QV Equities Portfolio: Positioned for Sustainable Earnings

17 July 2020 **ASX code: QVE**

In QV Equities Limited (QVE)'s end of financial year webinar on 14 July 2020, Investors Mutual (IML) Investment Director Anton Tagliaferro and Senior Portfolio Manager Simon Conn updated shareholders on market conditions and outlook, performance, and provided an overview of key shareholdings and recent investment activity.

Market conditions

Anton Tagliaferro reiterated IML's focus on quality and approach of owning established companies with a competitive advantage, recurring earnings, run by capable management, that can grow and which trade at a reasonable price.

Tagliaferro then outlined the impact of recent turbulence as a result of the COVID-19 pandemic, the sharp economic downturn, and the simultaneous momentum-driven run-up in a number of stocks and sectors. The unprecedented amount of government monetary and fiscal stimulus is making the outlook for the economy and sharemarket unclear. Major sectors such as tourism, hospitality, and entertainment are effectively currently on 'life support' from government intervention and the suspension of borrowing costs by their lenders.

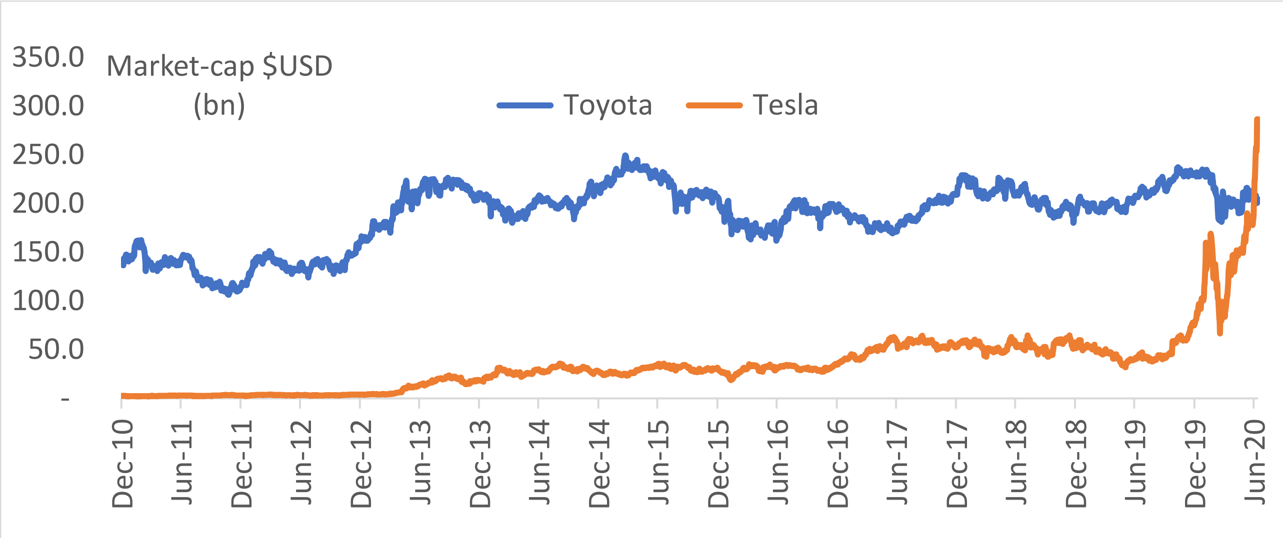
In IML's view, the sharemarket will be more volatile in coming months, and the key issue is determining what the 'new normal' will look like following the anticipated reduction in stimulus and supports as we head into 2021. While some commentators are predicting a sharp V-shaped recovery, IML's view is that conditions are likely to remain challenging as various travel bans and lockdowns persist. Most companies are also looking to reduce their labour costs and are cutting their capital expenditure plans in anticipation of lower demand going forward, further reinforcing IML's view of focusing on positioning the QVE portfolio defensively.

Performance update

Throughout history when 'creative concepts' have captured investors' imagination, this often leads to massive bubbles in various asset classes including the stockmarket. There seems no doubt that we are currently seeing some bubble-like conditions in certain parts of the stockmarket, such as in the 'buy now pay later' companies and the 'medi-tech' sector. Similar trends are being seen in many overseas sharemarkets.

This phenomenon is making it very difficult for value-style fund managers like IML to outperform, and QVE's portfolio has produced lacklustre recent performance relative to its benchmark in recent years as a result, Tagliaferro noted. However, history has shown that sharemarket conditions can change very quickly and quickly revert back to reality and fundamentals, so that an unglamorous packaging company can suddenly look much more attractive to investors when investors assume a more realistic stance.

Tagliaferro used the examples of **Tesla** and **Toyota** to illustrate the indicators of exuberance and irrationality in the current sharemarket. As the accompanying graph shows, Tesla's market-cap during the COVID-19 period – which is now trading at close to double its pre-COVID price – has now climbed well above that of Toyota, one of the largest and most profitable motor manufacturers in the world. This is despite Toyota's revenues being more than 10 times higher than Tesla's, while Toyota's profits dwarf that of Tesla.



Source: Bloomberg as at 13 July 2020

Locally, the market-caps of the so-called 'WAAAX' stocks – **WiseTech**, **Afterpay**, **Altium**, **Appen**, and **Xero** – have also taken off despite the highly uncertain economic outlook. In Tagliaferro's view, this was a clear sign the sharemarket was getting overheated, and for investors to be particularly cautious about companies like these which had captured investors' imaginations.

Tagliaferro also noted that it was a very tough environment for investors to earn income, with interest rates at record lows, rental cuts or deferrals on many residential properties, reduced dividends from many traditional sectors of the sharemarket such as banks and real estate investment trusts, and with many indebted companies conserving cash and raising capital to shore up their balance sheets. This was why QVE's Board felt it was important to announce its intention to maintain dividend payments for the half year and full year 2021 at the same level as in financial year 2020 – an interim dividend of 2.2 cents per share, and a final dividend of 2.2 cents per share, both fully-franked. This provides shareholders with certainty of income from their investment in QVE during a period when many companies will be cutting or cancelling their dividends.

Best and worst performers for FY 2020

Among the portfolio's best performers over the past financial year were **Sonic Healthcare**, **Ampol**, **Pro-Pac Packaging**, **Integral Diagnostics**, and **Bunnings Warehouse**. While Sonic had been affected by a reduced number of normal diagnostic tests in the COVID-19 environment, it has benefitted from carrying out COVID-19 testing for many governments around the world, and remains an extremely resilient business which had managed to achieve flat earnings on the previous year, a great result given the prevailing environment.

Disappointing performers for the portfolio included gaming companies **Crown Resorts**, **SkyCity Entertainment**, and **Tabcorp**, whose earnings had been affected by the COVID-19 lockdowns. Although these companies' share prices had recovered more recently, normal activity and earnings still needed more time to recover fully. **Southern Cross Media** and **Ooh!media** had also been disappointing as they were affected by substantial falls in advertising spend.

Portfolio activity

Anton Tagliaferro and Simon Conn then provided an overview of recent portfolio management activity. Conn reiterated that investment activity for QVE was on the basis of the portfolio being underpinned by good quality industrial companies with sustainable earnings from a diverse range of sectors, and the focus was now on identifying companies with solid and consistent dividends while still having cash ready to take advantage of potential buying opportunities as the result of a pullback in the market.

IML's investment team is undertaking a company-by-company assessment to identify companies which are industry leaders, which have a long record of producing recurring revenues and earnings, which were run by experienced management, and which had strong balance sheets, while also looking for company-specific growth drivers which will help the company perform well over the next three to five years.

A few examples were given – as shown in the following table.

Company-specific initiatives to grow in the next 3 to 5 years:	
Cost-outs →	Coles, Pro-Pac Packaging
Acquisitions →	Amcor, Sonic Healthcare
Contracted growth →	Shopping Centres Australasia, AusNet
Market share gains →	Integral Diagnostics
Restructuring →	Ampol, Orora

These examples included companies with an ability to reduce operational costs and become more efficient (such as **Coles** and **Pro-Pac Packaging**), companies that can make bolt-on accretive acquisitions (**Amcor**, **Sonic Healthcare**), companies that had contracted growth (**Shopping Centres Australasia**, **AusNet**), companies with the potential to make market share gains in their sector (**Integral Diagnostics**), and companies undergoing restructuring to unlock significant value, such as **Ampol** (formerly Caltex) and packaging firm **Orora**.

Recent purchases for the QVE portfolio over the previous six months included **Coles**, **Bunnings Warehouse** (whose long-term leases should enable the company to continue to pay a consistent dividend), **Orora**, and **Australian Pharmaceutical Industries**, which Conn described as a resilient business which owns the leading Priceline health and beauty retail chain. IML had also recently added **Spark New Zealand** (formerly Telecom New Zealand), whose margins were likely to be supported by more rational pricing in the country's telecommunications market.

Simon Conn also outlined the thinking behind a number of QVE's shareholdings. Queensland railway operator **Aurizon** is a strong business with highly-regulated and predictable recurring earnings. **Coles**, aside from being a company that has a very strong cashflow and balance sheet, was also implementing a $1 billion cost-out programme over the next five years, and is investing heavily in its warehouses as it consolidates and automates its network and replaces legacy IT systems. Victorian electricity and gas distributor **AusNet** has highly recurring and predictable earnings and a growing asset base driven by population growth and more recently from increased renewable penetration. Casino operator **SkyCity Entertainment** has long licenses in Auckland and Adelaide which will enable the company to generate very healthy cashflows in the years ahead, enabling the company to continue to invest significantly in its business while paying a dividend as things re-open. **Pro-Pac Packaging** is the clear number two in the flexible packaging industry in Australia behind Amcor, has resilient demand from its end markets in agriculture, food, and beverages, and is delivering earnings growth, improving cash generation, and rapidly reducing its debt.

Closing the gap

Anton Tagliaferro also outlined the steps the QVE Board had taken to look to close the discount between QVE's share price and its net tangible assets backing. The Board has put in place a 10 percent share buyback which has been very active because the discount to asset backing makes the purchase of shares at current levels very accretive to QVE shareholders at the current discount at which the shares are trading.

Reiterating the case for QVE

Summing up, Anton Tagliaferro reiterated the case for investing in QVE. Many companies outside the top 20 are not as well-researched as their larger counterparts, but many are very good quality companies that offer good opportunities to diversify one's portfolio to outside the top 20 stocks in Australia, which remains dominated by Banks and Resource shares, and which can also offer good dividend yields. In addition, IML – as the manager of the QVE portfolio – has a long track record of adding significant value in this segment of the market. The QVE portfolio is positioned defensively, holding well-established, good quality stocks in whose management IML has confidence.

QVE is also currently using the portfolio's cash holding to selectively participate in new stock issues and is also using the options market in selected stocks to enhance the income earned from many stocks in the portfolio, such as Orica and Amcor. Ultimately, IML anticipates that market conditions will return to valuing companies on the basis of their fundamentals, and in this environment, the companies in QVE's portfolio should be well-positioned to perform well for QVE's shareholders, as the fundamentals of the companies held in the QVE portfolio are very strong.