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

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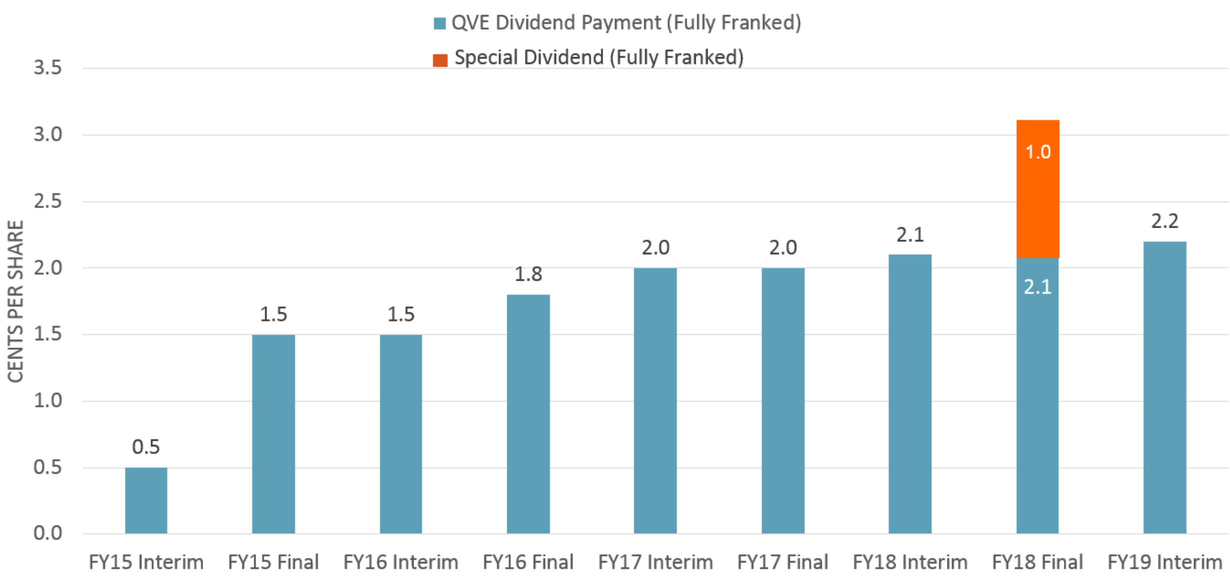
QV Equities (ASX:QVE) was launched in 2014 with the objective of providing shareholders with a portfolio of companies that sit outside the top 20 of the Australian Stock Exchange, selected by Investors Mutual (IML), a well-established value fund manager based in Sydney.

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.

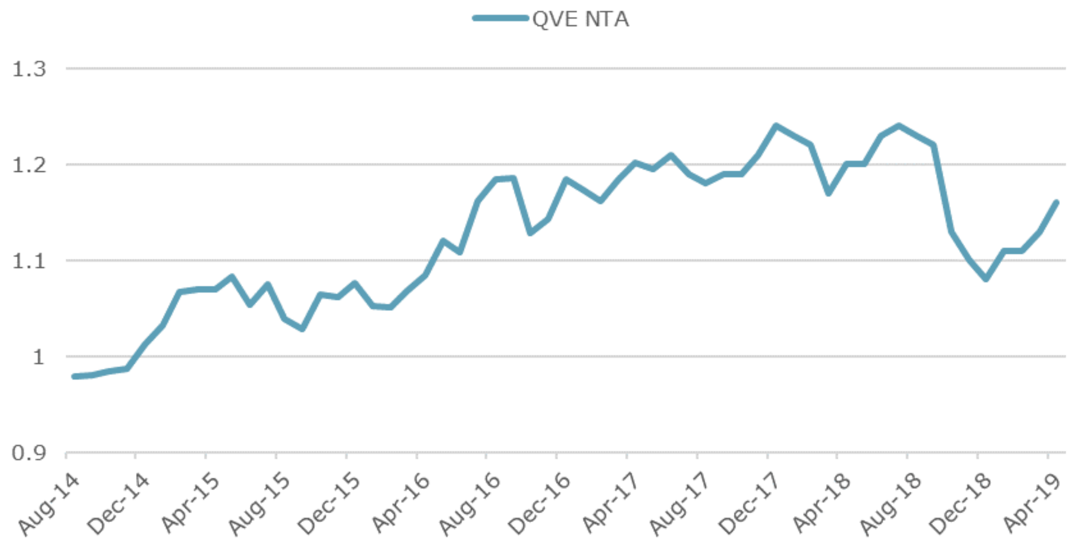
By and large QVE has achieved these investor outcomes as can be shown by the charts below which show the dividends paid to investors in chart 1 as well as the growth in the NTA since QVE's inception almost 5 years ago in chart 2.

Chart 1: Historical dividends to QVE shareholders



Source: QV Equities HY results to 31 December 2019 and Intermim 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

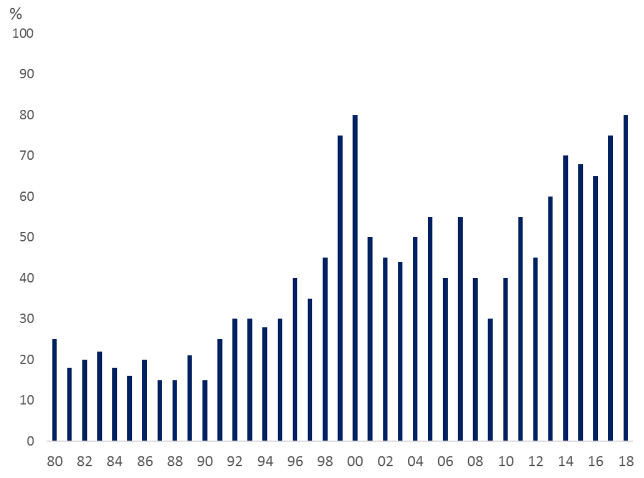
Many today are arguing that all of these companies have an extremely bright future because the world is changing so quickly that the valuation one pays for them is irrelevant. However, we would point out that this perceived rosy future appears to be more than captured in these companies' current share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