Independent wealth manager Samuel Weber updated his investment theses on four ideas he had presented at previous editions of European Investing Summit.

Samuel commented on Lanxess (Germany: LXS), Swatch Group (Switzerland: UHR), Holcim (Switzerland: HOLN), and Deutsche Bank (Germany: DBK).

Access the original presentations as follows:

- Lanxess (2021)
- Swatch Group (2020)
- Holcim (2018)
- Deutsche Bank (2017)

The following transcript has been edited for space and clarity.

Samuel Weber: As you know, John, I am a passionate reader of your publications, and it is a great pleasure to speak at one of your conferences again, now for the fifth time.

The world is constantly changing, and my human brain has the extraordinary ability to create stories and explanations in hindsight that often bear little resemblance to what was happening in real time. Therefore, one of my primary objectives in presenting my favorite European investing ideas at MOI Global is to have a well-documented account of my own thinking at the time of making some of the most important decisions of my investing career.

Another objective is to give my clients an opportunity to listen to my reasoning in an undisturbed environment of their own choosing. I invest a significant portion of their assets – sometimes 100%, as in the case of my brother, a 40-year-old surgeon whose life savings I invest on his behalf – and this medium gives us the opportunity to share my analysis without triggering any ad hoc discussions. Even though such discussions are usually very useful and important, they get even more productive if the client has listened to my MOI presentation first. Thank you for giving me this opportunity, John.

As I currently have no new investment to present, I decided to update my previous ones. Since presenting Deutsche Bank in 2017, the world has faced a global pandemic, the outbreak of a war in Europe, and the resurgence of inflation, among other things. These highly significant events in global history are reshuffling the cards for many investors. It is of prime importance for me personally to see how my theses are holding up in this new environment.

I will not repeat what I said in the past on this platform – enough has changed to focus on providing relevant, timely, and new information. Before I start with my presentation, though, please bear in mind that I do not give investment advice and may change my opinion without notice at any time. This material is based upon information I consider reliable as of the date hereof, but I do not represent that it is accurate and complete. I also want to say here something about risk in general. As always, I am not speaking about stock price fluctuation or stock price volatility but the risk of permanent capital loss.

On February 24, Russia invaded Ukraine. With this came the risk of the war spreading to other parts of Europe. There was a real possibility that Russia would immediately stop supplying Europe with natural gas. Even if this didn't happen, incredibly, many people supported the German gas embargo which would – at that point in time, if followed through – have led to a massive shock to the German economy, a real structural break with severe implications for the country's standard of living. With Germany being the economic engine of Europe, this would also have had drastic consequences for the whole continent.

In such a scenario, it wouldn't matter whether you own a chemicals company that directly depends on natural gas as a raw material or some other company that depends only indirectly on such supplies by buying the chemical products. To use an analogy, if the whole line comes to a standstill in front of a cliff edge, everyone stops immediately, even the one who stands last in line.

This acute danger is more or less gone now. We are left dealing with more manageable risks, such as inflation and some limited rationing though we can never be sure that something more drastic won't happen. When it comes to unmanageable risks, I follow David Deutsch's advice: "I'm going to make my investments on the basis that if this investment goes wrong, I have bigger worries than that."

As a citizen of Switzerland with two kids (or soon to be two kids), my well-being is deeply intertwined with that of Europe on many more dimensions than just my stock market performance. What does it help me if my portfolio performs well while my kids or I are fighting in a war or suffering from an acute economic depression with the associated shortages, poverty, and violence? I can't buy goods that haven't been produced, right? If I think there is a real chance for such a worse case to happen in Europe but not in other parts of the world, should I move my portfolio over there without also moving my family and myself?

For me, the conclusion is clear. As long as I'm living on the European continent, I will also invest here, but I don't deny the fact that North America has somewhat fewer risks to worry about than continental Europe.

Let's now move on to the companies. I presented Lanxess last October as my favorite European investing idea. As a diversified chemicals group with a significant industrial footprint in Germany – mainly in the advanced intermediate segment – the company is heavily affected by the war in Ukraine. It needs a lot of natural gas to fuel its operations and suffers from the commodity's high price and possible lack of supply.

More generally, inflation imposes significant working capital needs that lower operating cash flows and, more importantly, owner earnings, increase capital invested, and decrease the returns on that capital. This is a serious problem. Due to enormous working capital investments, the company didn't generate any owner earnings in 2021 and probably also in 2022. It had to invest 2.7 billion euros, which is its whole market cap in receivables and inventory and an increase of almost 1 billion euros compared to the previous year.

I must note here that the capital employed figures used in my analysis are based on pre-tax earnings and include intangible and cash assets. Therefore, the return on leveraged net tangible assets, as calculated by Buffett in his discussion of economic goodwill, would show significantly higher figures as more than 3.5 billion euros of intangible assets would be subtracted in the calculation from the 7.6 billion euros of total capital employed. When using the term “owner earnings,” I also refer to the definition by Warren Buffett in his shareholder letters.

Facing such a tremendously disadvantaged operating environment, Lanxess performs reasonably well. During the first half of 2022, it was able to fully pass on raw material and energy costs to its customers, increasing prices by 26% in the second quarter alone; it expects to increase full-year operating profits by more than 12%.

Raw material pass-through is contractually agreed with all customers, and Lanxess is working with urgency to also get energy cost pass-through into 60% to 80% of its contracts by the end of this year. The company has published an analysis of the potential costs of factory shutdowns due to a lack of gas, showing that even this – at worse and, so far, hypothetical scenario – could be managed with a limited annualized profit impact of around 100 million euros of EBITDA because the most gas-intensive plants are also the least profitable ones.

Additionally, concerning gas supply, Germany is divided into two parts, with the south and east being at least historically supplied mainly by Russia, and the north and west, where Lanxess is located, by LNG from global markets and pipelines from the Netherlands.

Most importantly, under the supervision of a superb management team, the company continues to deliver on its transformation towards a specialty chemicals group, having completed two acquisitions and divestments each within the past 1.5 years.

While there has been some sobering news about standard lithium, Lanxess recently announced a joint venture with Advent, allowing it to partly monetize one of its four segments – the weakest one, in my opinion – within the next 12 months and fully monetize it within the next four years at attractive valuations. This will allow it to deleverage its balance sheet and refocus its activities on more profitable segments. Furthermore, it closed two sizable acquisitions in its consumer protection business, catapulting this segment into the world leader in its area of biocides and a strong player in flavor & fragrances.

The valuation of Lanxess is dirt cheap. The company is currently valued at less than 3 billion euros. After fully monetizing its joint venture and given the current level of leverage, the company should be debt-free in a few years, assuming no further acquisitions.

On a projected EBITDA of around 1.1 billion to 1.2 billion euros, including some conservative organic growth estimates, it would then trade on an EV/EBITDA ratio of around 2.5 times. The ultimate valuation will depend on the competitive strength of the group, i.e., how sustainable its pricing power is and how much owner earnings it will generate. Judging from the exit multiples of between 9 and 17 times that Lanxess achieved on its divestments during the past five years, an EV/EBITDA ratio of more than 10 times should be achievable. Going forward, raw material and energy price inflation should normalize at a level that will allow the company to generate significant free cash flows.

Following David Deutsch's dictum, if that doesn't happen, and then inflation doesn't stabilize, we – meaning the citizens of Switzerland and Europe – will probably have bigger worries than the company's owner earnings. If, however, such a scenario should happen, the company's capital intensity is a disadvantage, but I think this disadvantage is more than reflected in the current valuation and stock market price.

Next is Swatch Group. When I presented the company in 2020, it was suffering from the effects of the global pandemic and, more importantly, from the government-imposed lockdowns. Since then, it has increased its revenues and profitability significantly. Even during the pandemic, it achieved a healthy level of operating cash flow by selling down inventories, thus releasing accumulated working capital.

Back then, I highlighted the company's capital allocation as a material weakness, and this has not changed. Unfortunately, it got worse. A few years ago, it engaged in a share buyback of around 1 billion Swiss francs to avoid paying negative interest rates on cash assets, giving me hope that – besides statements to the contrary – the CEO, who is also a significant shareholder, ultimately has a rational eye towards capital allocation.

Today, I am much less optimistic. Out of total balance sheet assets of 14 billion Swiss francs, inventories account for 7 billion, and cash and equivalents and short-term financial assets for 2.5 billion, amounting to a total net working capital of 9 billion Swiss francs. Theoretically, the company could monetize its gold and diamond assets of around 1 billion Swiss francs each, and, together with its cash assets, buy back far more than a third of its outstanding shares, thereby dramatically increasing its earnings per share, return on equity, and shareholder value.

On a recent earnings call, however, the management team showed no willingness to do such a thing. On the contrary, I had the unfortunate impression that the CEO wears his irrational conduct as a badge of honor. Given the size of the amounts involved and the unsatisfactory level of profitability during the past five years as indicated by mid-single digit returns on equity, I can't personally defend this conduct any longer despite my admiration for the Swiss watch industry and the Swatch Group's products.

I'm also worried about the company's irresistible passion to collect gold and jewelry. Don't get me wrong: Its financial performance isn't terrible and could still be much better if revenues grow strongly, given the inherently high operating leverage, but an average return on equity of 5.5% during the past five years is, in my opinion, insufficient for a publicly listed Swiss company of such high quality should it aim to outperform long-term Swiss market index returns, which historically stood at around 7% per annum.

Most certainly, the current level of profitability is priced in the current stock market valuation. More generally, relying on growth to generate reasonable returns isn't a responsible strategy, in my view, considering that Swatch Group clearly isn't a growth company. Last year's net sales, for example, were lower than in 2012.

I have some understanding for the CEO's position as a lot of economic crimes have been committed in the name of capital efficiency, and I support a reasonable safety buffer, but no amount of safety buffer can provide operational safety in the long term. Only watch-loving and buying customers can do that. No amount of assets on the balance sheet will compensate for a lack thereof. Meanwhile, the seriously depressed capital returns destroy shareholder value with no concomitant benefit.

When I presented Holcim in 2018, CEO Jan Jenisch was in the process of significantly transforming the company. He joined in 2017. Today, he has accomplished much of what he set out to do. Holcim achieved all its 2022 targets one year in advance. It reset its profitability, doubling free cash flow sustainably to over 3 billion Swiss francs, lifted the return on invested capital to above 8%, deleveraged its balance sheet, and laid the basis for the fourth segment – solutions and products – to become a significant profit center.

Holcim made many valuable divestments during the past four years for a total amount of more than 10 billion Swiss francs, most recently selling its India subsidiary to Adani Group at more than double its own valuation, meaning that it received more than 20% of its current market cap in cash by selling only around 10% of its earning power and even less of its free cash flow.

Right now, the company is basically debt-free. The proceeds from the divestment will be used for further acquisitions in the solutions and products segment, increasing its share of total revenues from around 8% in 2020 to more than 24% this year on a pro forma basis and potentially much more than 24%, depending on what acquisitions are to come.

The India divestment is particularly attractive given the significant hurdles the Indian government imposed on repatriating cash from the country and the current CO2-related discount that Holcim suffers from in the stock market due to its cement activities, with the Indian subsidiary having accounted for more than 20% of Holcim's total cement grinding capacity.

This also shows the disconnect between private and public markets. The fact that Holcim could sell the Indian subsidiary at such a high valuation is clear evidence that private owners value the cash-generating capacity of those assets, unlike public markets currently.

On a pro forma 2022 basis, the cement activities represent much less than 50% of total sales, and further declines in this number can be expected as the significant firepower is applied to other segments in the near future. I expect Holcim to continue executing on its transformation, significantly outperforming its 2025 plan, and to generate significant and growing free cash flows in the future based on its hundreds of local monopolies and attractive investments. Jan Jenisch has a proven track record in capital allocation and massive firepower to finance acquisitions, so the majority of Holcim's activities will soon consist of products and solutions unrelated to cement.

I also viewed the cement aggregates and ready-mix concrete activities as highly valuable. Not only do they provide the company with significant cash flows that fuel its transformation, but they also enable it to get into contact with its customers very early in the lifecycle of a building and infrastructure, allowing it to cross-sell other products and solutions. At least that's Holcim's strategic intent.

The valuation of under 10 times free cash flow and 8 times owner earnings is highly attractive, compounded by a tax-free dividend yield of around 5%. Also, the multiples are about 20% lower, taking into account additional profits from future acquisitions based on existing excess capital, and, as I heard recently, the CEO might well consider a share buyback of around 10% of outstanding shares.

Of all my investment ideas, Deutsche Bank was by far the most controversial. How could I possibly consider investing in a European unprofitable – and, by the way, criminal – bank? Didn't I know that this company is already insolvent, the value of its assets significantly overstated, its risk management broken, and its business inherently unprofitable?

While predictions of an imminent downfall can't be falsified by definition, I am happy to report that, five years after my analysis, it seems I turned out to be mostly correct. In the first half of 2022, Deutsche Bank achieved its targeted level of profitability, with a return on equity of 8% and net profits of more than 2 billion euros despite absorbing significant costs from its capital release unit on facing a global pandemic and the outbreak of a war in Ukraine. The return on tangible capital equity of the core bank even surpassed 10% in the first half of 2022, and its pre-provision profits increased from 1 billion euros in the first half of 2019 to more than 4 billion only three years later. This is a massive increase in profitability that I consider to be sustainable and to continue.

Deutsche Bank is benefiting from a clear momentum in all core businesses, most notably a sustainable recovery in trading revenues, rising interest rates, the quality of its asset base, and improvements in efficiency. Nevertheless, there are still a lot of doubts about its ability to keep up and further build on this recent performance.

Europe's financial industry resembles a construction site, and its banks suffer from material competitive disadvantages mainly related to their size compared to internationally active U.S. banks. Many European banks are significant holders of foreign debt from their home countries that are much less credit-worthy than Germany. On the continent, we are sometimes in a seemingly never-ending restructuring with no clear solutions in sight yet. We will hear more from Credit Suisse in a couple of weeks, and I'm extremely interested in how the restructuring of a hugely important Swiss bank will proceed from here on.

Despite the aforementioned doubts, I feel very well about Deutsche Bank's prospects, having observed closely the risk management and operational progress its management team has made during the past five years. The return on equity may soon surpass 10%, powered by a sizeable deposits franchise, leading to a yearly net profit of around 6 billion euros. On this basis, the bank is currently trading at a price/earnings ratio of less than three times.

Furthermore, it will pay out significant dividends and engage in meaningful share repurchases during the next few years, which will further enhance shareholder value. On my average purchase price, I expect a dividend yield of more than 15% pre-tax as soon as the payout ratio reaches the targeted 50% of net profits.

The following are excerpts of the Q&A session with Samuel Weber:

John Mihaljevic: Thank you, Samuel, for the presentation and these updates. Let's start with Deutsche Bank. It executed pretty much according to your expectations even though these were non-consensus outcomes at the time you presented. The point on share repurchases is very interesting because that's essentially the exact opposite of what I think the market has feared in the past. Could you elaborate a little on the potential timing of that? What kind of size might we see there?

Weber: I would have to look up the details again to answer this question in a detailed way. First, let me say something about your comments. I think the bank performed and executed according to my expectations, but 1.5 years after my presentation because there was this additional round of restructuring that I didn't foresee as my analysis was based on the former CEO, John Cryan.

Deutsche Bank got a new CEO and also made some changes to its initial plans. For example, it wound down the equity trading business, which I didn't foresee but analyzed at the time. I also commented on it in my later presentations. I agree with you that Deutsche Bank is executing very well, very satisfyingly for us and according to my revised expectations.

Regarding the share buyback, Deutsche Bank intends to lift the dividend payout to around 50% of net income during the next two to three years. This is doubling. Right now, I think it's around 5% or 10% of net income, and this doubles until it reaches 50%. Then, Deutsche Bank will see how much excess capital it has.

This also depends on how big the crisis will be in Germany based on the war in Ukraine. If there is a lot of excess capital, it will use it for share buybacks. This has the advantage that as long as the share price is still on such a depressed level and assuming there will be excess capital despite some challenges in Germany, there could be quite significant share buybacks in the next one or two years.

However, I recently read the ECB and European regulators demand that banks be extremely conservative. There are also some political considerations when speaking about share buybacks that Deutsche Bank can't influence.

Mihaljevic: How should we think about the effect of higher interest rates on the profitability of Deutsche Bank?

Weber: Higher interest rates are most certainly positive. I mean, they increase revenues. Also, they are very stimulative for debt trading. We have seen a decade of structurally low trading activity. This has changed, and I think this change is sustainable, so there are high levels of trading benefiting Deutsche Bank's investment bank. There is higher interest revenue benefiting pretty much all of Deutsche Bank's activities.

There is a question of how big the write-downs will be if we are going into recession now, but I am convinced of the quality of the assets. Even when I gave my talk in March 2020, in the middle of the coronavirus crisis, I was deeply convinced that Deutsche Bank has a high credit quality, asset quality, and this assessment has not changed. I expect the positive influence to be much, much higher than the negative one.

Mihaljevic: Looking a bit longer term and potential threats or opportunities from financial technology getting adopted – banking apps and so forth – how do you feel about the competitiveness of Deutsche Bank in light of some potential innovation-driven shifts?

Weber: I have quite a clear opinion on this. The big competitive advantage of Deutsche Bank and all other big traditional banks is the deposit franchise that provides a very cheap source of financing, much cheaper than everything else available in the market.

If a new player comes up and wants to compete – in lending, for example – it needs to finance itself with other sources. As soon as it wants to finance itself with deposits, it will become a bank. It will be regulated as a bank. There is no way for competitors to keep up with the big traditional banks' competitive advantage without also becoming banks themselves. This is quite a big advantage, I guess.

Of course, you never know. Innovation is unpredictable by definition, so we will see about that, but I'm not that worried. The competition in financial products is very much price-driven; customers are highly price-sensitive, and financing matters tremendously if you want to compete in this environment.

Mihaljevic: Regarding Lanxess, it sounds like the company has indeed been in the eye of the storm, especially with regard to headlines around natural gas supply. Could you elaborate a bit on capital allocation, what we might see, or what you would like to see in light of the very low valuation of the shares right now?

Weber: Lanxess announced that after receiving cash from the partial divestment of the fourth segment, it will use around 300 million euros for share buybacks and the rest to pay down debt. The company has some significant debt outstanding because it made two sizable acquisitions. The joint venture will allow it to deleverage.

In the future, I expect a much more stable situation. The acquisitions and divestments are mostly behind Lanxess now. It has repositioned itself and is now a pure chemicals company. What I would like to see – and what I expect to see – is that Lanxess will focus on growing revenues and the profitability of the businesses it now has.

There is still some small business in the segment that it put into the joint venture. There are the urethane systems that will also be sold, I guess, for an attractive valuation in the not-too-distant future, but the organization is right now very busy with establishing the joint venture.

There may be some portfolio adjustments going forward, but I think the big adjustments have been made, and there will be profitable growth ahead. I also expect the management team to allocate the profits in a very shareholder-friendly way. We will see about that. There is no information outstanding, but I think we shareholders will be happy with those decisions.

About the instructor:

Samuel S. Weber is an independent wealth manager based in Zug, Switzerland. He is a passionate value investor, who is focused on generating long-term, market beating returns by investing in high-quality opportunities in the stock market (www.samuelsweber.com). Samuel holds a master's degree in strategy and international management from the University of St. Gallen and is a member of the Board of Trustees of HBM Fondation.