasn't been seen since the 2000/2001 tech boom - which as many remember ended in tears for investors who had invested in the IT sector.

### IPOs with negative earnings



Source: Topdown Charts, Jay R Ritter

### ***So how is the QVE portfolio currently positioned?***

IML has always sought to invest in companies with the following characteristics:

- Companies that in our view have a **sustainable competitive advantage**
- Companies that generate fairly **recurring and predictable earnings**
- Companies run by a **focused and honest management team**

and which in our view are **trading at a reasonable price**.

In essence the QVE portfolio is invested in sound Industrial companies that have a strong franchise and that we believe have realistic growth plans over the next 3 to 5 years.

Given the patchy economic outlook we are also attracted to companies that we believe are on a path to grow over the next 3 to 5 years, with a defined plan as to how best to create value for shareholders.

The table below highlights companies, that QVE owns, which are focused on executing company specific initiatives to deliver long-term earnings growth for their shareholders:

Company specific initiatives – examples	
Cost-outs →	Pact Group
Acquisitions →	Steadfast, Integrated Diagnostics
Contracted growth →	Genesis Energy, Shopping Centres Australasia
Market share gains →	GWA, Tabcorp
Restructuring →	Nine Entertainment, Caltex

We are also selecting companies with solid and sustainable dividends, thus providing the QVE portfolio with a reliable and consistent source of return:

Portfolio Holdings	Yield	Portfolio Holdings	Yield
Genesis Energy	5.9%	Ausnet	5.4%
GWA	5.6%	Aurizon	5.0%
Southern Cross Media	6.6%	Skycity Entertainment	5.2%
Tabcorp	4.5%	Sydney Airport	5.3%
Nine Entertainment	5.7%	Regis Healthcare	4.7%
Crown Resorts	5.1%	Shopping Centres Australasia	5.6%
Hotel Property Investments	6.1%	Charter Hall Retail	6.4%

Source: IML; FY19 estimates as at 2 April 2019. Past performance is not a reliable indicator of future performance

### **Why QVE remains relevant for investors today?**

IML continues to maintain a disciplined focus on 'quality' and 'value', which is key to ensure that QVE's portfolio is underpinned by a well-researched, diverse range of sound industrial companies which we believe are trading on reasonable valuations and which, in our view, have good prospects to grow their earnings and dividends over the next 3 to 5 years.

We continue to believe that being selective and focused on the long term will serve investors well into the future - and this remains QVE's focus.

*Investors Mutual Limited AFSL 229988 (IML) has prepared this information, as the Investment manager for, and on behalf of, QV Equities Limited ACN 169 154 858 (QVE). This information has been prepared for the purposes of providing general information only and does not constitute personal financial product or investment advice as it does not take into account your investment objectives, taxation situation, financial situation or needs. An investor must not act on the basis of any matter contained in this presentation in making an investment decision but must make its own assessment of QVE, conduct its own investigations and analysis, and seek independent financial, taxation and legal advice. Past performance is not a reliable indicator of future performance.*



# QV Equities: Top 10 Holdings

30 April 2019

The ex20 segment of the Australian sharemarket represents an opportunity to invest in a broad and diverse group of companies. As the appointed manager of QVE, Investors Mutual (IML) invests in good quality companies that, in IML's view, demonstrate the attributes of ***strong competitive advantage, recurring earnings, capable management*** and the potential to ***grow their earnings and dividends over time***.

IML then applies a disciplined valuation framework to ensure that these companies are purchased ***at a reasonable price***. This approach to investing has achieved returns that are more consistent and less volatile than the Australian sharemarket, for over 20 years.

## Where we are finding opportunities in the current market

Having sold out of its interests in Macau and Las Vegas, **Crown** is now fully focused on operating its well-established casino entertainment complexes in Melbourne and Perth – both of which are underpinned by attractive long-term licences. The domestic gaming markets are relatively mature and generate a significant amount of cash flow. Crown was successful in being awarded a licence by the NSW Government for a second casino in Sydney in 2013. Crown is currently building Sydney's second casino resort at Barangaroo, which is scheduled to open in the first quarter of 2021. We believe this casino will successfully compete for market share with Star City's casino at Pyrmont, as Crown has a reputation for building world class entertainment destinations and has long demonstrated the skills of profitably operating casino facilities.



**Amcor** is a global leader in the supply of packaging materials for the food, beverage, consumer goods, healthcare and medical sectors across both flexible packaging and rigid plastics.

It has operations in North America, Europe, Latin America and Asia. In developed countries, the packaging business is mature and low growth but with efficient operations and significant free cash flow generated.

In the last decade, Amcor has successfully utilised this cash flow to make strategic bolt-on acquisitions as part of its growth strategy. Amcor is now in the process of taking over Bemis and has identified USD 180 million of synergies which can be extracted from merging both companies which should underpin its earnings growth for the next 2 to 3 years.

**Steadfast** operates the largest insurance broker network and underwriting agency in Australasia, distributing over \$5 billion of premium through a network of 388 trusted insurance brokers. Steadfast provides scale benefits, bargaining power with insurers and a superior outcome for clients in terms of cover and price.

Over the years Steadfast has used its close relationship with its broker network to selectively acquire businesses that they believe they can add value to. This provides a pipeline of low risk, bolt-on acquisitions to drive earnings growth and we expect the company to continue making selective value accretive acquisitions in the years ahead.





**Sonic Healthcare** is the largest pathology provider in Australia as well as the largest in Germany, Switzerland & UK and number 3

in the US. As the population ages there will be an increasing demand for pathology tests. Advancements in new pathology tests are also leading to further volume growth for the industry. Sonic has an excellent management team that are also investing in technology to further automate the company's processes to ensure greater efficiencies over time.

**Aurizon** is a national rail freight operator, which owns and operates a monopoly below-rail infrastructure, and also competes in the above-rail haulage business. The Aurizon Network business owns the Central Queensland



Coal Network, which is the railway infrastructure that connects coal mines in QLD to their respective ports. This business has recently struck a 10 year deal with the mining industry, which guarantees the terms on which Aurizon Network will provide access to the railway. Importantly, the deal allows Aurizon Network to earn an appropriate return on its very substantial infrastructure investment. This will now provide Aurizon with a secure source of profits and it also reduces regulatory risk going forward. Aurizon's above rail business also earns stable profits owing to its long term (10-12 year) contracts with customers. This combination of quality assets allows the Aurizon group – which is now extremely well managed – the opportunity to produce substantial free cashflow and pay attractive dividends.



**Spark Infrastructure** is an infrastructure investment company with significant holdings in high quality, long duration monopoly electricity assets. These assets include 49% stake in South Australia Power Networks, 49% in

Victorian Power Networks and 15% in Transgrid (NSW). Spark's revenues and earnings are underpinned by regulated returns for fixed five-year terms. There is also an increasing opportunity to earn unregulated revenues through growth in building and connecting renewable generation assets, such as commercial wind and solar farms, to the grid.

**Caltex** is Australia's leading petrol and diesel supplier to the retail, aviation and mining industries. While at some stage electric vehicles will have an impact on the company, this is not expected to have any noticeable impact before 2035 at the very earliest. In the meantime, the company continues to generate good cashflow, has large property holdings and has \$900 million in excess franking credits. With the stock trading on a PE multiple of less than 13 times, we believe this well-established company is currently trading at a very attractive valuation.



**GWA** is the leading designer and supplier of products and technology focused on the Bathrooms and Kitchens (B&K) segment. GWA's recent acquisition of Methven further strengthens its position in the \$780m Australasian taps and

showers category. Significant scale and innovation across B&K has allowed GWA to strengthen relationships with key customers. At the same time, this very well managed company is increasing its exposure to the fairly resilient renovation and repair market and building its market share in this segment through distributors such as Bunnings and Reece.





**Clydesdale Bank** is the largest of the UK challenger banks with full service capabilities in retail and SME banking. It was divested from NAB in 2016 with an independent management team, strong capital position, and solid deposit funding base. In 2018 Clydesdale acquired Virgin Money and announced cost saving initiatives of £120m pounds. Clydesdale has also received advanced accreditation from the UK regulator, and with £1bn of capital in excess of regulatory minimums

there is £400m that could potentially be released to shareholders. We see Clydesdale as a conservatively managed retail and SME bank. While the UK banking market remains very competitive, we believe the company is attractive trading at 0.6x book value and a PE of 8x with significant potential to improve margins and return excess capital to shareholders over time.

**Pact Group** is a diversified group made up of: rigid plastics packaging in Australasia, contract manufacturing and materials handling (predominately crate pooling).

Pact's performance has been severely impacted by higher input costs and electricity prices in Australia in the last 18 months. This has seen the company's PE fall to 10x. We believe the company is well positioned to recover and do well in the future given: 1) the high quality of its crate pooling business which is underpinned by long term contracts with Woolworths and Aldi; 2) input cost price recovery in their contract manufacturing business through price increases; and 3) a newly appointed and well credentialed CEO whose main objective is to extract \$50m of cost savings over the next 3 years by optimising the company's manufacturing footprint in Pact's rigids plastics business.



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