ValueInvestor INSIGHT
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Investor Insight: Lucerne Capital

Despite not often having the wind at his back as an investor, Pieter Taselaar has done just fine, thank you, by mining mispricings among European mid-caps.

INVESTOR INSIGHT

Lucerne Capital Management
Thijs Hovers (*l*) and Pieter Taselaar (*r*)

Investment Focus: Seek solid, high-return companies in the process of stepping up their games in ways that the market doesn't appear to sufficiently recognize.

Given the secular backdrop in Europe since he founded Lucerne Capital Management in 2002 to invest there, you might expect Pieter Taselaar to regret that going-in choice. But that's not at all the case. "We're not investing in Europe to be in Europe, we're investing in Europe because we know it well and we think it's inefficient," he says. "That's how we generate returns."

And generate returns he has. His long/short Lucerne Capital Fund, now with $750 million in assets and co-managed with Thijs Hovers, has returned a net annualized 11.2% since inception, vs. 1.2% for the STOXX Europe 600 Index. At a time when investor enthusiasm for European stocks is particularly low, they're finding upside in such areas as wireless towers, mining equipment, banks and diversified industrials.

You started your firm 17 years ago to take advantage of what you saw as inefficient pricing in European mid-cap stocks, and you're still doing the same. One might think some of that inefficiency would have been competed away by now.

Pieter Taselaar: A lot has changed, but the old sources of inefficiency are still there and there have been new ones since. One underlying cause of inefficiency is that public equities are just not as popular with institutional or individual investors in continental Europe. If you look at total market capitalization as a percentage of GDP in countries like Germany, France and the Netherlands, it's about half of what it is in the U.S. The lack of a big equity culture has always made stocks at the margin less well followed, particularly when you get past the biggest companies.

If you look at European equity-index returns since we started, they certainly wouldn't inspire increased enthusiasm for equities there. Europe has structurally lower growth, causing many investors to avoid it, and fund flows out of Europe into the U.S. have only increased in recent years. That adds to our opportunity. Europe represents 25-30% of world GDP, and per-capita GDP levels in many countries are similar to the U.S. There's a lot going on, with well-run companies with excellent regional or global franchises. We say that allocating capital to Lucerne is not a bet on Europe, but provides exposure to a handful of world-class, well-researched companies that happen to be domiciled in Europe and might be mispriced as a result.

Thijs Hovers: The changing regulatory environment has also impacted research coverage. [Note: The revamped Markets in Financial Instruments Directive, which went into effect at the beginning of 2018, requires fund managers to pay separately for investment research that previously had been provided for free when bundled with other brokerage services.] Even three years ago we'd see maybe 13 or 14 analysts on a €3 to €5 billion market-cap company, but that number today has probably halved. We also believe the quality and experience level of the analysts has declined, which affects the research as well.

Another change since Pieter started the firm is in the money that's moving into passive, quant and short-term liquidity products. The percentage of total equity trading in Europe from fundamental, single-stock volume is around 10%. As a result, we're seeing more volatility driven by macro headlines and tweets. Dealing with that can be a challenge, but also an opportunity for fundamental investors with a longer-term horizon and investor base.

Within your target opportunity set, what kinds of companies attract your interest?

TH: We have a fairly comprehensive screening process that on the long side helps to identify high-return companies with good reinvestment opportunities and cash flow and that are also attractively valued. We look for things like solid organic growth that is showing up in the top line and in earnings before interest, taxes, depreciation and amortization [EBITDA]. We want to see decent pricing power reflected in improving gross margins. We're looking for cost bases that are growing less quickly than gross profits and for returns on invested capital that are solid and trending upwards.

At the same time, we want to see low capital intensity and evidence of good capital allocation, with optimized balance sheets and excess cash preferably being used to buy back stock. Finally, as a first pass at valuation, we look at multiples like EV/EBITDA relative to the company's own history. We also want to see free-cash-flow yields that are positive and growing.

PT: Ideally these are companies that can compound value at 15-16-17% just by growing their cash flow and reinvesting it in the business or buying back stock. If you buy them at a discount to intrinsic value, your IRR over three to five years can be 20%-plus. Things don't always play out in a linear fashion but we can benefit from maintaining a longer-term perspective.

What types of things are going on that contribute to these higher-quality companies not being appreciated by the market?

TH: TKH Group [Amsterdam: TWEKA] would be a good example. Over a number of years the company has transformed itself through R&D and select acquisitions from basically a producer of industrial cable to a broader supplier of high-end technology solutions for applications like machine vision, tire manufacturing and parking systems. Since 2007 its EBITA has grown at 10% per year and its return on invested capital has doubled, to more than 25%.

While that's gone on, the company has become more complicated to understand, it still has legacy businesses that don't really fit, and management hasn't done a great job in articulating its story to the market. As a result it's been relatively hard for the market to discover it and the stock has chronically traded far below peer multiples. We were here early and saw the change going on and the potential impact. You have to be patient, but we think management is strong and the value they're creating will be recognized sooner rather than later.

PT: The wireless-tower business is maybe another example of the type of area we discover before the market does. The tower business in Europe is at least ten years behind where it is in the U.S. The leading independent, Cellnex [Madrid: CLNX], went public only in 2015 and with a nearly €10 billion market cap is now starting to be recognized by the investment community. We knew the positive dynamics of the business well from the U.S., as telecom operators sold off their tower portfolios to independent companies that could run them far more efficiently and with high incremental profitability as new tenants were added to existing towers. We didn't buy Cellnex at the IPO, but got in below the €14 IPO price in early 2017 when the stock fell into the low-teens. [Note: Cellnex shares now trade around €33.75.]

We now see much more opportunity in what we think will be the next important player in the market, which has a longer name [Infrastrutture Wireless Italiane] but is known as Inwit [Milan: INW]. This was spun out of Telecom Italia, also in 2015, but is around €5 billion in market cap and isn't very well followed by the investment community. The big news with it is that it is in negotiations with Vodafone to merge the two companies' tower assets into Inwit, which we believe will produce a step-change in the company's earnings, growth profile and corporate governance. We don't think the market is recognizing any of that and, post deal synergies, the stock trades at around 16x EV/EBITDA. For comparison, Cellnex trades at 21x and the U.S. tower companies such as American Tower trade at 25x-plus.

You've written about expanding your research efforts in technology. Is that a fertile area for ideas in Europe?

PT: It's true that when people think of Europe they don't think of tech. There aren't really the mega-cap tech giants you have in the U.S., and what is here usually has an industrial aspect to it, say related to semiconductor manufacturing, like BE Semiconductor or ASML Holding, or to industrial design and development, like Dassault Systemes.

Among mid-caps in Europe there is actually an attractive subsector of niche software businesses with market-leading positions in certain verticals. One in which

Thijs Hovers, Pieter Taselaar

Benign Neglect

As a senior managing director based in New York responsible for selling Dutch bank ABN AMRO's European equity research in the late 1990s, Pieter Taselaar zeroed in on what he thought was a great opportunity: to start a long/short hedge fund focused on mid-sized companies in continental Europe. "Investor interest in these companies was low and I thought the price anomalies were high," he says.

With seed funding from ABN AMRO, Taselaar in 2002 started Lucerne Capital Management to take advantage of those anomalies, which he believes are as prevalent now as they were then. Continental Europe still doesn't have nearly the equity-investing culture of the U.S. or the U.K., he says, and the weak long-term performance of equities there has further dampened investor interest. As in the U.S., money flowing into passively managed funds doesn't value fundamental company research. On top of that, new regulations to unbundle investment brokerage charges for research and transactions have resulted in steep declines in third-party research budgets. "Markets are always changing, of course, but if anything we'd argue there's more inefficiency in mid-cap European equities than ever," he says. "Maybe that's surprising, but it works to our advantage."

we established a position earlier this year is Aveva Group [London: AVV], the global market leader in engineering and industrial software for the energy and chemicals industries. The company in its current state was formed in 2017 when it merged with the software business of Schneider Electric, the French electric-components manufacturer. We think they're just starting to realize the potential top and bottom line synergies from the combination. The market is starting to take notice, but we believe if we're right about the growth potential that the multiyear equity IRR from here is still quite attractive.

You've also written about private-equity firms becoming more active in Europe. Is that a potential catalyst on the upside?

TH: One theme we do expect to develop this year is for financially astute buyers to increasingly try to take advantage of severely depressed public valuations. That isn't always great news. At the end of last year CVC, the global P/E firm, made an all-cash bid to reacquire Ahlsell, a Swedish construction-products distributor we owned that it had taken public only two years before. While the offer was at a 32% premium to the then share price, the stock had been weak prior to that and even including the premium CVC only paid about 8x EBITDA. On a six to 12 month view, it was a horrible trade for us.

PT: This theme is a talking point with a number of our companies that generate a lot of cash but don't use it as effectively as they should to maximize shareholder returns. To that end, TKH, which we spoke about earlier, just held a well-received capital-markets day to announce plans to simplify its corporate structure, get out of a number of legacy businesses and reinvest capital in higher-growth verticals.

For another of our portfolio companies, Intertrust [Amsterdam: INTER], we actually spoke at their recent annual meeting to make our case that they address what we think is a ridiculously low equity valuation by instituting a new and predicable capital-allocation framework that emphasizes share buybacks and selective M&A to build out its trust and corporate-services business lines. One message in all these cases is, "Keep doing what you're doing to grow the business organically and generate cash, but beware that if you aren't proactive about capital allocation and investor communication, you might be vulnerable soon yourself." That helps increase the sense of urgency.

ON SHORT IDEAS TODAY:

More than one owns shopping centers with tenants under threat from increased Internet penetration in retail.

What's attracting your attention these days on the short side?

TH: Broadly speaking, we look within our same European opportunity set for mirror images of our longs. That means companies with structural headwinds, declining growth, weak pricing power, declining returns and demonstrably poor capital allocation. Examples of that we've been short for some time are the publicly traded postal businesses like Osterreichische Post [Vienna: POST] or Royal Mail [London: RMG]. Given the structural issues with these businesses, it's very difficult long-term to see how they're going to generate cash flows.

PT: We put a lot of emphasis on digging below the surface to determine how a company is generating what might appear to be attractive revenue and operating-profit growth. When that growth comes at the expense of cash flow or returns, that can signal a good short idea. One recent example of that would be Victoria [London: VCP], a manufacturer of carpeting in the U.K. Its EBITDA has been growing quite nicely in recent years, compounding at around 15% per year. But if you dig deeper, you see that in order to generate that growth they're using so much capex, working capital and increased debt that the cash flow to shareholders over the past several quarters has been decreasing quite rapidly. They're just throwing more money at a declining-return business. Because we're consistently running screens on this type of thing, we think we can pick up on it at times before the average analyst or buyside person does. [Note: After hitting a multi-year high of nearly £9.00 per share in May of last year, Victoria shares currently trade at around £5.00.]

We see you have a few real estate-related shorts in your portfolio. Can you describe the general thesis there?

Jaap Pannevis: These are generally structural shorts of companies that we believe have deteriorating business models. Look at Wereldhave [Amsterdam: WHA], which owns what they call "convenience shopping centers" primarily in the Netherlands, France and Belgium. These are basically local shopping centers with tenants under varying levels of threat from increased Internet penetration in retail. That's putting rental income under pressure, which is a problem for a leveraged business where rent is the only source of revenue.

People seem to think the stock is cheap because it has a very high dividend yield of just over 10% and trades at a big discount to net asset value. But we believe the assets on the books today are significantly overvalued, free cash flow is in a state of perpetual decline, and the stock trades at a premium to private market value based on recent M&A. We expect as the real estate gets revalued that the company will be forced to cut the dividend or raise capital, or both. We think it's a melting ice cube.

Turning back to some longs, describe your case for Epiroc [Stockholm: EPI.A].

JP: The company, formerly the mining and rock-excavation division of Atlas Copco [Stockholm: ATCO], was spun off a year ago this month. I'd argue Atlas Copco is the highest-quality industrial company in the world, and Epiroc was its fastest-growing division over the past 15 years.

Management concluded its main compressor business and the mining division would each be better off with dedicated leadership making independent capital-allocation decisions.

Epiroc provides equipment for hard-rock drilling, such as underground excavation of copper or gold. It and Sandvik, which is also based in Stockholm, control 80-90% of the hard-rock business globally and as a result benefit from strong pricing power and earn very high returns on capital – around 40-50% in Epiroc's case.

One-third of the business comes from selling the drilling equipment, and two-thirds is in aftermarket service and spare-parts supply. The original-equipment business can be volatile, tied to miner capital spending, but the service business is very stable and has grown at a 10% compound rate for more than a decade. Service revenues tend to track the actual ore output from mines, which tends to grow at a consistent low-single-digit rate every year.

Other aspects of the business we like include that the company's reputation for quality and safety is a high barrier to entry for competitors. If you're running a mine, the last thing you want is for your equipment to break down or for it to cause a safety issue. You go with the high-quality provider and are more focused on increasing productivity, which is what Epiroc's tools are built to do. We also appreciate the asset-light structure of the business model. The company focuses primarily on product development, design and assembly, leaving much of the heavy manufacturing to suppliers. That reduces capital intensity, provides flexibility to respond when demand goes up and down, and helps drive those high returns on capital.

Do you have an opinion on where we are in the mining capital-equipment cycle?

JP: We like the mining cycle here. The big miners have come through a boom and bust cycle and today have strong balance sheets and generate a lot of cash. From a depressed level – global annual mining capex peaked at $140 billion, fell to $60 billion, and is now about $70 billion – we're seeing a pickup in spending and expect that to continue for some time. That would obviously be a tailwind for Epiroc.

How cheap do you consider the shares at today's price of 97.50 Swedish kroner?

JP: The stock trades at 11x EV/EBITA on our 2020 estimates, a valuation we don't believe reflects the earnings potential of one of the higher-quality industrial businesses out there. Similar businesses, including Atlas Copco or the big elevator companies which also have a very high service component to their earnings, trade at EV/EBITA multiples closer to 15x.

If we assume the historical annual revenue growth rate of around 8% – also the company's target – and some improvement in operating margin as management finds cost efficiencies in the stand-alone entity, we think operating profit over the next few years can increase at a rate of 10%-plus. That would translate into 15% annual growth in free cash flow and a similar IRR for us on the equity if there's no re-rating. There would be further upside if the market better appreciated the story and the stock re-rated to peer levels.

When this was spun out, it was done

INVESTMENT SNAPSHOT

Epiroc
(Stockholm: EPI.A)

Business: Global manufacture and sale of equipment and related consumables used primarily for drilling and rock excavation; spun off from Altas Copco Group in mid-2018.

Share Information
(@6/25/19, Exchange Rate: $1 = 9.29 SEK):

Price	**SEK 97.50**
52-Week Range	SEK 72.44 – SEK 105.92
Dividend Yield	2.1%
Market Cap	SEK 115.61 billion

Financials (TTM):

Revenue	SEK 39.84 billion
Operating Profit Margin	20.6%
Net Profit Margin	14.4%

Valuation Metrics
(@6/25/19):

	EPI.A	S&P 500
P/E (TTM)	20.6	22.8
Forward P/E (Est.)	18.6	17.8

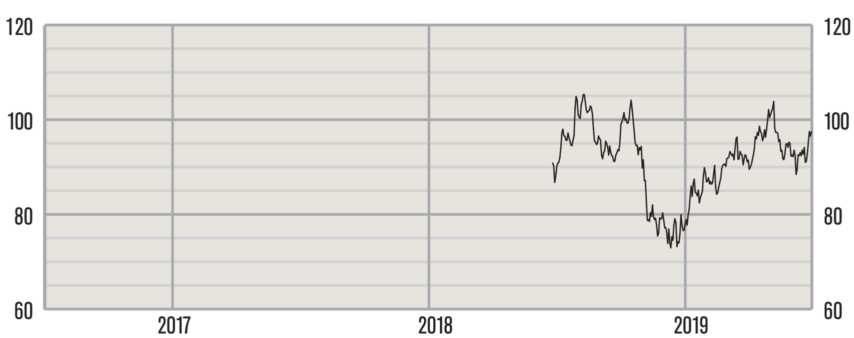
Largest Institutional Owners
(@3/31/19 or latest filing):

Company	% Owned
Alecta Pension Insurance	3.0%
Norges Bank Inv Mgmt	2.8%
Swedbank Robur Fonder	2.4%
Vanguard Group	2.1%
Harding Loevner	1.8%

Short Interest (as of 5/31/19):

Shares Short/Float	n/a

EPI.A PRICE HISTORY



THE BOTTOM LINE

The company is well positioned to capitalize both on its newfound status as an independent firm and on a favorable turn in the mining capex cycle, says Jaap Pannevis. Even if depressed valuation levels persist, he thinks the shareholder return from today can at least match the 15% medium-term growth in annual free cash flow per share he expects.

Sources: Company reports, other publicly available information

on a 1:1 basis and there was hardly any of the type of marketing to the investment community that often goes on. They didn't create overly optimistic expectations, I'd actually say to the contrary. They plan for the most part to let the results speak for themselves, and we believe they will.

Explain in more detail the upside you see in Italian tower-company Inwit.

JP: As Pieter mentioned, Inwit announced earlier this year that it planned to merge with the comparable business in Italy of Vodafone. The result will be the largest and best tower portfolio in the country, with a total of about 22,000 towers.

I should say up front that the merger agreement hasn't yet been signed, so there isn't complete certainty it will close or on the final terms. We're confident all will go as planned, and imagine one reason the stock is inexpensive is that the market is waiting for the deal to be finalized.

Inwit, after the deal, will be the fastest organically growing tower company globally, capable of increasing EBITDA at 12-15% annually over the next five years. That will be driven by the normal tenancy additions for 4G network densification, by cost synergies in combining overlapping towers, and by the planned rollout of 5G technology by both Telecom Italia and Vodafone using Inwit infrastructure. Cable is not highly penetrated, so there's a more aggressive rollout plan for 5G in Italy than you'll likely see in other countries.

We also expect a step-change improvement in corporate governance. Telecom Italia has been the majority owner since Inwit's IPO, but post-deal it and Vodafone will each own around 30%. That to us signals a more independent company, with management focused clearly on maximizing the value of Inwit as a standalone entity. That's particularly important as the new Inwit will have the size and ambition to follow in Cellnex's path as a consolidator of European towers.

The shares have done quite well since the beginning of the year. At €8.60, how are you looking at the potential from here?

JP: Pre the deal, Inwit has been running with a net-cash balance sheet, in large part because it has been consolidated on Telecom Italia's financials. After the deal we expect it to re-lever to closer to the 5-6x net debt to EBITDA level at which most similar companies operate. So the 12-15% EBITDA growth we expect, now on a more levered balance sheet, should translate into high-teens annual growth in free cash flow per share.

As Pieter also mentioned, the stock trades at a material valuation discount to where Cellnex trades today. If we assume some re-rating, to say 20x EV/EBITDA, we believe that plus the free-cash-flow growth can translate into an equity IRR of at least 20% over the next three to five years.

Describe more fully the transformation you're betting on in TKH Group.

JP: The company today now organizes itself around growth verticals, such as fiber-optic networks, machine vision and tire-build systems that are growing organically at 10%-plus per year, and its traditional cable and connectivity businesses, which

INVESTMENT SNAPSHOT

Infrastrutture Wireless Italiane
(Milan: INW)

Business: Milan-based owner and operator of approximately 11,000 wireless communications towers located mostly in Italy; partial spinoff from Telecom Italia in 2015.

Share Information
(@6/25/19, Exchange Rate: $1 = €0.88):

Price	**€8.58**
52-Week Range	€5.87 – €8.69
Dividend Yield	2.5%
Market Cap	€5.15 billion

Financials (TTM):

Revenue	€377.8 million
Operating Profit Margin	53.1%
Net Profit Margin	36.2%

Valuation Metrics
(@6/25/19):

	INW	S&P 500
P/E (TTM)	37.6	22.8
Forward P/E (Est.)	29.6	17.8

Largest Institutional Owners
(@3/31/19 or latest filing):

Company	% Owned
Threadneedle Asset Mgmt	4.8%
Artemis Inv Mgmt	3.2%
Norges Bank Inv Mgmt	1.9%
Azimut Capital Mgmt	1.7%
Vanguard Group	1.1%

Short Interest (as of 5/31/19):

Shares Short/Float	n/a

INW PRICE HISTORY

THE BOTTOM LINE

If the company's pending merger closes as expected, Jaap Pannevis believes it can increase EBITDA 12-15% annually through increased network densification, new technology adoption and cost savings. If the shares also re-rate somewhat toward peer levels, he thinks that can result in an equity IRR over the next three to five years of at least 20%.

Sources: Company reports, other publicly available information

grow more or less in line with GDP. Over a long transformation period, the growth businesses now account for just over 50% of total revenues and management has formally committed to take that to 80-90% within three years. Part of that will come from continuing to invest in organic-growth capex, which has at times been at the expense of near-term profitability, and part from a recently announced effort to dispose of roughly half of the traditional business lines.

What do they do in something like building tires that offers growth potential?

JP: This is a good example of the type of thing TKH is good at. They have developed an end-to-end system to manufacture tires that is basically taking share from in-house systems of the large global tire manufacturers. The big tire makers value TKH's state-of-the art technology and the operating-expense savings that can come from outsourcing various elements of the production process. The growth is driven by increasing market share rather than by relying on rapid end-market growth.

In an area like machine vision the company has to have state-of-the-art technology as well, but it also benefits from the increased use of optical systems by a wide range of manufacturers looking to make their production processes more efficient. They operate in somewhat different niches, but this business is similar to that of Cognex [CGNX], which is better known in the U.S. In general, we think TKH's machine-vision business can grow at a 15-20% rate over multiple years as the penetration of the technology increases.

Given that the stock popped 10% after management's capital-markets-day presentation earlier this month, we take it they're trying to do a better job of telling the story.

JP: This is something we've tried to stress to management for some time. We consistently hear from other investors that the company is too complex and difficult to understand. They did a fairly good job at the recent meeting in targeting specific asset sales and in setting more concrete goals for revenue growth, margins and return on capital. It was an effort to show how committed they are to shareholder value creation and it seemed to have a positive effect.

What upside do you see in the stock, now trading at around €53.50?

JP: Businesses like this with 8% or so organic revenue growth, strong operating leverage and very good incremental returns tend to trade at higher multiples, say 20x earnings and 15x EBITA. Because the story here is still playing out and the stock still isn't particularly well covered, it trades today at 15x forward earnings and around 11x EBITA.

We expect revenue growth and operating-margin expansion to result in 15%-plus annual growth in free cash flow over the next three to five years. Add to that the free-cash-flow yield of about 6%, and we'd expect to earn at least a 21% annual return on the stock. But we also think as the business mix and return profile improve that our exit multiple will be higher than today's level. If we're right, that would likely push the IRR over 25%.

INVESTMENT SNAPSHOT

TKH Group
(Amsterdam: TWEKA)

Business: Industrial conglomerate providing technology and systems in four core areas: vision and security, mission-critical communication, connectivity and smart manufacturing.

Share Information
(@6/25/19, Exchange Rate: $1 = €0.88):

Price	**€53.40**
52-Week Range	€38.36 – €56.65
Dividend Yield	2.6%
Market Cap	€2.24 billion

Financials (TTM):

Revenue	€1.63 billion
Operating Profit Margin	8.8%
Net Profit Margin	6.7%

Valuation Metrics
(@6/25/19):

	TWEKA	S&P 500
P/E (TTM)	20.8	22.8
Forward P/E (Est.)	15.3	17.8

Largest Institutional Owners
(@3/31/19 or latest filing):

Company	% Owned
Allianz Global Inv	9.9%
Teslin Capital	5.0%
ASR Nederland	4.3%
NN Inv Partners	3.0%
Lucerne Capital	3.0%

Short Interest (as of 5/31/19):

Shares Short/Float	n/a

TWEKA PRICE HISTORY

THE BOTTOM LINE

The market has been slow to appreciate the company's successful and ongoing transformation toward higher-growth and higher-return business lines, says Jaap Pannevis. He believes with some valuation re-rating that the 15%-plus annual growth in free cash flow he expects over the next three to five years can translate into a 25% IRR on the stock.

Sources: Company reports, other publicly available information

Banks are few and far between in your portfolio. Why are you high on the prospects for Austria's Bawag [Vienna: BG]?

JP: It's fair to say we don't particularly like banks in Europe. We find very few that we believe can generate returns in excess of their cost of capital.

That said, we do like Bawag, which is smaller than the giant banks in Europe and focuses on specific niches – namely lending to German small and medium-sized companies and providing personal loans to private individuals in Austria – where it has consistently earned solid returns. Last year the company earned a 17% return on equity, two to three times the return of most banks in Europe. In addition to picking out profitable niches, the corporate culture is also very focused on costs. The cost/income ratio target – which they consistently hit – is less than 40%, quite a bit lower than other European banks.

The company has a somewhat checkered past, having almost collapsed in the mid-2000s due to a commodities-trading scandal at an affiliate. We assume the impacts of that are well past.

JP: Following that, Bawag in 2007 was sold to a U.S. investment group led by Cerberus Capital Management and GoldenTree Asset Management. Under their ownership the business was streamlined and very much put on a more solid foundation. It came public again in 2017 and we think continues to distinguish itself as one of the continent's best-managed and most conservatively capitalized banks.

Are you counting on any changes in Europe's dismal interest-rate environment?

JP: Not to any real extent. Bawag management has shown that it can operate in this environment and still keep net interest margins at a healthy level. If interest rates ever did go up, we calculate that every 100 basis point increase would be 15% accretive to the company's EPS. But that's very much free optionality that we don't take into account in our investment thesis.

How are you looking at valuation with the shares trading today around €36.50?

JP: The stock today, for a bank earning a 17% ROE, trades at only 1x book value and at 7x our estimate of 2020 earnings. U.S. banks with very similar return and profitability characteristics would trade more in the 11-12x P/E range.

So part of our thesis is that the stock deserves to re-rate, but we probably wouldn't own it just for that. Now comes the interesting part. Bawag is currently in the regulatory process to gain approval from the European Central Bank for a large share-buyback program. We're confident it will get the approval and the potential to shrink the share count is quite significant.

The company earns roughly 250 basis points on its Tier 1 capital above what it needs from a regulatory standpoint, which is 12%. Management has committed to returning all of that excess capital to shareholders in dividends and share buybacks. On a market cap today of roughly €3.6 billion, they're looking this year to pay €200 million out in dividends and buy back €400 million worth of shares. And they can do this every year. So just from

INVESTMENT SNAPSHOT

Bawag
(Vienna: BG)

Business: Commercial bank providing products and services – through branches and online – to retail, small-business and corporate customers primarily in Austria and Germany.

Share Information
(@6/25/19, Exchange Rate: $1 = €0.88):

Price	**€36.60**
52-Week Range	€34.08 – €45.22
Dividend Yield	0.0%
Market Cap	€3.62 billion

Financials (2018):

Revenue	€1.17 billion
Operating Profit Margin	48.9%
Net Profit Margin	37.3%

Valuation Metrics
(@6/25/19):

	BG	S&P 500
P/E (TTM)	8.4	22.8
Forward P/E (Est.)	8.0	17.8

Largest Institutional Owners
(@3/31/19 or latest filing):

Company	% Owned
GoldenTree Asset Mgmt	25.7%
MainFirst Bank	2.6%
Norges Bank Inv Mgmt	2.2%
T. Rowe Price	1.3%
Vanguard Group	1.2%

Short Interest (as of 5/31/19):

Shares Short/Float	n/a

BG PRICE HISTORY

THE BOTTOM LINE

The company's focus on specific profitable niches and its emphasis on cost control distinguish it from most European banks that struggle to earn their cost of capital, says Jaap Pannevis. Just from expected capital return in the form of dividends and share buybacks, he believes that from today's price the shares offer a 15%-plus annual recurring yield.

Sources: Company reports, other publicly available information

capital return we're looking at a more than 15% annual recurring yield. If they deliver on that, there's little question the stock would trade for quite a bit more than 7x earnings.

While most of the other businesses that we've talked about are steady-state compounders, this is more of a traditional value idea. But it's pretty interesting when management is committed to buying back more than 10% of the market capitalization every year when the stock for now appears to be very undervalued. We've been happy to see that both the company's CEO and CFO, who already own a lot of stock, have been buying more in the open market.

We see you have nearly 40% of your portfolio invested in Dutch companies, which we assume isn't a coincidence given that you're all originally from the Netherlands. Is there anything else driving that?

TH: Our exposure in the Netherlands isn't always that high, but we do see it as a fertile market for finding niche global or regional businesses with high returns and good governance. It is worth noting that only about 5% of the total revenues from this exposure are generated in Holland. It's a very small country, so successful companies early on look well beyond the home market for opportunity. We've actually seen a large number of such companies going public in the past few years on the Amsterdam Stock Exchange. I'd also highlight that the country is in good shape, with better growth than most of the rest of Europe, 3% unemployment, low inflation, debt-to-GDP at around 50% and a budget surplus.

With all that, undeniably there's probably some home bias involved. We have a deep understanding of the culture, the accounting, the corporate governance and we should be able to communicate well with management. None of that makes a bad idea a good one, but it has to be helpful in trying to see things more clearly. VII