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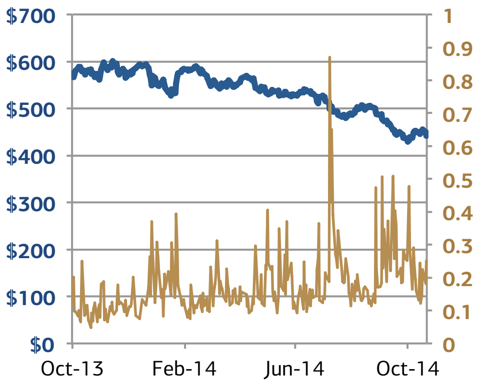
Swatch Group (UHR VX) one-year share price in CHF (blue) and volume (gold, in mln shares)



Source: Bloomberg, November 5, 2014

Swatch Group (UHR VX)

Price	CHF 441.5
Rating	**SELL**
Price target	**CHF 409.6**
Difference	**-7.2%**
Market Cap	CHF 23.6 bln
Simple Moving Avg.	0.2 mln
P/E	13.2x

Source: Bloomberg, November 5, 2014

Europe | Luxury

Swatch Group (UHR VX)

Ticking down

+ Falling sales in Greater China

Strength in its Omega brand and in the mid- to high-end watches is not enough to save Swatch from declining sales in Greater China. The company is seeing a sharp decline in Hong Kong, and our checks with some European retailers also indicate that Chinese nationals are purchasing fewer watches in Europe.

+ Mounting inventories, a 2015 catalyst

The company appears to have been selling into inventory over the past year, and this is adding pressure to retailers and distributors. We expect the ultimate sell-off will reduce sales for China by more than 7% in 2015, bringing the whole group to flat or slightly declining sales, as China sales represented almost 38% of Swatch's total sales in 2013.

+ Tighter margins

Margins will fall, as watch prices have not been raised for one year and distributors are offering more discounts to destock inventories. We assume that Swatch will slow its production rate, which will then increase unit cost, as fixed costs in the cost of goods sold remain significant.

+ Smart watches

We think that smart watches such as the soon to be released iWatch, will undermine the company's basic line, such as Swatch, Balmain, and Calvin Klein, which collectively contribute about 10% of Swatch's sales in China.

+ Valuation

We reiterate our SELL recommendation and adjust our target price from CHF 485.8 to CHF 409.6, which is derived from a DCF model based on a WACC of 8.7%.

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Slowing business

We conducted our most recent interviews on watch sales with retailers and distributors in 10 cities in Mainland China. After two years of anti-corruption campaigns, the political impact on watch sales is now negligible in South China, but still influences the sales of luxury watches in North China, especially in Beijing, where retailers informed us sales are not back yet. A worsening economy has been hurting buyers' purchasing power all across China.

One exception for luxury watches is Omega. Based on our checks, it remains among the most popular brands with mild growth rate or flat sales in different cities, and only one retailer we interviewed told us about a decrease, of 40% YoY. We believe Omega will report an increase of sales in 2014, thanks to the launching of its new Omega Master Co-Axial in the second half of the year. We estimate that this will drive up total sales of Swatch's luxury watches by ~5% during the year, as Omega has contributed the most to Swatch's luxury watch sales in Mainland China.

Spending by Chinese tourists is a significant driver of luxury watch sales, but this year sales have fallen.

Spending by Chinese tourists is a significant driver of luxury watch sales. Selling prices of high-end watches in Mainland China are 30% higher than in other countries. For several Chinese buyers, retail stores in Mainland China are just a place to choose the watch models they like, which they then purchase in other countries when traveling. A watch retailer with annual revenue of more than EUR 10 mln per store in Europe told us that over 50% of its customers are from Mainland China, and watches with prices between RMB 60,000 and RMB 70,000 are the most popular. According to the retailer, sales to Chinese nationals fell 20-30% YoY this year.

Hong Kong decline

The National Day holiday (Oct 1–7) is supposed to be the Gold week for Hong Kong' retail industry every year. However, the Occupy Central protest that occurred in late September forced many retailers in premium commercial locations to close their stores temporarily during the holiday. According to a Hong Kong Retail Management Association poll, the retail sales decline in Hong Kong ranged from 15% to 50% for the first five days of October, despite estimated growth of visitor arrivals at Hong Kong. Among all sectors, watches and jewelry products fell most, by over 30% YoY.

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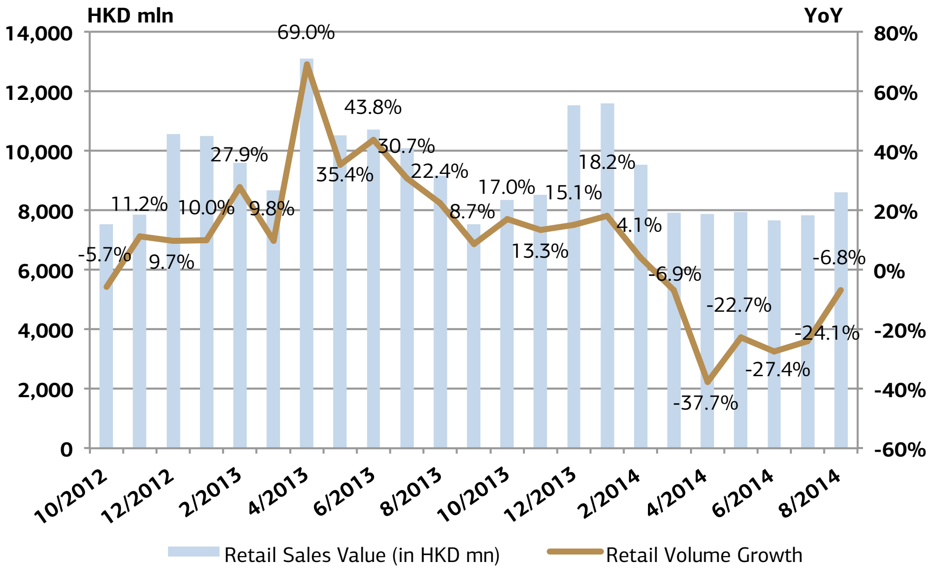
Hong Kong sales had fallen 16% through August before there were any protests.

However, the strong fall in sales cannot only be blamed on the protests. Reported monthly retail sales value of Jewelry, Watches & Valuable Gifts had already fallen since the beginning of 2014. According to Hong Kong Census and Statistics Department, monthly sales of Jewelry, Watches & Valuable Gifts in August decreased by 6.8% YoY and YTD sales value was down by 16.3% YoY.

Chart 1. Monthly sales value of Jewelry, Watches & Valuable Gifts



Source: Hong Kong Census and Statistics Department

In 2014 H1, large distributors such as Emperor and Hengdeli reported negative growth rate in watch sales in Hong Kong. These retailers together represent about half of Swatch's sales in Greater China.

Table 1. HK retailers 2014 H1

YoY sales growth rate	2014 H1
Hengdeli	-11.7%
Emperor	-6.4%

Source: Company data, J Capital Research

Mainland visitors to HK are increasingly younger and with less purchasing power.

Chinese tourists account for over 70% of Hong Kong's total visitors. Although visitors from Mainland China kept to double-digit growth through August, there is a trend toward younger visitors with less purchasing power and shorter stays. Given that the Occupy Central movement continue to have an impact on the Hong Kong retail industry, we are negative on watch sales in the region

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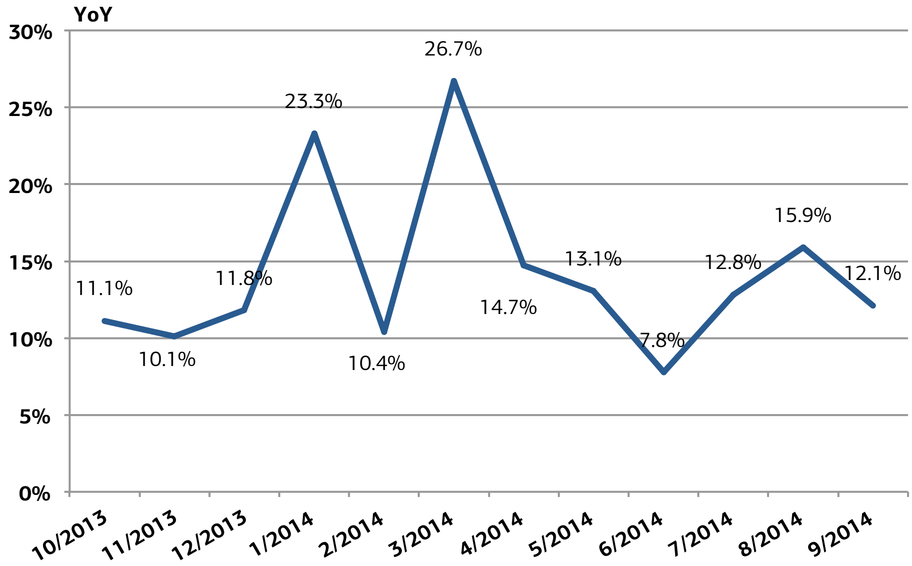
and estimate a YoY drop of 30% in 2014 Q4 and a fall of 15% YoY in 2015.

Chart 2. Tourist arrivals from the Mainland



Source: Hong Kong Tourism Board

Mounting Inventories

We believe Swatch is still building inventories in the Great China region, thus contributing to higher sales.

In addition to gifting—one of the main drivers of watch sales before the government's anti-corruption campaign—channel expansion contributed greatly to Swatch's sales in the Greater China region over the last years, and we believe the company is still building inventories in that region, either through investing in its own retail channels or in distributors.

Our analysis shows that there might be excessive inventories in Greater China. In 2013, Swatch reported CHF 3.2 bln of sales in Greater China, an increase of 11.8% over the previous year, contrasting with the 7.5% YoY drop of FHS' total export value to Greater China. During the same period, four listed distributors based in Greater China reported flat or negative sales growth rate and saw inventories growing in their balance sheet.

Table 2. Distributors' watch sales

HKD mln except when noted	2012	2013	YoY
Hengdeli*	15,112	15,359	1.6%
Emperor	5,320	5,143	-3.3%
Oriental**	3,733	3,477	-6.9%
Harmony of FYD	1,371	1,363	-0.6%
Total	25,536	25,342	-0.8%

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Total Amount in CHF mn	2,939	2,916	-0.8%
Swatch Sales in Greater China (CHF mn)	2,569	2,869	11.7%

*Watch sales excluding Harvest Max, exchange rate HKD:RMB=1:0.7862 as of Dec 31 2013.

** Watch sales of FY 2014 ended March 31.

Swatch is depending more in Hengdeli to pile up inventories, while other distributors and retailers are facing pressure to clear inventories.

Our interviews with distributors and retailers also confirmed that some are facing pressure to clear inventories. Most of them have over 1,000 units at one store, i.e. about RMB 100 mln in inventory. A retail store we interviewed reported 2,000 units of inventory, which is abnormal according to sales staffs.

Hengdeli, 9% owned by Swatch Group, is one of the largest watch distributors in Greater China. We estimate the company accounts for a third of Swatch's total sales in Greater China, and we think HDL has become the most important channel for Swatch to pile up inventories in China. Back in 2007, HDL only purchased 38.2% of watches from Swatch Group, but the portion increased to 67% in 2013. In the meanwhile, HDL expanded its retail stores from 210 in 2008 to 470 in 2013. Thus, we think most of Swatch's sales growth from 2008 to 2013 was from store rollouts rather than organic growth.

Table 3. % of Hengdeli's total purchases from Swatch Group

	2008	2009	2010	2011	2012	2013
% of purchases from Swatch	47%	57%	50%	62%	64%	67%
No. of stores	210	270	350	405	452	470

Source: company data

In 2014 H1, HDL reported 13.8% YoY growth of watch sales and retail revenue growth of 12.4% YoY, compared to Emperor's 2.1% sales drop during the same period. Emperor chose to slow down its expansion of watch stores, and Oriental has already shut down 10 retail outlets in FY 2014. Yet, HDL continued its expansion by opening 26 new retail stores in Mainland China in 2014 H1, surpassing the 22 store openings in 2013. We estimate the inventories stuffed in new stores of Hengdeli can help Swatch to sell about CHF 100 mln in watches.

Meanwhile, Swatch claimed that it would invest capital for future growth, opening new retail stores and offering new products, even though its inventories increased to CHF 5.7 bln at end of 2014 H1 from CHF 5.4 bln in 2013.

E-commerce platforms provide another channel through which watch sales have been growing very fast. Although Swatch Group

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claimed that they have not authorized any e-commerce companies to distribute their watches, we found that many brands can be purchased online. E-commerce platforms are competing with traditional retailers, and, therefore, driving selling prices down for mid-end watches.

Screen shot from JD.com. Taken in November 2014.

Falling margins

We believe the potential falling trend of watch prices and mounting inventories will drive down Swatch's operating margins.

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Our checks with retailers and distributors show that watch prices have not increased in 2014, while previously, prices had gone up by 5% to 10% each year. Under inventory pressure and in order to compete with some new sales platforms such as e-commerce for mid-end watches, some distributors are offering more discounts secretly. According to one sales people, they provided discounts of up to 30% to customers for select models.

To compensate for the loss in Hong Kong watch sales and to attract more buyers from Mainland China, some brands have already started to adjust their pricing strategies. For example, Hublot, a luxury watch brand owned by LVMH, cut its selling prices in Mainland China and began offering the same prices as those in Hong Kong. We believe other companies, including Swatch, will follow and adjust their selling prices in Mainland China, cutting them by about 10-20% on average, even though the government has not lowered down the luxury VAT rate yet.

Additionally, mounting inventories will force Swatch to cut its production, which will then drive the company's margins down.

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Swatch has stopped disclosing gross margins since 2013. Based on the margins they provided in 2012, we estimate that variable costs, including change of inventories and purchase of raw materials, accounted for aprox. 50% of total COGS, and fixed costs of COGS represented the rest. Once the group slows production rates and lets distributors rebalance their inventory levels, variable costs will decrease, but unit cost will rise as fixed costs remain at the same level.

Table 4. Gross margin by segment

	2010	2011	2012
Watches & Jewelry	51%- 62%	50%-61%	52%-58%
Production	26%- 29%	28%-30%	28%-33%
Electronic Systems	32%- 35%	25%-32%	24%-33%

Source: Company data

The smart watch threat

Smart watches are already affecting the sales of fashion and entry-level brands.

There has been heated discussion on the potential threat of the soon to be released iWatch on Swiss watch sales. Even though Swiss watch manufacturers, including Swatch Group, tried to downplay the threat, we believe the future launching of iWatch, as well as the other smart watches, have already affected sales of fashion brands such as Balmain and Calvin Klein, and the basic brand Swatch. Buyers of all of fashion and basic range brands are less obsessed / loyal when compared to buyers of traditional watches, such as Omega.

Retailers in Mainland China also believed that the iWatch won't affect their sales of traditional Swiss watches. Their fashion brand sales, however, are facing increasing pressure, and not only because of the iWatch, but also because inventories are high for those brands when considering the life cycle of each model.

We estimate sales of fashion and basic range brands account for ~10% of Swatch's total sales and should be less than 3% of total EBIT. Our research also indicates that these brands represent less than 10% of sales in Mainland China. We assume a 20% YoY decline of sales of fashion brands and basic range from Swatch Group for 2014 and 30% in 2015.

Growth of mid-end watches

Our interviews show that there is real demand for mid- to high-end watches with an average selling price under RMB 30,000 per unit. Brands such as Longines and Tissot represent about 50% of

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Demand for high-end and mid-end watches has been rising, but it's not sufficient to reverse the decline in other categories.

total sales of the retailers we interviewed. The two brands remain the most popular and have seen double-digit growth since the beginning of this year in all cities we visited. However, these sales are not sufficient to reverse the decline in other categories.

Valuation

Given our findings in September and October, we estimate that Swatch's sales growth rate for 2014 in Greater China will remain at 1%, driven by sales of mid- to high-end watches and by channel stuffing at retailers and distributors in Mainland China. We assume Swatch will address its inventory levels in 2015 and thus sales will drop by 7.2% in Greater China and by 0.6% for the entire group in 2015e. EBIT margins will fall to 20.9% in 2014e and 18.5% in 2015e, as the company has significant fixed costs.

Table 5. Sales estimates

CHF mln	2013	2014e	2015e
Total sales	8,456	8,695	8,646
Sales from Greater China	3,208	3,208	2,977
EBIT	2,064	1,817	1,604
EBIT margin	24.4%	20.9%	18.5%

Source: Company data, J Capital Research Estimate

Our target price of CHF 409.6 is derived from a DCF model based on a WACC of 8.7%.

WACC	
Risk Free Rate	0.5%
Market Risk Premium	8.1%
Equity Beta	1.02
Cost of Equity	8.8%
Cost of Debt (Pre-tax)	2.1%
Cost of Debt (After tax)	1.7%
Target Debt weight	0.6%
Target Equity weight	99.4%
Tax Rate	19.5%
WACC	8.7%
Terminal Growth	2.0%

Source: Company data, Bloomberg, J Capital Research Estimate

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Sensitivity Analysis		WACC				
		7.7%	8.2%	8.7%	9.2%	9.7%
Terminal growth rate	1.0%	434.0	404.9	379.6	357.3	337.6
	+1.5%	454.1	421.6	393.5	369.1	347.7
	+2.0%	477.7	440.9	409.6	382.6	359.1
	+2.5%	505.8	463.6	428.3	398.1	372.1
	+3.0%	539.8	490.7	450.2	416.1	387.1

Source: Company data, Bloomberg, J Capital Research Estimate

Risks

1. A renewed stimulus and an ending to the anti-corruption campaign would drive up watch sales.

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

4. Rebound of Hong Kong retail sales

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