QVE

MANAGER

INSIGHTS

QV Equities: Top 10 Holdings

31 December 2020

Investing beyond the 20 largest companies in the Australian sharemarket provides access to a broad and diverse range of good quality companies. As investment manager for QV Equities (QVE), Investors Mutual (IML) invests in well-established businesses that have a ***strong competitive advantage; a history of recurring earnings; that are run by capable and experienced management;*** and that possess all the ingredients required 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 overall Australian sharemarket for over 20 years, while generating long-term capital growth and income.

Where we are finding opportunities in the current market

Amcor

ASX: AMC

Amcor is one of the world's largest packaging suppliers with operations all around the world. Amcor's operations are highly cash-generative and have produced steady earnings and dividend growth over time thanks to a combination of organic growth as well as through accretive bolt-on acquisitions.

IML believes Amcor is well-positioned with over 90% of its sales being made to fast-moving consumer goods companies such as Nestle, Unilever and Pepsi. Amcor's revenues and earnings have proven to be relatively steady and predictable even at times of economic uncertainty.

Ampol

ASX: ALD

Ampol is the largest importer distributor and retailer of transport fuels in Australia. This position is supported by the ownership of high-quality infrastructure such as import terminals, the Lytton refinery, a broad network of storage assets and a nationwide retail network.

Ampol's fuel distribution and retail businesses underpin the company's profits, while the Lytton refinery generates more volatile returns. Growth is being generated from Ampol's international acquisitions in New Zealand and the Philippines as well as through ongoing cost reductions and margin improvement.

The recently appointed CEO, Matt Halliday, has a strong focus on return-on-capital and is reviewing asset utilisation across the business. This review has resulted in a decision to sell underperforming retail sites to property developers as well as monetising a 49% stake in 203 other retail properties. These initiatives have released capital for return to shareholders and enables Ampol to distribute some of its large franking credit balance. We expect continued cost and capital discipline to drive good performance.

Aurizon

ASX: AZJ

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

The below-rail business, known as the Aurizon Network, owns vital rail infrastructure assets in Queensland. The Aurizon Network has 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 substantial infrastructure investment thereby providing the company with a secure source of profits. The company also plans to increase profits over time by taking costs out of the business.

The above-rail business owns locomotives and wagons used to haul coal and other freight earning stable profits owing to its long-term contracts with customers.

This combination of quality assets allows the Aurizon group to produce substantial free cash flow, pay attractive dividends, and buy back its own shares.

AusNet Services

ASX: AST

AusNet is a regulated utility which owns monopoly infrastructure assets used for electricity and gas distribution and electricity transmission in Victoria and South Australia. AusNet's earnings and cashflows are highly predictable and recurring, given the majority of the company's revenues are contracted or regulated.

The growth in new gas and electricity connections continues to be driven by the increased generation from renewable energy facilities as part of Australia's transition to a lower carbon economy as well as by long-term population growth.

In IML's view AusNet is a sound investment as its electricity assets operate under a revenue cap and hence do not take volume risk, while customer credit risk is borne mostly by the large integrated energy retailers, which have very strong balance sheets.

Crown Resorts

ASX: CWN

Crown Resorts is an owner and operator of integrated gaming resorts in the Australian market. It holds long term, exclusive gaming licences in the Victorian (2050 expiry) and Western Australian (2060 expiry) markets and a second casino licence in Sydney (2113 expiry).

Crown has strong recurring earnings, underpinned by its long-term gaming licences, while history has shown that gaming expenditure tends to hold up relatively well during periods of weak economic activity.

While there are issues to be resolved with the NSW ILGA inquiry, in our view the quality of assets and prospects of significantly improved governance moving forward will see the underlying value in the business unlocked.

Orica

ASX: ORI

Orica is the largest explosives player in the world with operations in every major mining region globally. The company manufactures and distributes ammonium nitrate and detonators as well as other mining-related services to all the major mining companies in the world.

The business has very strong recurring earnings as Orica typically sells its products on 3-5 year contracts, where demand is linked to mining volumes. We believe the outlook is strong for Orica in the medium term as the company has a number of internal growth drivers which will generate earnings growth in the years ahead.

These growth drivers include launching new products (wireless detonators), cost out programmes, as well as acquisition synergies from Orica's recent acquisition of Exca (Peru's leading manufacturer and distributor of industrial explosives). Once Exca is fully integrated it will establish Orica as the number one player in Latin America.

Orica has an experienced management team and Board and a strong balance sheet.

Pact Group

ASX: PGH

Pact Group is a manufacturer and supplier of rigid plastic and metal packaging in Australia, New Zealand and increasingly internationally. The company primarily converts plastic resin into packaging and related products for customers in the food, beverage, chemical, agricultural and industrial sectors.

The business is increasingly moving into the circular economy through its growing pooling operations in returnable plastic crates and garment hangars, servicing the supermarket and retail clothing sectors respectively. The company is in the process of exiting its contract manufacturing division.

A new refreshed management team is refocusing the company on the core packaging division while bringing improved capital allocation discipline to the business. The strategic pivot towards a focus on sustainable solutions, we believe, will provide a source of sustainable competitive advantage and significantly improve returns over time.

Sonic Healthcare

ASX: SHL

Sonic Healthcare is a global pathology company, holding market leadership positions in most of its geographies (Australia, Germany, the UK and Switzerland). Sonic is also the number 3 player in the US market.

Despite significant weakness in pathology volumes during the global lockdown, these volumes have recovered to pre-COVID levels for most of Sonic's businesses. This combined with continued elevated levels of COVID testing - which Sonic has been contracted by various Health authorities around the world to perform - provides a level of confidence in Sonic's earnings outlook in these uncertain times.

Sonic has a highly capable and experienced management team. The company generates very strong cashflow and has a strong balance sheet. This positions the company to emerge from the economic downturn in a much better position than many of its smaller or more leveraged competitors.

Southern Cross Media ASX: SXL

Southern Cross Media is Australia's largest radio station owner, controlling the Today and Triple M networks in Australia's five capital cities and also operates around half of the country's regional radio network.

The company also owns a network of regional TV stations under an affiliation with Nine Network. While not a high growth industry, radio is cash generative and has traditionally been a very stable advertising medium.

After raising equity in March 2020 Southern Cross Media now has a strong balance sheet and will benefit from the improving advertising market. We also view the company as a potential target in the event of further media sector consolidation such as a private equity funded combination with an outdoor advertising player.

Tabcorp ASX: TAH

Tabcorp owns valuable gaming licences across the lotteries and wagering sectors in Australia. We view Tabcorp's lotteries division as one of the best businesses in the Australian market as it is a monopoly business which holds long-term licences and with earnings growth to be driven by increased digital penetration and new and enhanced games. The segment now accounts for more than half of the company's earnings.

IML welcomed the recent arrival of the new Chairman and the management team renewal being undertaken by Tabcorp. We believe Tabcorp has the opportunity to extract substantial cost savings from its operations and will benefit from a heightened focus on its wagering division.

Why invest in QVE?

Many investors who have self-managed superannuation funds own holdings in the largest companies in Australia such as the big four banks, Telstra and Woolworths. Adding exposure outside the top 20 provides an opportunity for investment in a diversified range of quality companies in less researched sectors such as utilities, packaging, and gaming.

Many of these are very well-established businesses managed by proven management teams and often offer attractive dividend yields. Owning QVE therefore provides exposure to a diversified portfolio of good quality companies in a variety of sectors and industries.

IML, in conjunction with the QVE Board, is focused on maintaining and potentially growing the QVE dividend over time. While IML cannot predict when its investment style will come back into favour, what the investment manager can do is to continue to work hard to provide a good dividend stream for patient shareholders who are prepared to wait for the share prices of the companies held in the QVE portfolio to more accurately reflect what we believe the companies are worth.

QV Equities Ltd.