Samuel S. Weber of SW Kapitalpartner GmbH presented his investment thesis on Swatch Group (Switzerland: UHR) at European Investing Summit 2020.

The following transcript has been edited for space and clarity.

Samuel S. Weber: Thank you for hosting me a third time at this conference. Three years ago, I spoke about Deutsche Bank, and two years ago, about LafargeHolcim. Today, I want to speak about Swatch Group. First, a disclaimer: I'm not providing any advice, and I may change my opinion without notice at any time.

Swatch Group is one of my favorite investment ideas, and since I'm Swiss, I feel a personal responsibility to help the investor community better understand this company.

Before I do that, I'll say a few words about my first two investment ideas: Even though Deutsche Bank has been one of the best-performing big bank stocks internationally in the last 18 months, it still trades below the price I paid for it, between €9 and €11 per share. When I made the presentation three years ago, the stock traded at around €15 per share. I started buying at the end of 2017 and have significantly increased the position since then. Operationally, Deutsche Bank is well on track to deliver on its target return on tangible equity of more than 9% in its core bank in 2022, which would imply an intrinsic value of around tangible book value, at more than 3x today's share price of €7-something — around €23 tangible book value per share. In hindsight, I overestimated the speed with which this turnaround would be executed. It's taking about two years longer than I expected. Even though Deutsche Bank will probably manage to achieve the return profile I envisioned for it, it will do so on a much lower revenue base and with much lower costs than I initially assumed. If I'm correct in my assumption that this company will trade at around book value (€26 per share) in a couple of years' time, this would imply a return of around 80% in five years since my presentation three years ago. Let's see how this story continues.

LafargeHolcim, since my presentation two years ago, has operationally outperformed my expectations pretty much on every metric. I estimated the company would generate a free cash flow of CHF 3 billion in 2023, which it achieved last year already, four years earlier than I expected. However, the stock still trades at around the price that I paid for it two years ago, and the company is now valued at a multiple of only 9x its 2019 free cash flow. Even on an estimated 2020 basis, the company seems undervalued, trading at a free cash flow multiple of only 10x to 15x on depressed free cash flows. Given the quality and sustainability of those cash flows, and the high probability that they will increase significantly in the next few months due to a catch-up effect, and considering the low level of current interest rates on Swiss treasury bonds, 20x free cash flow is a fair multiple, implying a doubling of the stock price within a few years.

The main reason why these two stocks lacked the performance I envisioned for them despite delivering operationally is, of course, the coronavirus crisis. Both companies engage in activities that depend on healthy economic growth to generate attractive returns for their shareholders, and the stock market is obviously afraid of a major deterioration in their operating performance. As I mentioned in your conference on intelligent investing in crisis mode back in March of this year, the time to prepare for a crisis is before it happens, and both companies have been well prepared for — and to some extent may even profit from — the current crisis.

Let's now turn to the topic of this presentation, the Swatch Group.

The company sells watches, obviously, but on a deeper level of analysis, it sells emotions. Emotions are universal, and that explains why watches are sold in pretty much every country on the planet. To understand how Swiss watches create emotions, we must analyze the psychology of watch buyers. To do this, I rely heavily on the essay *The Psychology of Human Misjudgment* by Charles T. Munger, which lists 25 common human psychological tendencies. This topic has been researched academically by Kahneman and Tversky, and forms the basis of Kahneman's best-selling book *Thinking, Fast and Slow*. Stated simply, many people love watches because they like or even love the beauty, tradition, and craftsmanship of watchmaking. A mechanical watch takes energy from movement. It is very complex and beautiful.

For example, my own watch, the Speedmaster Moonwatch made by Omega, Swatch Group's biggest brand, possesses a Master Co-Axial Chronometer. This watch movement consists of 368 — I repeat, 368 — components, and is subjected to eight tests in 10 days to ensure superior precision, anti-magnetic characteristics, and many other important qualitative characteristics. These tests are conducted by the Swiss Institute of Metrology, a highly credible and independent institution, allowing the Swatch Group to offer a comprehensive five-year warranty for this watch. The watch also has a miniature moon on it that shows the current positioning of the moon in its moon phase.

Many people, myself included, are fascinated by the complexity, beauty, quality, and longevity of such a product. Once you dive into the art of watchmaking, you can learn more and more about these fascinating objects in a never-ending journey. Further up the value scale, you can find grand complications, such as the Tourbillon, which was invented by Abraham-Louis Breguet, who opened his first workshop in 1775 (245 years ago), and laid the foundation for what today is Breguet, one of the most luxurious watch brands in the Swiss watch industry. It is owned by Swatch Group and generates around CHF 400 million of revenue. It produces fascinating and innovative products that build on its unique heritage.

Heritage is important here. Nowadays, we read a lot about the increasing pace of change, and even though that may be true, change itself is nothing new. It is and always has been an important aspect of life for everyone everywhere. A mechanical watch offers emotional stability — something to hold on to emotionally in a world where everything else is always changing.

Furthermore, a brand's heritage allows marketing departments, which are amazing storytellers, to come up with a sheer endless list of reasons why we should buy a watch. The heritage of a brand enables more fascinating storytelling and gives established brands a significant competitive advantage. That explains why it's so difficult for new brands to gain a foothold in this market.

To give you an example, take a look at the little moon on my watch. If you look closely with a magnifying glass, you'll find a little footprint on the moon, which is a reference to the Apollo 11 mission. The Omega Speedmaster was the first watch on the moon, worn by all three astronauts on the Apollo 11 mission, and specifically by Buzz Aldrin at the famous moment, at 10:56 p.m. Eastern Time on July 20, 1969, when Neil Armstrong put his left foot on the lunar surface and famously declared, "That's one small step for man, one giant leap for mankind." There is even an incredible — and true — story of the Apollo 13 mission in April 1970, when all electrical systems on board the space shuttle failed and the astronauts had to use their mechanical Omega Speedmaster watches for navigation, saving their lives. So much for the often-touted lack of functionality of these products. (By the way, Claude Nicollier, who is the first and only Swiss person to have been in space, is a member of the board of directors of Swatch Group.)

You can see that this provides fantastic marketing material, directly appealing to several psychological tendencies. Furthermore, watch buyers — among them many collectors — do not feel any saturation. Emotions never stop. They are always with us, powered by input from the real world in an autocatalytic way. Emotions create emotions that create emotions. There is no end to this process. If I buy a watch today, I do not get any less joy from it just because I already own another watch. The emotional fulfillment is not subject to the same kind of saturation that we experience from eating or fulfilling any other kind of basic human need. It doesn't even matter whether these emotions are positive or negative.

To give you an example, when asked by a financial analyst whether it is bad for the Swatch Group, and specifically its brand, Omega, that the Olympic Games have been postponed from 2020 to 2021 (because this is an important event for the brand), the CEO answered that on the contrary, the demand for those watches is now even bigger because these are the watches from the year when the Olympic Games didn't take place. Emotions react to the real world, and they never get weakened by it.

Going back to the 25 psychological tendencies that Charlie Munger lists in his essay, these act together and reinforce each other to create the attractive appeal of Swiss watches. Munger calls this the Lollapalooza effect — number 25 on his list. There are many other tendencies to analyze.

People not only have a natural tendency to like or dislike certain things such as watches, but they also like being liked, and they dislike being disliked. When a watch is given to us as a gift, it tells us that we are appreciated by another human being, something we all long for. I personally got my watch on my 30th birthday from a close friend of mine whom I like and admire, so I associate my watch with a great person and a great moment of my life. Memories and associations like that make every watch unique and add to its value. If you lose a watch that you love and you buy the same product again, it is not the same watch. It is not the same experience. The product does not generate the same emotions. That explains why a watch that was actually worn by an astronaut on the moon sells for a very different price from one that just relies on the story for marketing purposes, while the latter sells for a higher price than a watch that doesn't have a story to tell in the first place.

Furthermore, we not only like being liked, but we also like to belong to a group. Social proof is a powerful psychological tendency. When you buy a watch, not only do you have to like it, but the people you care about must also like it. Every watch brand appeals to a cultural niche, and in the case of Swatch Group, each of the 18 different brands appeals to a different social group.

The story continues: not only do we want to belong, but we also want to be unique. Status seeking is another powerful psychological force. Formulated more positively, it means that we humans seek to differentiate ourselves from our companions. Each one of us is special and unique, and we express this uniqueness with our own unique personal watches. Like many of the other psychological tendencies, status seeking has a clear evolutionary rationale, as we know from the famous peacock example. Watches, because they are so expensive, are a credible status signal. It is one of the most sustainable paradoxes that in order to be credible, a status signal has to cost, respectively it has to hurt somehow.

For a man, there aren't many luxury items to choose from, so watches have almost monopoly status in this regard. This helps explain the pricing power for watch sellers. A man doesn't like to save on gifts for his wife, and the same is true for a luxury item that he buys for himself. It would be inconsistent to be worth a lot as a human being but to save money when expressing that emotion. For example, the website of the Master Co-Axial Chronometer (the movement that is inside my watch) states: "Eight tests over 10 days … We've raised our standards. You can too." This sentence directly appeals to my excessive self-regard, and is an effective pricing strategy, which is further supported by other marketing techniques that, among other things, make use of famous people or other kinds of authorities that we like and admire.

Our natural tendency to be overly optimistic further supports us in concluding that we can afford the watch that we want, at least to a certain extent. The watch of our dreams may be out of reach, which increases its appeal to those who can afford it — the famous scarcity principle, or what Charlie Munger calls the deprival super-reaction.

Many watch purchases are impulse purchases, so the products need to be available in store, explaining to a large degree the capital intensity of Swatch Group's value creation, something which we will look at later, when analyzing the company's return profile.

I'll quickly go through a few more tendencies. Once we own a watch, its value increases further. This is called the endowment effect, and it may help explain why there are so many watch collectors all over the world. If we own a mechanical watch but do not wear it, then after a few days, it stops working. We must reset it before being able to use it again, which plays directly into our human tendency to either use something or forget about it.

So far, I have highlighted the bright side of watches, but there is also a dark side that I can summarize like this: envious people spend money they don't have on products they don't need. We need to maximize the good while minimizing the bad. Not every person who buys an expensive watch should be buying it.

The emotions that I have analyzed in detail underlie the Swatch Group's value creation.

They are hardwired into our brains and are therefore sustainable. They probably won't change. What may change, however, is how these emotions are expressed, and this leads us to the next part of the presentation.

You may have noticed that I haven't spoken of any functional value so far. You may ask whether smartwatches that are functionally more useful than traditional watches —unless you find yourself in a space shuttle without electricity — may pose a threat to the traditional watch industry. Smartwatches seem to compete with traditional watches in several respects. They show the time, are worn on the wrist, signify status, satisfy tribal instincts, and compete in the same price class as some lower-priced and even some quite high-priced Swiss watches. To the extent that smartwatches create emotions, I consider them substitutes to Swiss watches. Many people think that wearing such a watch is cool, and coolness is undoubtably an emotion that is also targeted by some watch brands, among them Swatch and Tissot, the latter of which just came out with its own smartwatch. However — and this is crucial — they seem to be like an additional watch brand that satisfies a specific kind of emotion — a functional kind of coolness rather than a game-changer for the whole watch industry.

To underline this conclusion, let me give you a thought experiment. In 2015, the Swiss watch industry sold around 28 million pieces for a total value of CHF 20 billion. I don't know the volume for 2014, but the total value exported was CHF 22 billion, CHF 2 billion more than one year later, so the volume numbers for 2014 must be similar to those in 2015. For the thought experiment, imagine that along comes a true substitute — a product that perfectly substitutes the emotions that are created by Swiss watches — and within five years, this substitute sells 30 million pieces per year — a higher number of watches than the traditional watch industry sold in total in 2015. In this scenario, how many traditional watches will be sold in 2019? The answer is not many. If the market demand is 30 million pieces and the perfect substitute sells 30 million pieces within a few years, we would expect the traditional industry to have almost vanished. However, in 2019, the traditional Swiss watch industry still exported around 20 million pieces, while Apple and other smartwatch producers additionally sold a much higher number of smartwatches. Nevertheless, 20 million in 2019 is much less than 28 million in 2015, so let's zoom in on the developments from 2015 to 2017.

The first striking observation is that the total volume decline in those two years, from 2015 to 2017, happened almost exclusively in the below CHF 200 price category. Why did the incremental 20 million Apple watches plus all the other smartwatches that came on the market in those two years, displace only around four million Swiss watches? Either the market size for Swiss watches almost doubled from 2015 to 2017 — an unlikely hypothesis, given the challenges to this industry, which I will talk about later — or the two products simply aren't true substitutes. I'm convinced that the latter hypothesis is true and that those two product categories aren't true substitutes. Why? Because the volume decline of exported Swiss watches can be explained by another factor. In 2015, the Swiss Central Bank decided to let the Swiss franc float freely against the euro, leading to significant cost inflation for Swiss watch producers. This probably explains a big percentage of the observed volume declines from 2015 to 2017. Many small watch producers simply cannot compete in the global market with the increased cost structure.

In 2018, Apple again sold around 20 million smartwatches, while the export volumes of the Swiss watch industry declined by only half a million, and less than one million in the lowest price segment. In 2019, Apple increased the volume of smartwatches sold from 20 million to 30 million pieces — an additional 10 million units on the market — while the Swiss watch industry exported only three million fewer pieces. Here again, the volume decline can be explained by another factor. Last year, the Swatch Group dissolved its partnership with Calvin Klein, reducing the number of exported Swiss watches by around two million pieces, explaining most of the volume reduction from 2018 to 2019 in the lowest price segment.

To sum up: adjusting for the two main factors that explain the decline in exported volumes of Swiss watches, the influence of smartwatches on the Swiss watch industry is limited, and the hypothesis that smartwatches are a perfect substitute for Swiss watches has clearly been falsified by the data.

However, corrected for these two factors, the export volumes in the lowest price segment still declined somewhat, and the Apple Watch and other smartwatches may have played a role in that development. After all, those products create emotions and are worn on the wrist, but the influence of smartwatches is much less pronounced than the press and journalists seem to think. Analyzing the press is outside of the scope of this presentation, but the terminal decline of the Swiss watch industry is a fascinating story that interests many people, and when journalists must choose between accurate reporting and generating clicks, we know the outcome. If you read these reports with enough attention to detail, you'll find statements such as the one made by the CEO of Tissot, in which he clearly says that smartwatches didn't affect the volumes of his brand. Furthermore, analysis of Apple's latest product launches indicates that Apple follows a different strategy from that of traditional watchmakers. The company sells hardware to support its software sales. Watchmakers, on the other hand, don't sell hardware. They sell watches.

We must also not forget that smartwatches may even create opportunities for traditional watchmakers, as the biggest enemy of the watch industry is people who don't wear anything on their wrists. This could change due to smartwatches, and that could significantly increase the market for Swiss watches. Furthermore, Tissot recently entered the market with its own version of a smartwatch, based on its own operating system, and I am keen to see how many of these watches are sold in the next few years.

Overall, the historical numbers tell a clear story. Before 2010, the Swiss watch industry had been a growth industry for many decades. From 2010 to 2015, there was stagnation in Hong Kong and slowing growth in China, but global growth continued. Since 2015, the industry has stagnated while Hong Kong has imploded, and China has resumed its growth trajectory. Without Hong Kong, the industry would have grown globally. Hong Kong was its biggest market, so the implosion in Hong Kong had a significant effect on the whole industry. Also, growth would have been on a smaller scale than we were used to historically.

While nobody knows the future, chances are good that this growth story will continue. Six months ago, I put up a post on my LinkedIn page showing a graph of Swiss watch exports since 1975, and I asked whether this looks like an industry in crisis. I doubted it. Today, six months later and despite corona, I still do.

To win in the future, the Swatch Group must win the battle for the mechanical movement, and the company has significant competitive advantages that will help it do so. Among other things, Swatch Group develops more than 200 patents each year compared to 24 developed by its biggest competitor last year. Regulations around the label “Swiss made” impose significant costs on producers, because a high percentage of their production must be located in this high-cost country, but it also offers access to the deep associations that international watch buyers have with this country.

The production of the Swatch Group is vertically integrated, with 90% of its value creation located internally, which differentiates it from many of its competitors that are more highly focused on marketing. Distribution, brand heritage, and marketing all play a major role in winning against the competition, and the Swatch Group has leading market positions in each of these dimensions, with significant growth potential. If 10 billion people inhabit this planet in 2050, and if 50% of them are adults, and 20% of these adults are interested in watches, and only 10% of them end up buying a watch every five years, we would arrive at today’s market size of around 20 million watches per year. There are many levers for the watch industry to increase this addressable market. Taking into account the Swiss watch industry’s ingenious marketing, its powerful brands, its heritage, distribution, and pricing power, and considering that human emotions won’t change over the next decades (because they are hardwired into our brains) and reacted very favorably in the past to Swiss watches, and considering that watches are culturally accepted everywhere, the Swiss watch industry seems to have a good chance of increasing its sales going forward, although the extent to which this market potential can be realized remains uncertain.

This takes us to our next question: how do we value the Swatch Group? Revenues have increased strongly during the past 30 years, from CHF 2 billion in 1989 to almost CHF 8 billion in 2014, but they did so in a highly irregular fashion and with several multiyear periods of stagnation and even decline. The current crisis led to a revenue decline at levels never previously experienced in the history of this company.

The Swatch Group follows a policy of consistent and reasonable price increases. This means that the price effect on revenues is consistent, and any irregularity in revenues must be explained by declines in volume. As a side note here, consistent price increases are important for watch buyers, because when you spend thousands or even tens or hundreds of thousands of francs on a watch, you must trust that these watches will keep their worth over time. This can only happen if the companies that sell those products have a reasonable and consistent pricing policy over long periods of time, and why certain practices, like giving rebates or radically changing pricing every year, are harmful for the industry in the long term.

I see four main explanations for the company’s irregular revenue pattern. First, the Swiss watch industry sells a small volume of products, and irregularity is normal when dealing with such small numbers. Last year, for example, only 0.7% of all people in the world bought a watch (assuming every watch was bought by a different person). Second, except for the most faithful collectors, most watch buyers don't buy a watch every year. They buy one every five to 10 years depending on economic and other circumstances. Third, many watches are bought by tourists, and they travel to where they can find the best deal. Because the Swatch Group does not have the same margin level in every country, and exchange rates differ between countries, the company's revenue and margin level is influenced by where customers buy watches. Last but not least, the Swiss franc doesn't develop linearly, which influences the level at which foreign revenues are translated in the reporting currency. This point is crucial when considering that 40% of the company's costs are in Swiss francs while more than 90% of its revenues are in a different currency.

The Swatch Group generated an average return on equity of around 14% during the past 20 years, with a clearly decreasing trend since 2014. The average price-to-book ratio during those 20 years was 2.5x, a valuation that is consistent with the average return on equity during that time considering the prevailing level of market interest rates. Let me explain this thought in a bit more detail. If I assume that the market rate of return in Switzerland during the last 20 years was, on average, around 6% per year, and if I assume that the company earns a return on equity of around 14%, then this company's market value should trade somewhere above 2x book value (14 divided by 6). Even though this calculation is somewhat oversimplified — among other things, it ignores taxes — this is an important point for investors. The market has valued this company rationally over the long term.

By now, we should be able to answer the question of why this company has been able to generate a significantly higher return than prevailing market returns — 14% versus 6%. We must also recognize that the Swatch Group was able to generate this attractive return on equity of 14% despite expensing most of its marketing and production costs in the income statement. Some of those costs build customer goodwill and pricing power and therefore should have been capitalized, increasing both the company's past return on equity and book value.

Looking at the performance of both the Swiss market index and the Swatch Group stock since the beginning of the millennium, we see that for the first time in the last 20 years, the Swatch Group stock cumulatively underperformed the Swiss market index. My guess is that the declining return on equity since 2014 is the main reason for this performance. This is quite worrying, but it could also indicate a rare and attractive buying opportunity. Therefore, the most important question is: how concerned should we be about the declining return on equity since 2014?

Let's now analyze the company's return on equity in more detail from 2015 to 2019. Revenues stagnated from 2015 to 2019, but as I've mentioned, the stagnating revenue development is not unusual for the company, and it happened three times in the last 30 years. It is important that the company doesn't invest too much capital in times of low growth because it is a capital-intensive company, and its value creation happens mostly internally and consumes a lot of capital. Rational capital allocation is important for this company and its shareholders. Otherwise, we would not see a lot of value creation going forward. I am comforted by the fact that the company's book value did not increase over the past five years when revenue stagnated. Since 2017, the company invested less in capex than the amount it depreciated in the income statement, explaining the high free cash flow conversion ratio of over 91% from 2015 to 2019, and 97% in the last three years. I must mention that I included in the book value the amortized and the impaired goodwill of past acquisitions, mainly of Harry Winston, as I consider those acquisitions to be well worth their purchase price — I don't agree with Swatch Group's accounting treatment of writing off this goodwill against equity.

The average return on equity in the last five years was a little over 6%, significantly lower than the average of the last 20 years (14%), but 6% is still much higher than what we can earn from an investment in 10-year treasury bonds in Switzerland, which currently trade at around -0.5% internal rate of return per annum for the next 10 years. This indicates a risk premium of almost 7%, and that the book value is worth the amount that has been invested in it despite the decreasing returns compared to previous periods. Overall, this shows that the company is still healthy, despite decreasing profitability trends.

That's not the whole story, however. Nick Hayek, Swatch Group's CEO since 2013, dislikes financial markets and analysts. While I understand his dislike for the short-term profit motives that are omnipresent in this ecosystem and that endanger long-term success, if a company underperforms an index over 20 years, that might tell you something that you wouldn't want to hear. You cannot honestly say that over 20 years, the Swatch Group's price development doesn't tell you anything about the real development of the company. While I understand the CEO's dislike for short-term stock market performance, I don't understand it when it comes to long-term stock market performance.

There are some worrying signs regarding capital allocation. If we look at the various brands which fall under the Swatch Group, the Swatch brand only generated around CHF 400 million of revenues in 2019 — much less than Omega, Longines, Tissot and Harry Winston. Despite being such a small brand for the company overall, the company recently built a new headquarters at a cost of CHF 220 million, of which CHF 125 million is for the Swatch brand. If I assume a profit margin before tax of 10% — a high estimate — that means the company spent more than three years of this brand's pre-tax profits to build its new headquarters. While the CEO often touts the benefits of this brand to the group, particularly the high industrial production numbers and the millions of units that give the group the manufacturing capabilities it needs to innovate and succeed with its other brands, these advantages must be quite substantial to justify this large expense. As an outsider, I have no data to evaluate this claim in any detail, so I have no choice but to trust the CEO. It would help if the CEO didn't dislike financial markets so much — that would help me trust him more. It also doesn't help that the company doesn't publish any kind of segment reporting for its different brands, which in and of itself could be saying something. Maybe they don't want us shareholders to know.

While I generally do trust Nick Hayek and his management team — after all, they've had an amazing track record for many decades and are significantly invested in this company (alongside other shareholders, they own 25% of the company) — it is no secret that Nick Hayek is emotionally attached to the brand Swatch and may have built the new headquarters for this reason alone. There was also the purchase of the Grieder Building on

Bahnhofstrasse in Zurich that the group made a few years ago for an estimated CHF 400 million. While both buildings are undoubtably highly admirable, the question is: why is the Swatch Group the best owner of them, and why did the company not use that CHF 600 million to either buy back shares or give it back to owners via dividends? The use of the phrase "Swatch empire" by management is particularly worrying. When listening to the CEO and his management team, I get the impression that they may be pursuing a higher purpose — some ideal that is worth more to them than simply generating profits. The problem is that the management team spent shareholder money to pursue this purpose — money that could either have been invested more profitably or paid back to shareholders. The CEO and his family only own 25% of the company, so the other 75% is owned by outside shareholders that may not share the family's taste for beautiful buildings. Disregarding Mr. Market's short termism is one thing that I fully understand, but putting one's own taste ahead of the interests of others while paying for things with their money, is a different thing. I consider the former a true strength of the company, and the latter as somewhat worrying for shareholders.

There are also many significant positives that counterbalance those negatives. First and foremost, the CEO and his community of peers bought additional shares for CHF 167 million in the middle of this crisis. This is a significant investment that provides strong evidence that they fully believe in this company. While the company faced a revenue decline of more than 50% in the first half of 2020, it still generated positive operating cash flow and still has a high equity-capital ratio and significant cash in its balance sheet, showing that it is robust through difficult times.

If we look at Dupont's analysis of return on equity, it becomes clear that the driver of the past decline in return on equity is the net profit margin. Leverage ratio and asset turnover were on quite a stable path and decreasing slightly over many decades. Leverage is low because the company doesn't use much bank debt. Asset turnover decreased because, first, they own more stores, and second, they bought Harry Winston which sells very expensive items that it needs to have available on inventory, because if you buy a luxury item for CHF 500,000, you don't want to wait for it to be delivered. You want to buy it right there and then, so it has to be available on inventory.

If I insert a trendline into this analysis, it shows that if the net profit margin reverses to the long-term trend, the return on equity will more than double from last year's level of a little more than 6% to around 13% to 15% — its long-term mean. For this to happen, the company's revenues must increase significantly from today's depressed levels and revert to the long-term growth rates.

One of the biggest questions regarding an investment in Swatch Group is whether a reversion to the mean is probable or whether we must assume permanently lower returns going forward. In my opinion, as you can guess by now, there are several reasons to believe that the long-term growth trend of Swiss watches will continue.

As I discussed before, past revenues developed in a highly irregular fashion. Stagnation and even decline over many years is not unusual, so why should it be different now? Smartwatches are not the threat that they are commonly perceived to be, and the emotional apparatus of us humans, which reacted so favorably to Swiss watches in the past, will not change. Also, due to the corona crisis, the Swatch Group laid off 2,500 employees, saving structural costs of around CHF 300 million, equating to around 2.5 percentage points on equity. This means that with the current cost structure, the return on equity in the last five years would have been 8.8% rather than 6.3%. Importantly, these layoffs do not affect the well-functioning parts of the group, but the partnership with Calvin Klein and the stores in Hong Kong, which were already deteriorating before corona. Past inefficiency, ironically, allows the company to cut fat now without reducing its earning power going forward.

There are also encouraging trends in geographies and places where the forced lockdowns have ended. This increase was much stronger in its own stores than in wholesale, showing that there is healthy consumer demand. Wholesale channels always lagged the company's own distribution channels because they need to clear their inventories before investing in new products. Despite all this, there is no guarantee that we will see a reversion to the long-term mean in the company's revenues and net profit margin. It is possible that the return on equity has deteriorated permanently from historical levels. Many bank reports that I've read in the last few years have argued that the Swiss watch industry — and especially the Swatch Group, with its focus on asset-intensive industrial production— suffers from excess capacity. If that is the case, shareholders will have a difficult time going forward.

Swatch Group generates a return on equity that is much higher than what we can earn from investing in Swiss treasury bonds, and likely higher than what we can earn from investing in the Swiss stock market. If the past revenue development resumes its growth trajectory, this return on equity will increase significantly.

The company currently trades below book value. This is valuable book value. The return on equity indicates value, while it may significantly increase. You can currently purchase the company at a discount to this book value, while it should maybe trade at a substantial premium. The book value includes around CHF 4 billion of sellable assets. If you subtract that from the market capitalization of around CHF 11 billion, you get to CHF 7 billion, and that is only 10x the depressed free cash flow average from 2015 to 2019. If you assume normalized free cash flows and you subtract the sellable assets from the balance sheet, you get to a price earnings of not even 5x. If you take the whole market cap, it's not even 7x price earnings based on normalized free cash flows.

Clearly, if the demand for watches vanishes, this is still expensive — the economic value of a watch in inventory that cannot be sold is zero — but I think watches will be in high (though certainly fluctuating) demand in the next decades. Therefore, Swatch Group currently seems enormously undervalued.

I'll end this presentation with a few words on the biggest risks. As the CEO said in a recent interview, "I am astonished how many products the competition sells with pure marketing." While he may be right, this leads to the question: what does that tell us about consumers? Do they really care about what is inside a watch, or do they simply care about marketing? If they only care about marketing, the Swatch Group has a huge problem with its capital-intensive production base employing 35,000 people. While there are certainly both kinds of customers out there, I think many do care, especially the collectors. Over time, the qualitative differences in the production quality will compound, leaving a huge gap between marketing-focused companies and the Swatch Group. Without vertical integration, it is much more difficult to achieve a close fit between a product and its marketing story, giving Swatch Group a further significant competitive advantage.

A much bigger risk in my eyes is China. One-third of Swatch Group's revenues are generated in this region, and I can imagine a world where the Communist Party doesn't allow people to express their emotions through luxury items. After all, doesn't that contradict the communist spirit? I am not an expert on this topic, but it is a risk I see — not probable but certainly possible. Right now, it doesn't look to be going that way, as we can see from the tax-free zones and reduced luxury taxes, among other things.

The Swatch Group does not sell many watches in India despite the country being home to 1.5 billion people. If that is because the country is mostly poor, that should change over time, and India should develop into a significant market for the Swatch Group. If it is because Indian consumers don't like watches, that would be a different story. India does have a rich tradition when it comes to gold and other luxury items. Many rich people from India buy Swiss watches, but outside of the country because of complicated bureaucratic rules that hinder business in India. Until that changes, India will remain below its potential.

Last but not least, a few years ago, the CEO of Swatch Group announced an innovation: a battery based on the material vanadium that may be more efficient than traditional lithium ion batteries and may have some additional advantages, such as shorter charging cycles and increased safety. There is no current news on this project and our investment thesis does not depend on this value being realized, but there may be some significant option value hidden inside of this company.

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

John Mihaljevic: I'd like to ask about the competitive landscape within the Swiss high-end segment, since it seems like the high end is the place to be, where the emotions are strongest and so forth. Can you talk a bit about the positioning of Swatch Group brands versus other high-end Swiss brands?

Weber: I partly addressed that question with the fact that the production capability of Swatch Group is by far the best compared to all the other companies. Rolex is the most serious competitor to the Swatch Group, and I don't know what their production capabilities are. There's also Patek Philippe, but that's quite a small company competing mostly against the Breguet brand. If you house 35,000 people and half of them are in production, that's about 17,000 people, some of whom can make products that are valuable and quite rare. Those skills are rare. Because Swatch Group doesn't get rid of employees in tough times, it keeps those skills alive and within the company. That enables the company to produce top-quality and expensive watches. Also, we shouldn't underestimate the attractiveness of the lower-priced watch segments. Tissot is a significant brand for the Swatch Group, with great margins. I estimate that the operating margins for Tissot may be well above 20%. Those are also attractive products. For many Chinese people, Tissot is a luxury item. We should not underestimate that for hundreds of millions, or even billions of people, Tissot is a luxury Swiss watch. The Swatch brand may also be much more attractive in the future once it sells more on the internet with lower costs compared to traditional retail channels.

As I said, many competitors in the high-priced segments focus a lot on marketing, but once consumers look beyond the marketing, they will see stark qualitative differences. For example, last year or two years ago, a competitor flooded the market with watches, and then there was the crisis in Hong Kong and some terrorist attacks in Europe, and that company bought back their watches from the retailers and destroyed them. How can you credibly promise your customer long-term value creation if you buy back and destroy your own watches? You need to be consistent. You need to have a solid pricing strategy for many decades. Many of the marketing-focused competitors also give rebates and change their pricing erratically. If I buy an expensive watch today, and two weeks later it's 10% cheaper, and two years later, it's 30% cheaper, I feel cheated. If you cheat your customer, that's not a recipe for success.

Mihaljevic: What would you like to see on the capital allocation front here, given the balance sheet and everything else you mentioned?

Weber: I would like them to invest whatever they can, but invest it profitably. Instead of buying buildings, which is a low-return asset, allow shareholders to invest the money that they receive via dividends in any way they want. The Swatch Group should focus on what they do best, which is producing, marketing, distributing, and selling watches. They shouldn't invest money in assets that offer a lower return than their core business, rather than paying everything out to shareholders. They generate a lot of excess cash, and that excess cash will increase once the growth trajectory returns. If the company somehow associates paying out the money with not being entrepreneurial, and instead invests it into low-return buildings or other low-return opportunities, then that has a significant effect on the company's value creation, and also on its market capitalization. It would be a pity if the Swatch Group doesn't earn the market capitalization that it deserves because it doesn't reinvest its excess cash profitably.

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 and providing patient capital to SMEs with the overall aim of fostering productive investments in Switzerland and Europe. To achieve the latter, he founded the SW Kapitalpartner GmbH (www.swkapitalpartner.com). Samuel holds a master's degree in strategy and international management from the University of St. Gallen.