Europe | Luxury

Swatch Group (UHR VX)

3 March 2014

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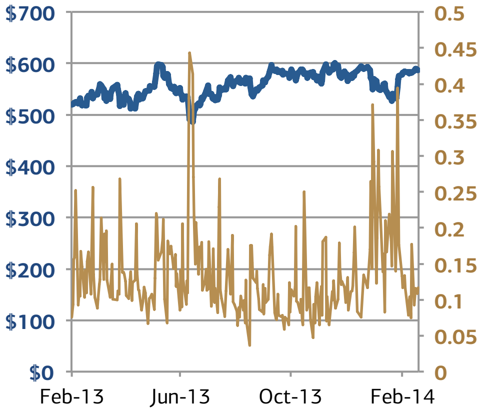
Time to sell

Swatch Group (UHR VX) one-year share price in CHF (blue) and volume (gold, in mln shares)



Source: Bloomberg, March 3. 2014

+ Strong growth of Swiss watch exports to China?

We are unexcited by the strong, 18.8% jump in Swiss watch exports to China in December 2013, as it followed a sharp drop in November and was measured against a very low base. Compared to December 2011, exports were still down. Furthermore, we think inventories are probably rising.

+ Watch sales doing badly

Our checks with points of sale in Mainland China confirm our negative view on current watch sales. Now, not only are the high-end luxury brands falling, but the mid-tier, where growth has been projected, is also starting to trend negative.

+ Data disparities indicate a rise in inventory

Disparities between Swatch's weak sales data and strong Swiss export data may indicate a rise in inventory levels in distribution channels or in bonded zones.

+ Swatch has over-invested in Mainland China

Our view that Swatch has over-invested on the mainland and is seeing a margin decline is being borne out, as the company's operating profit and margins have flattened, as evidenced by the most recent Key Figure Report, once we exclude exceptional income from the Tiffany settlement.

+ PT CHF 485.8; recommendation: SELL

We increase our price target to CHF 485.8 after modifying model assumptions. We use a DCF model based on a WACC of 9.6% and terminal growth rate of 3%.

Swatch Group (UHR VX)

Price	CHF 587
Rating	**SELL**
Price target	**CHF 485.8**
Difference	**17.2%**
Market Cap	CHF 30.93 bln
Simple Moving Avg.	0.113 mln
P/E	16.57x

Source: Bloomberg, March 3, 2014

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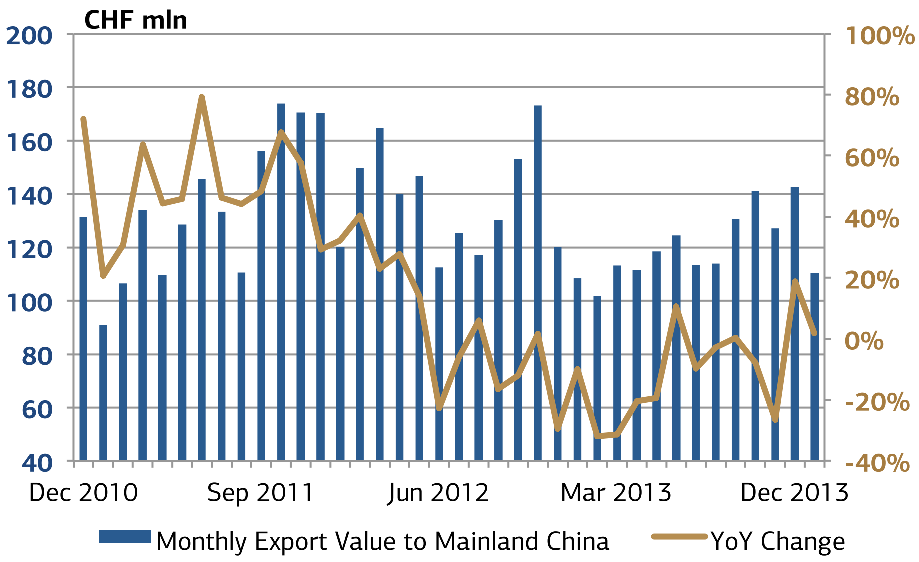
Where is the turning point?

According to the Federation of the Swiss Watch Industry, exports to Mainland China, the third-largest export destination for Swiss watches, increased by 18.8% YoY in December 2013, compared with a decline of 29.4% YoY in December 2012.

Chart 1. Swiss watch exports to China



Source: FHS

While exports of watches to China increased in December, the overall value of exports in 2013 presents significant declines.

However, we believe it's too early to see a recovery. December's increase in exports to China could be explained by high expectations by Chinese vendors, now dashed, or it could be explained by a delay in reported figures from November, when exports fell by 26.5% YoY. Additionally, last year's comparison base is low, which makes December's YoY growth rate seem that much stronger. If we look at full-year 2013 export data to both mainland China and Hong Kong, values show significant declines, of 12.5% and 5.6%, respectively.

Table 1. Annual growth rate of Swiss export value to Mainland China and Hong Kong

	2010	2011	2012	2013
Hong Kong	46.9%	28.4%	6.8%	-5.6%
China	57.1%	48.9%	0.9%	-12.5%

Source: FHS, J Capital Research

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Disappointing industrial performance

China's luxury market performed poorly in 2013.

Industry reports are not very positive either. A report by Bain indicates that China's luxury market grew by around 2% in 2013, versus 7% in 2012 and 30% in 2011. Wristwatches and men's clothes were hit the hardest due to decreases in consumption by government employees. Watch sales went down by 11% YoY in 2013 compared with a 5% decline in 2012 and a 40% increase in 2011.

A recent report by the World Luxury Association (WLA) on consumption of luxury goods during Spring Festival also shows a bad start for 2014. The WLA indicates that they expect 2014 sales to decline further given the ongoing anti-corruption activity and no immediate strong surge of demand from normal consumers.

Table 2. Consumption during Spring Festival

USD mln	2011	2012	2013	YoY Change
Domestic consumption				
Apparel	320	290	60	-79.3%
Leather Goods	190	70	50	-28.6%
Jewelry	330	210	120	-42.9%
Watches	490	20	3	-85.0%
Cosmetics & Perfumes	120	80	80	0.0%
High-end Spirits	250	120	30	-75.0%
Others	50	40	7	-82.5%
Total	1750	830	350	-57.8%

Source: CCPIT

Not only did domestic consumption fall, but the World Luxury Association reports that Chinese tourists overseas spent a staggering 52% less on watches than they had during the holiday in 2012. Swatch derives a large portion of sales from Chinese overseas.

Faltering start for mid-end watches

Sales of watches in various Chinese cities decreased significantly during January.

Our recent interviews at sales points in a few Chinese cities show flat to declining sales of watches in January compared with December 2013. Sales of high-end brands in 2013 dropped significantly, by up to 50% in certain cities. Less expensive brands targeting China's middle class, like Longines and Tissot, which had seen modest growth, experienced declines of 10-20% in cities like Qingdao and Jinan.

For the period starting from January 2014 through Spring Festival,

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watch sales were flat for high-end brands and increased by less than 5% for brands like Omega, Longines, and Tissot. We believe that current sales of watches accurately reflect the underlying demand at the beginning of 2014. Clerks in Shandong province told us that they used to have customers buying 10 Rolex watches at one time, but this has no longer been the case since 2013.

A Longines Store in Jinan. Photo by J Capital | Feb 13, 2013.

Clerks we talked with are not very positive on the watch industry, and one of the most negative views expects that the industry will not recover for several years.

Interviewees overall have little transparency on the market in 2014. Selling prices of watches have not been raised since January 2013, while, before 2012, there were regular price increases of 5-8% twice per year for most brands. In addition, clerks in Jinan informed us that their monthly salaries had been halved due to bad sales performance.

Conflict between sales data and export data

Swatch reported net sales in 2013 of CHF 8,456 mln, up 8.5% YoY. While the growth rate of net sales slowed down to single digits for the first time in the past few years, the company still maintains a much higher rate than the YoY growth of the total value of Swiss watches exported to the world.

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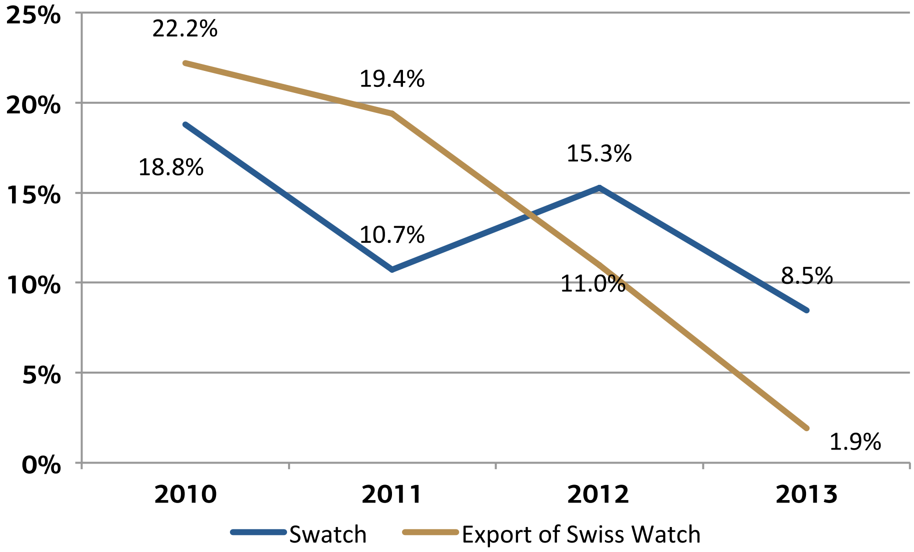
Chart 2. YoY sales growth rate



Source: Company data, FHS

Reported sales by Swatch conflict with Swiss data on exports of watches.

We noticed several inconsistencies in 2012, when watch sales began to be affected by China's anti-corruption drive. For instance, Swatch's reported sales diverge from Switzerland's data on watch exports. The disparities between Swatch sales growth rate and that of Swiss export value also apply to the net sales reported from Greater China.

Though Swatch dis not disclose its sales from Greater China in the its brief 2013 Key Figures report, we can assume that Greater China accounted for 35% of Swatch's total net sales in 2013—in 2012 the region accounted for over 36% of the company's total net sales. By doing this, we arrive at an estimate of 3.2% YoY growth in Greater China during 2013.

This means that, since 2012, the growth rate of Swatch's sales in Greater China has been higher than the growth rate of Swiss exports to China and Hong Kong.

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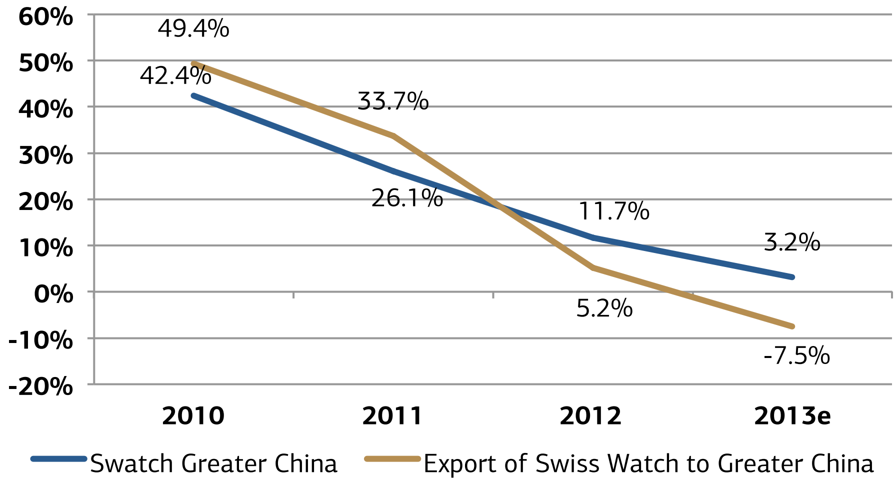
Chart 3. YoY sales growth rate of Swatch vs. Swiss export data



Source: Company data, FHS, J Capital Estimate

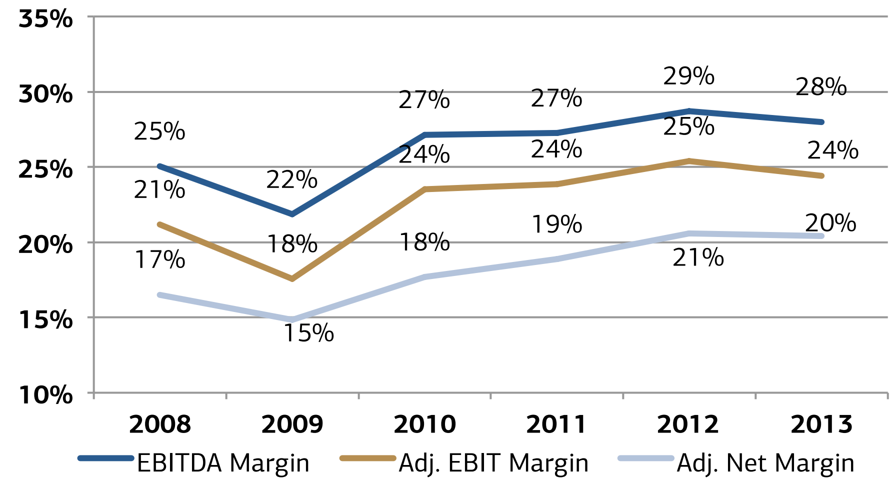
According to our interviews, Swatch may be facing inventory build-up in distribution channels in Mainland China or it may exporting watches from China's bonded zones.

Lower margins

Swatch 2013's EBIT was flat, and its adjusted EBIT diminished when compared to 2012.

Swatch reported that FY 2013 operating profit increased by 17% YoY to CHF 2,314 mln, thanks to its legal success against Tiffany, which we estimate added more than CHF 250 mln to the company's EBIT. Excluding all exceptional income and non-recurring operating income, we come up with a flat 2013 EBIT, up 4.3% YoY to CHF 2,064 mln, while the adjusted EBIT margin went down to 24.4% from 25.4% in 2012.

Chart 4. Margins



Source: Company data, J Capital Research

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Valuation

We apply the sum-of-parts method to estimate future revenues by geographic region. For Greater China, we arrived at our estimates based on our interviews at various sales points for different brands, plus industry analysis.

Given our findings at the beginning of 2014, we estimate that Swatch's sales growth rate for 2014 in Greater China will remain single digit, at around 2.5%, driven by sales of middle-end watches.

Our target price of CHF 458.8 is derived from a DCF model based on a WACC of 9.6%.

Table 3. WACC

WACC	
Risk Free Rate	1.0%
Market Risk Premium	8.0%
Equity Beta	1.08
Cost of Equity	9.6%
Cost of Debt (Pre-tax)	2.1%
Cost of Debt (After tax)	1.6%
Target Debt weight	0.6%
Target Equity weight	99.4%
Tax Rate	21.0%
WACC	9.6%
Terminal Growth	3.0%

Table 4. Sensitivity analysis

		WACC				
		8.6%	9.1%	9.6%	10.1%	10.6%
Terminal growth rate	+1.0%	517	481.4	450.1	422.3	397.5
	+1.5%	540.3	501.1	466.8	436.7	409.9
	+2.0%	567.1	523.5	485.8	452.8	423.7
	+2.5%	598.3	549.4	507.4	471.1	439.3
	+3.0%	635.1	579.5	532.3	491.9	456.9

Table 5. Scenario analysis

	Bear	Base	Bull
Growth Rate of Greater China	-5%	3%	10%
Total Net Sales of Swatch in 2014 (CHF mln)	8,759	8,974	9,190
Target Price (CHF per Share)	453.7	485.8	527.4

Source: J Capital Research

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Risks

1. A renewed stimulus, which would drive up prices
2. Reduction of luxury tax could increase the sales of imported watches in Mainland China
3. Other geographic regions could grow faster than we expected

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