QV Equities Investment Manager Update

4 November 2020 **ASX code: QVE**

At QV Equities Limited (QVE)'s recent investor update, Investors Mutual Investment Director Anton Tagliaferro and Senior Portfolio Manager Simon Conn updated shareholders on QVE's investment strategy, dividends and capital management policies, recent investment performance, and key shareholdings and investment activity.

Investment Strategy

QVE's objective is to generate long-term capital growth and income. The company is overseen by an experienced board with a majority of independent directors, while IML as investment manager has a long track record of adding value outside the top 20 stocks.

Anton and Simon reiterated the case for investing in a diversified portfolio of shares outside the top 20. Many investors who have self-managed superannuation funds own holdings in the largest companies 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 offering attractive dividend yields. Owning QVE therefore provides exposure to a diversified portfolio of good quality companies in a variety of sectors and industries.

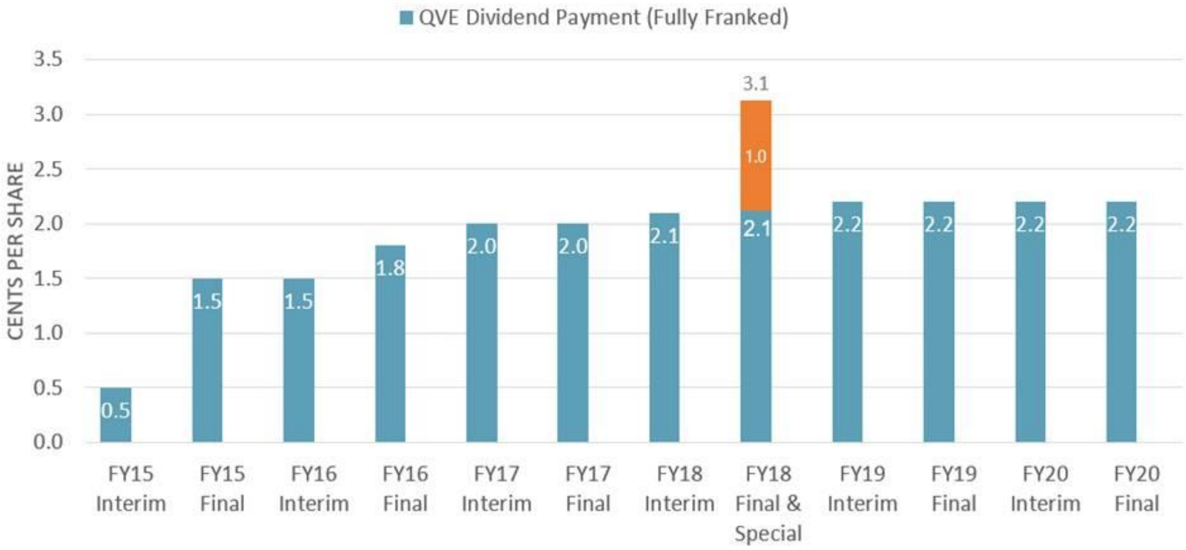
Anton and Simon also outlined IML's investment philosophy of buying companies with a competitive advantage and with a history of producing recurring earnings. It is also important for the company to have capable management which IML has assessed to ensure that what the company says externally reflects what is really going on within the company. IML also buys companies the investment manager believes will be able to grow their values over the long term, and also focuses on ensuring that the stocks in QVE's portfolio are trading at a reasonable price.

Dividends and Capital Management

Anton and Simon also updated investors on QVE's dividends and capital management policies.

IML is extremely focused on looking to maintain and potentially grow 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 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 better reflect what the companies are worth.

As the chart shows, QVE has achieved a track record of consistent dividend payments since launch six years ago.



Source: QVE

The QVE Board has announced its intention to maintain dividend payments to shareholders for the half and full year 2021 at 4.4 cents per share.

The Board has also recently adopted a policy of **paying dividends on a quarterly basis**. In an environment where interest rates are at record lows and where many investors are in need of more regular income, the Board acknowledges that it is in the best interests of shareholders to distribute dividends on a quarterly basis moving forward.

The Board's current intention is to pay its first quarterly dividend, for the September quarter, in December 2020. The opportunity to receive an annual dividend of 4.4 cents per share is equivalent to a 5.4% fully franked yield at the current share price.

QVE's Board is also mindful that the share price continues to trade at a discount to its net tangible assets (NTA) per share. The Board and IML are focused on building long-term value and income for shareholders and addressing the issue of the discount to NTA. The share buyback in place since 2019 has therefore been extended to September 2021. Apart from supporting QVE's share price, the main advantage of the current buyback is that the shares are being purchased at a discount to NTA and cancelled, thereby increasing the NTA per share for remaining shareholders.

Recent Investment Performance

Financial Year 2020 was one of the most turbulent on record. The COVID-19 virus was declared a global pandemic in March 2020, and most countries around the world, including Australia, implemented varying degrees of shutdowns and lockdowns of many sectors of their economies.

To counter the economic fallout from the pandemic, the Reserve Bank of Australia reduced interest rates to a record low of 0.25%. In addition, the Australian Government introduced unprecedented fiscal stimulus measures – in particular, providing income support to millions through the JobKeeper and JobSeeker programmes. Despite all this stimulus, the Australian economy entered its first recession since 1991.

The Australian sharemarket, as measured by the S&P/ASX 300 Index, experienced a sharp correction at the outset of the pandemic, falling over 20% in the March quarter, although a rally in the June quarter limited the loss in FY 2020 to negative 7.6% for the ASX 300 for the 2020 financial year.

QVE had a difficult 12 months, with the portfolio down 14.5%, compared to the ex-20 benchmark's return of negative 5.3%.

This was a disappointing result, and while QVE's investment performance was broadly in line with the benchmark during the March quarter correction, the portfolio's performance did not match the sharemarket's subsequent strong gains in the June quarter.

Anton and Simon both acknowledged that QVE's recent investment performance had been disappointing. Part of the underperformance has been the result of a period when the sharemarket has been driven by strong interest in many speculative or 'concept' stocks, which has been unfavourable for value-style investment managers like IML.

The investment manager's caution towards many highly-valued and cyclical sectors such as the technology and resources sectors impacted performance. IML considers many stocks in these sectors to have higher risks in the current environment, and for these reasons, they have been excluded from the QVE investment portfolio.

In IML's opinion, the current sharemarket is not being priced in a rational manner. It is fairly commonplace to see many relatively unproven companies – many of whose share prices have soared in the last six months – being valued far more highly than well-established, good quality companies. A case in point is **Afterpay**, whose share price has increased tenfold since its lows in March. At the time of writing, it was being valued at more than that of **Amcor** and **Brambles** COMBINED! This makes very little sense to IML, given that Amcor and Brambles are successful global companies generating huge cashflows, with Amcor being one of the largest packaging companies in the world and Brambles being the largest global pooled pallet provider. Amcor and Brambles make a combined over US$2 billion, while Afterpay is still trying to build its operations in various parts of the world and is yet to make a profit.

Companies like Afterpay and **WiseTech Global** may somehow yet prove to be successful in the very long term (although there are huge risks and uncertainties), but in reality they are currently unproven businesses, while many well-established companies such as **Aurizon**, **Incitec Pivot**, **Tabcorp** and **Orica** appear extremely undervalued, particularly given the cashflows these companies generate. It makes no sense to a value manager like IML to be buying the many popular concept companies that look very optimistically priced, especially at a time when many well-established, good quality companies are trading at very reasonable prices. Ultimately, the market always reverts to fundamentals – and to companies with real profits and real dividends.

Anton and Simon also outlined QVE's best and worst performers during 2020. The best performers included **Sonic Healthcare** (whose testing business had performed very well through the COVID-19 period), **Integral Diagnostics**, **Pro-Pac Packaging**, **Nine Entertainment**, **BWP Trust** (which benefits from its long leases with Wesfarmers), and regulated utility **AusNet**.

Pro-Pac Packaging has strong recurring earnings from its packaging operations, a much improved balance sheet, a highly-motivated management team and a significant opportunity to grow its earnings through a major site consolidation plan which will deliver significant cost savings. Another strong performer, **Nine Entertainment**, benefitted from its Stan streaming business which now has over two million customers, making it the clear number two to Netflix in Australia.

Disappointing performers for FY20 included companies affected by the pandemic lockdown, such as **Crown Resorts**, **SkyCity Entertainment Group**, and **Tabcorp**. (The outlooks for Crown and Tabcorp are discussed in more detail below.) **Southern Cross Media** and **oOh!media** were similarly affected by significant declines in advertising, which is now recovering as business expenditure normalises as Australia moves out of its enforced lockdowns. **Event Hospitality & Entertainment**'s hotels and cinemas businesses had also been badly affected by lockdowns, Anton outlined, although Events has a strong balance sheet backed by a strong property portfolio.

QVE's holding in **Virgin Money UK** also disappointed, although Simon Conn noted that moving forward, the firm's high-quality modern technology infrastructure positions the company well in the UK market. While **Origin Energy** and **Oil Search** had suffered from low oil prices as a result of travel bans, these companies will benefit when the oil price eventually recovers, and could potentially become takeover targets, as their prices had become very attractive for potential would-be predators.

Key Holdings

Anton and Simon also provided an overview of QVE's top 10 holdings and recent portfolio investment activity.

QVE Top 10 Holdings	
Amcor	5.0%
AusNet	4.6%
Crown Resorts	4.6%
Ampol	4.5%
Aurizon	4.5%
Orica	4.5%
Tabcorp	4.4%
Pact Group	3.9%
Sonic Healthcare	3.6%
Coles	3.5%

Amcor is one of the world's largest suppliers of rigid and flexible packaging products, with operations globally. The firm's operations are highly cash-generative and have produced steady earnings and dividend growth over time thanks to organic growth as well as bolt-on acquisitions. Amcor is a defensive business, with over 95% of sales into defensive end markets including food, beverage and healthcare. Amcor's revenues and earnings should remain steady at a time of great economic uncertainty.

AusNet remains a core holding for QVE because the Victorian electricity and gas distributor's key assets are regulated and earn recurring and predictable revenues and earnings, which in turn provides cashflows and earnings certainty. The firm has also consistently grown its assets over time.

Crown Resorts has a dominant position as the leading integrated casino and resorts operator in Australia. The business remains attractive because of its very strong asset base, its market-cap strongly supported by the casino assets in Sydney, Melbourne, and Perth, as well as the valuable long-dated licenses (extending, in Sydney's case, out over 100 years). This will enable Crown to generate a recurring and predictable income stream when things normalise. The 'domestic grind' business' earnings are highly recurring, and more than 90% of Crown's earnings are derived from these 'grind' customers.

The evidence at the New South Wales Independent Liquor and Gaming Authority's enquiry has been disappointing, showing that improvements were needed in some of the company's governance aspects as well as in its management of the 'junket' market. The current share price is 'baking in' a lot of bad news for a business which is currently looking cheap and should be able to continue to generate substantial cashflows and dividends when things settle down.

Ampol (formerly Caltex) is a leading convenience retailer and supplier of transport fuels. The company benefits from huge economies of scale, owning Australia's largest network of service stations, and critical fuel distribution infrastructure including import and storage terminals, pipelines, and a Queensland-based refinery. Ampol has a strong balance sheet and a new management team which is rationalising the use of capital in the business (such as the spinoff of its service station properties into a property trust) and taking out costs, which should improve the returns the company can generate in the future.

Aurizon owns a rail infrastructure business in Queensland with a 10-year regulatory-agreed returns framework. The company also operates a haulage business operating under long-term contracts which transports metallurgical coal used for steel-making from the various coal mines in Queensland to the ports. The company benefits from having customers in the mining industry which are very low on the cost curve. Aurizon has a healthy balance sheet, with strong and sustainable cashflows which are used to generate a favourable dividend yield.

Orica is a global leader in the manufacture of explosives, its main competitive advantage being its scale, and with a network of well-located ammonium nitrate plants close to its customers. Orica generates a recurring earnings stream from its three- to five-year contracts with its customers. The company has a significant research and development pipeline (particularly in wireless blasting technology), and also has an extremely experienced management team and Board. Orica's balance sheet is very strong, and in IML's opinion the company is trading at a very reasonable valuation. Earnings growth and cost savings over the next three to five years should be driven by the introduction of SAP enterprise resource planning software, synergies from the acquisition of Peruvian explosives manufacturer Exsa, and operating efficiencies from better inventory management and plant optimisation.

Tabcorp owns valuable gaming licences across lotteries and wagering in Australia. The company's long-term monopoly lotteries license and earnings growth from increased digital penetration and new and enhanced games will continue to make Tabcorp an extremely high-quality business, which IML believes to be significantly undervalued. There is also potential for substantial cost savings from Tabcorp's current cost review, with the company now focused on extracting better returns from its wagering division.

Pact Group, the clear number one player in the rigid plastic packaging market in Australia, has a well-established pallet pooling business with predictable recurring cashflows and a reasonable valuation. Pact has increasing earnings exposure to the growing plastics re-use and circular economy, which now accounts for almost 28% of group earnings. This creates a genuine competitive advantage for the core packaging business. Pact's joint venture with Asahi and **Cleanaway** will turn previously used resin into new packaging, allowing Asahi to meet its recycling commitments. The reorganisation of Pact's packaging segment should see the business stabilise and grow, and produce efficiency improvements and opportunities to reduce costs, with earnings able to be enhanced in time by efficiencies from site optimisation. The quality of the business and its earnings should also improve as pooling's share of Pact's earnings continues to grow.

Sonic Healthcare is the largest private pathology provider in Australia, the United Kingdom, Germany, and Switzerland, and the number three player in the United States. The balance sheet is sound and the firm's excellent management team continues to invest heavily in technology to automate laboratory processes to produce greater efficiencies over time. Advances in technology and disease detection and an ageing population are generating increased demand for pathology tests, leading to further volume growth for the industry. Although the COVID-19 pandemic had meant that Sonic had been affected by falls in the volumes of standard pathology tests, the company was benefitting greatly more recently from virus testing all around the world, and the pandemic has illustrated the essential service nature of the business.

Coles has been added to the QVE portfolio over the last 12 months on price weakness. Coles generates very strong cashflows and is implementing an ambitious cost-out program, redesigning, consolidating and automating its supply chain. This should remove significant costs over the next three to five years, increase operational efficiencies, and make a substantial contribution to Coles' ability to increase its margins, profits and dividends in coming years.

Investment Activity

Anton and Simon also went through the companies bought and sold from the QVE portfolio during 2020. Positioning the portfolio more defensively, IML had sold out of **Sydney Airport Holdings**, on the view that the company will take many years to return to pre-pandemic earnings, and out of **Unibail-Rodamco-Westfield** on COVID-19 concerns. IML had also taken advantage of a share price rally to exit **Myer Holdings**, because the firm is taking considerably longer than the investment manager had hoped to restructure itself. IML had also sold out of **GWA**, because of its significant exposure to residential construction in what appears likely to be a slowing housing market.

Companies added to the QVE portfolio over 2020 included **Alumina**, **BWP Trust**, **Cleanaway**, **Coles Group**, **Home Consortium**, **Metcash**, and packaging firm **Orora**.

Home Consortium is a real estate investment trust which has a strong management team in place and whose properties are underpinned by a stable tenant base of typically large national brands or essential services such as government services and childcare centres, and which has a long weighted average lease expiry profile. Grocery and liquor wholesaler **Metcash** has invested heavily in recent years in efficiency programmes to ensure that its independent retailers can compete effectively with the other larger supermarket chains. Metcash received an unexpected boost during the COVID-19 lockdown as more shoppers switched to the convenience of neighbourhood stores. This has enabled the company to gain market share, which IML believes Metcash will retain some of in a post-pandemic environment.

Company-Specific Growth Drivers

Anton and Simon also gave examples of the kinds of company-specific initiatives IML has identified which should enable the stocks in the QVE portfolio to grow over the next three to five years, summarised in the following table.

Company-specific initiatives to grow in the next 3 - 5 years	
Cost-outs →	Coles, Orica
Accretive acquisitions →	Amcor, Pro-Pac Packaging, Sonic Healthcare
Contracted growth →	Charter Hall Retail, AusNet
Market share gains →	Metcash
Restructuring →	Ampol, Orora

Companies like **Coles** and **Orica** should be able to grow their businesses by taking out costs (for example, through rationalising their operations). Companies like **Amcor**, **Pro-Pac Packaging**, and **Sonic Healthcare** should be able to make earnings-accretive acquisitions. IML also favours companies with contracted growth or long-term licenses (like **Charter Hall Retail REIT** and **AusNet**), those which should be able to make sustained market share gains (such as **Metcash**), and companies which are restructuring (like **Ampol** and **Orora**). Many of these companies will also be among the biggest beneficiaries of efficiency gains through deployment of technology, for example in **Coles**' rationalisation of its distribution.

Summary

In summary, IML remains a disciplined and true-to-label value investor which continues to actively manage the QVE portfolio by holding a diversified collection of well-established, good quality companies outside the ASX top 20 underpinned by reasonable valuations, while remaining on the lookout for good companies to add to on share price weakness.

In addition to long-term capital growth, IML also remains focused on generating income for the QVE portfolio, seeking investment opportunities that pay sustainable and growing dividends with attractive franking credits, and using the ASX options market to supplement this income. The portfolio's cash holding is also being used to buy back shares at a discount to net tangible assets. The portfolio's cash reserves will be used to continue to pay dividends to shareholders, as well as to take advantage of attractive opportunities presented by market volatility.

Shareholders in QVE should hopefully stand to benefit over the long term from what seems like a 'double discount' based on the combination of a portfolio of relatively cheap and undervalued stocks generally trading at very reasonable valuations along with the QVE share price discount to net tangible assets.

Ultimately, IML anticipates that market conditions will at some point return to valuing companies on the basis of their fundamentals, and the focus will shift to more proven businesses. 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 in the QVE portfolio remain strong.

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