QV Equities: Buying quality and value at a discount

QV Equities Ltd.

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ASX code: QVE

Market capitalisation: $280 million

QV Equities Limited (QVE) is a listed investment company (LIC) providing access to a diversified portfolio of listed securities which portfolio manager Investors Mutual Limited (IML) believes represent quality and value in the ex20 segment of the market.

The company listed in 2014 and, like many other listed investment companies (LICs), QVE has been trading at a discount to its net tangible asset (NTA) value. This led the QVE Board to recently approve an on-market buyback of up to 10% of shares which the Board expects to contribute to QVE's NTA per share.

As the manager of the QVE portfolio, IML's philosophy has always been to invest in good quality companies that, in our 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 valuation filter to ensure it buys companies it believes are trading at ***a reasonable price***. IML has applied this philosophy for more than 20 years and has achieved returns that have been more consistent and much less volatile than the Australian sharemarket over this period.

The QVE portfolio focuses on the ex20 segment of the market for a number of reasons:

- There is more diversity in the ex20 part of the market in terms of industry sectors in the ASX
- There is much less research conducted on this segment of the market than on top 20 stocks
- Many ex20 stocks are leaders in their field and are often attractive to larger companies from a takeover point of view
- There are often very solid yields on offer among ex20 stocks.

IML has a long record of adding value in this segment of the market and is confident that, over the long term, the QVE portfolio will yield investors reasonable capital growth and a consistent income stream.

Equities Ltd.

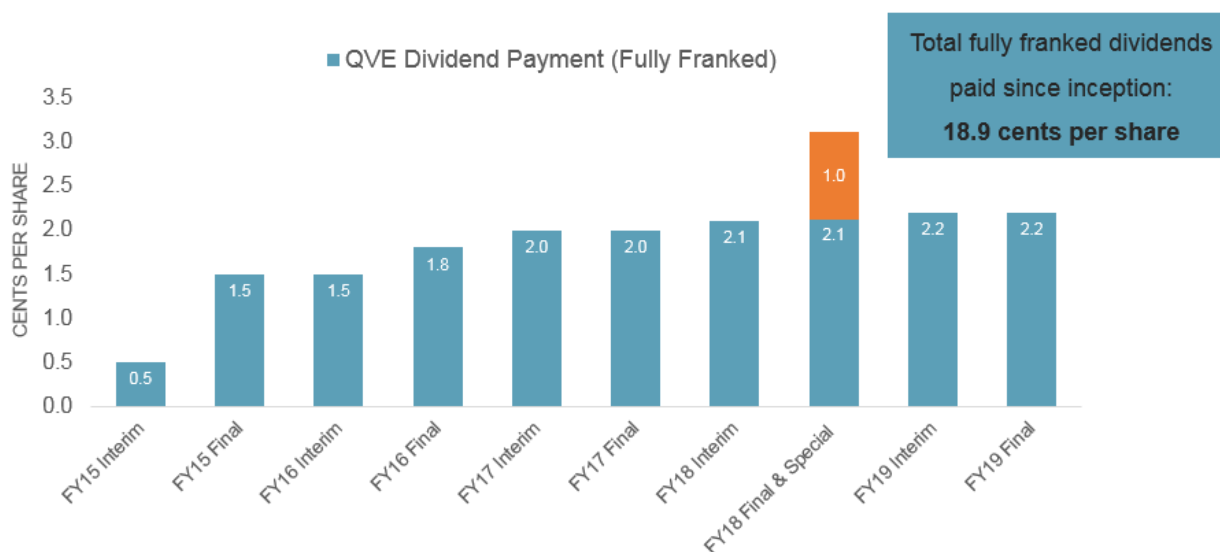
Solid yields are on offer among ex20 stocks

Income has always been critical for many investors – more so than ever with term deposit rates currently at record lows.

Since its listing, QVE has delivered a steady stream of franked dividends to its shareholders and, to date, has paid a total of 18.9 cents a share in fully franked dividends since inception in 2014.

The chart below shows the consistency and growth in QVE's dividends per share over the last 5 years.

Historical dividends paid to QVE shareholders



Source: QVE Annual Report as at 30 June 2019

While QVE does not provide forecasts on future dividends, the Board's stated intention is to continue to pay steady to growing dividends to shareholders in the years ahead.

QVE's top 10 holdings

While many LICs are trading at discounts to their NTA, we would point out that the focus of the QVE portfolio is on well-established, good quality companies that pay dividends. As a result, the QVE portfolio stands out when compared to many other LICs.

In this article, we take a deeper look at QVE's top 10 portfolio holdings as at the end of November 2019 and offer brief reasons as to why these stocks are held in the QVE portfolio.

Amcor

Industry: Global flexible and rigid plastics packaging manufacturer

Competitive advantage: Amcor is a global leader in packaging materials for the food, beverage, consumer goods, healthcare and medical sectors with operations in North America, Europe, Latin America and Asia where it is often the number 1 or 2 player in those markets.

IML's view: Amcor's packaging operations tend to be fairly mature and low growth in the developed economies in which it operates (US and Europe). Having said this, its significant operations in developing economies (mainly Latin America and Asia) offer much higher growth, although these operations can be more volatile. Amcor's packaging business tends to be very defensive given the sectors it services (food, beverages and pharmaceuticals) and Amcor's diversity across various parts of the world also tends to help add stability and diversity to its earnings. Amcor pays a very attractive dividend underpinned by a business which generates significant free cashflow.

In the last decade, Amcor has successfully utilised this cashflow to make many significant and strategic bolt-on acquisitions as part of its growth strategy. More recently, Amcor acquired the US-based Bemis business using scrip in a transaction which valued Bemis at over US$6 billion. As a result, Amcor is one of the largest flexible packaging companies in the US.

In addition to the continued volume growth expected from Amcor's emerging markets exposure, the company plans to extract US$180 million worth of synergies from merging Bemis into Amcor. We expect the continued growth in emerging markets and Bemis synergies will help underpin Amcor's earnings growth for the next 3 to 5 years. In addition, Amcor is attractive as it offers a sustainable dividend yield of more than 4.5%.

Crown Resorts

Industry: Casinos, hotels, entertainment and digital gaming

Competitive advantage: Having sold most of its overseas operations in recent years, Crown now generates the vast majority of its income from operating its well-established casino entertainment complexes in Melbourne and Perth – both of which are underpinned by exclusive and long-term licences in both cities.

IML's view: Crown's existing gaming operations generate significant free cashflow. Crown plans to open a new casino resort at Barangaroo in Sydney in the first quarter of 2021. We believe this casino will successfully compete for market share with Star City's relatively poor casino

offering in Sydney as Crown has a reputation for building world-class entertainment destinations and has demonstrated the skills of profitably operating casino facilities.

In addition, Crown's balance sheet remains very strong and, despite some short-term, industry-wide headwinds in the high-roller market, we believe the company looks very attractive on a 3 to 5-year view. Crown has consistently paid healthy dividends and currently yields an attractive 4.9%, making it a compelling investment.

Aurizon

Industry: National rail freight operator

Competitive advantage: Aurizon owns and operates the rail system in Queensland and competes in above-rail freight haulage. Aurizon's Network business also operates the Central Queensland Coal Network, which is the railway infrastructure that connects coal mines in Queensland to their respective ports.

IML's view: Aurizon's return from its rail network is regulated by the Queensland Competition Authority (QCA). In 2018, the QCA proposed a low return of 5.4%. In 2019, management worked hard to improve that rate of return through discussions with mining customers. Subsequently, Aurizon organised a new deal, which allowed the company to earn a return of 6.3% on its rail network – a far better outcome – in return for more efficient maintenance practices to assist miners' productivity.

While the stock has been a strong performer over the last 12 months, we still see it as sound long-term value. The quality of the assets owned by Aurizon – which is now extremely well managed following the appointment of a new management team in the past few years – allows the company the opportunity to produce substantial free cashflow and pay attractive dividends to shareholders.

Aurizon yields around 5% fully franked. In addition the company has a strong balance sheet and is currently doing a buyback. Management also has a number of cost-out opportunities to improve earnings, primarily around the automation of certain maintenance practices.

Caltex

Industry: Transport fuels and convenience retail

Competitive advantage: Caltex is the largest importer, refiner and distributor 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.

IML's view: Caltex's fuel distribution and retail businesses has always underpinned Caltex's profits, while the Lytton refinery generates more volatile returns. Growth is being generated from international acquisitions in New Zealand and the Philippines, as well as cost reductions and margin expansion in existing operations.

The recently appointed CFO, Matt Halliday, has a strong focus on return on capital and is reviewing asset utilisation across the whole business.

This review has resulted in a decision by Caltex to sell 50 underperforming retail sites to property developers and a proposal to offer a 49% stake in 250 other retail properties to investors through an initial public offering (IPO). These initiatives will release capital for return to shareholders and enable Caltex to distribute some of its large franking credit balance, which is currently worth $3.31 per Caltex share.

The attractive assets and potential for restructuring has recently attracted takeover interest from Canadian convenience retailer Alimentation Couche-Tard (ACT). ACT has proposed to acquire Caltex for $34.50 per share which has highlighted the value in Caltex. At the time of writing, the Caltex Board has rejected the offer although discussions between the two parties are ongoing.

Sonic Healthcare

Industry: Pathology provider

Competitive advantage: Sonic is the largest private pathology provider in Australia, the UK, Germany and Switzerland and No. 3 in the US.

IML's view: As the population ages, there will be an increasing demand for pathology tests. Advances in technology and disease detection have also helped create new pathology tests which is also leading to further volume growth for the industry. Sonic has an excellent management team that continues to invest heavily in technology. The investment is aimed at further automating many of the company's processes in Sonic's global lab network to ensure greater efficiencies over time.

In recent months, Sonic has successfully integrated acquisitions in Germany and the US, while continuing to generate strong revenue in Australia. In addition, Sonic's balance sheet is sound and its long-term prospects remain good. We see another positive on the horizon in the form of margin expansion potential in Australia as Sonic's collection centre rents moderate from very high levels.

Steadfast

Industry: Insurance broking and underwriting

Competitive advantage: Steadfast operates the largest insurance broker network and underwriting agency in Australasia, distributing more than $5 billion worth of premium through a network of 388 insurance brokers.

IML's view: We are firm believers in Steadfast's strategy which is allowing the company to lift its premium prices and increase volume. Steadfast has also experienced strong growth from its underwriting agencies, which have driven earnings 16% higher in FY19.

The Steadfast Client Trading Platform (SCTP) has so far lived up to its promise of better client outcomes, and this is reflected in the company's strong FY20 outlook.

For more details on Steadfast SCTP, please read IML's recent article entitled *"How does a prudent investor get exposure to new technologies in a sensible manner?"*

Virgin Money UK (formerly Clydesdale Bank)

Industry: Clydesdale Bank has rebranded itself Virgin Money UK following its takeover of the Virgin business.

Competitive advantage: The former Clydesdale Bank is now the sixth largest bank in the UK. Clydesdale's takeover in 2018 of Virgin Money has provided the 178-year-old bank with further scale through significant synergies to be extracted over the next few years from this acquisition. The Virgin acquisition also offers the Bank the opportunity to increase deposit margins since the combined entity can now offer current accounts not previously available to Virgin Money customers. Clydesdale has recently rebranded itself Virgin Money as it uses this new branding to reposition the bank as a challenger bank that offers many new products and technology-enabled services to customers.

IML's view: In recent years, Clydesdale's performance has been impacted by the intense competition in the UK banking sector. In addition, Clydesdale's performance has been impacted by larger than expected provisioning for the mis-selling of payment protection insurance (PPI) when the bank was owned any National Australia Bank. The total cost of PPI proving to be significantly higher than the indemnity provided by National Australia Bank (NAB) at the time of Clydesdale's demerger in 2016. The 31 August 2019 deadline for PPI claims has now passed so we'll not see further provisioning, removing a significant source of pressure on the share price.

We expect the combined entity of Clydesdale and Virgin to deliver synergy benefits of close to £200m by FY22 which we believe will help drive earnings higher in the next few years. In addition, the company trades on a forward P-E of 6x and at a 30% discount to book value. The Bank has a very strong capital position, with 13.3% tier 1 capital – more than 2 percentage points above regulatory requirements. In addition, the bank's loan book is conservatively positioned with a focus on mortgage and SME lending, and the funding position is also very strong with over 75% deposit funding.

We see material upside to Virgin Money UK's share price in the next few years as the company delivers on the synergies from the Virgin acquisition. In addition, any resolution of the uncertainty surrounding Brexit could provide a further upside catalyst.

Tabcorp

Industry: Lotteries, wagering and gaming services

Competitive advantage: Tabcorp has been granted exclusive licences to operate its businesses across Australia for the next several decades, putting it in a very strong competitive position.

IML's view: Tabcorp has met digital disruption head-on in its lotteries business, although traditional wagering remains a very competitive part of Tabcorp's portfolio of businesses.

The lotteries business now makes up about half of the company's earnings. The lotteries division has very strong defensive characteristics and a very solid earnings growth profile. The increasing penetration of digital lotteries is a significant opportunity as digital customers spend approximately 50% more than non-digital customers. Within wagering, Tabcorp's apps are among the best available in the sector.

Tabcorp's FY19 lottery earnings were well ahead of expectations, with the division's share of the digital market rising +23.5%. In addition, Tabcorp also offers and an attractive, sustainable dividend yield of over 4.5% fully franked.

GWA

Industry: Importer of bathroom, kitchen and laundry fixtures

Competitive advantage: GWA owns the Caroma and Dorf brands amongst others. The company has transformed itself from being a manufacturer of its products to sourcing its products through exclusive agreements with offshore manufacturers.

IML's view: GWA ticks a lot of boxes. We rate the company's CEO, Tim Salt, very highly. He has reinvigorated the company's brands with a strong focus on new product development and reinvigorated its sales and marketing operations. The company has successfully transitioned from being the manufacturer of its products to a designer and distributor model.

The acquisition in early 2019 of New Zealand-based tap maker Methven is a good example of how GWA intends to grow its businesses. GWA has an existing tap range with Dorf and Clark to which it can now add the well-regarded Methven range. This will allow the company to leverage its existing sales and marketing teams with a broader product range and will result in attractive efficiencies. The Methven acquisition has also given GWA a beachhead into certain overseas markets, such as the UK, where Methven has operated successfully for some time.

GWA has a strong balance sheet and its yield of over 5% fully franked is extremely attractive in the current low interest-rate environment.

Orica

Industry: Commercial explosives and blasting systems for the mining and infrastructure markets

Competitive advantage: Orica is the world's largest explosives manufacturer. It is the global leader in the provision of ground support in mining and tunnelling, and the leading supplier of sodium cyanide for gold extraction.

IML's view: The relatively recurring and defensive nature of Orica's businesses combined with its global market dominance makes it a quality holding for the QVE portfolio.

The company remains on track to post stronger earnings in the 2020 thanks to better pricing as well as further improvement in the company's operating performance and efficiency.

In addition, the company has recently developed the world's first wireless detonation device which we believe – following many discussions that we have had with Orica's mining customers – can revolutionise mining and mine plans into the future.

We believe Orica's wireless detonation systems and R&D innovation will help Orica increase its market share and margins in the years ahead. In our view, these increases will underpin the company's earnings growth over the next few years.

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Conclusion

A growing number of industries and sectors are currently undergoing significant change, which is creating a challenging environment for many companies.

However, through our active, research-led stock-selection process, IML has a long history of identifying companies that are often out of favour in the short term – but that we believe represent very good quality and value over the longer term.

In terms of our strategy for QVE, we seek to buy good quality stocks when we believe they are trading at a reasonable price, with our focus being on populating the portfolio mainly with well-established industrial companies. We selectively take profits when a share price is nearing full value.

We overlay the IML mantra – strong competitive advantage, capable management and recurring earnings as well as the potential to grow earnings and dividends over time. When we find companies with these qualities, we will only buy them if they are available at a reasonable price.

Many companies held in the QVE portfolio are also utilising other strategies that will boost their growth in the next 3 to 5 years with initiatives such as cost-out programmes, new product launches or strategic acquisitions which will enhance the long-term prospects of the company.

We believe the value of many of these activities is not yet reflected in the share prices held in the QVE portfolio – which is why we believe that the prospects for many of QVE's holdings look promising over the next 3 to 5 years.

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