



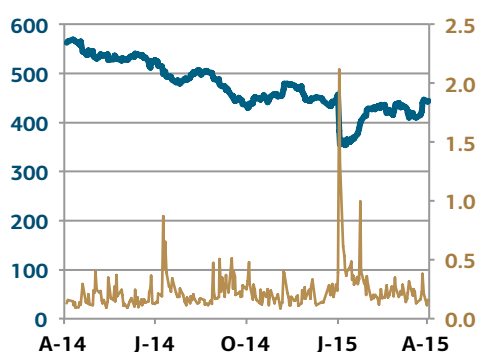
April 21, 2015

Europe | Luxury Swatch (UHR VX)

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



Source: Bloomberg April 20, 2015

Swatch (UHR VX)

Price	CHF 432.50
Rating	Sell
Price target	CHF 381.2
Difference	11.9%
Market Cap	CHF23.82bn
Avg. Trading Volume	273,312
Float	98%

Source: Bloomberg April 20, 2015



Sales Ticking Down

+ Inventory build

Purchases by Swatch retailer Hengdeli on the Mainland in Q1 saved Swatch from reporting a sharp sales decline, but Hengdeli stores, like other retailers, are carrying inventories of 10 to 20 months amid falling sales. Q2 is likely to decline.

+ Weak Hong Kong sales and competition from Apple

Other headwinds include competition from pre-sales of the Apple Watch, which went better than we expected and will, we think, undercut sales of mid-range watches like Tissot. Additionally, Chinese tourism in Hong Kong is declining.

+ 2015 to Fall by About 11%

For the full year, we estimate that Swatch's Greater China watch sales will drop by 11% YoY.

+ Valuation

We lower our target price from CHF 409.6 to CHF 381.2 by applying a DCF model with WACC of 8.7%.

Watch sales continue to decline

Our most recent checks on watch sales in both Mainland China and Hong Kong convinced us that 2015 will be a tougher year in the Greater China Region. We estimate that retail sales for Swatch in Q1 fell 10-30% across regions.

The decline in luxury and high-end watches was the greatest, at about 25% YoY, while mid-end watches were flat or grew in the low single digits. In Hong Kong, the plunge in watch sales in Q1 from lower mainland tourism is likely to will drag down retail sales further in 2015. Mid-end watch sales will probably will slow, given high inventories and competition from the Apple Watch.

Hengdeli contributed all the growth in Swatch sales in Greater China. The company increased purchases from Swatch by CHF 202 mln in 2014, while Swatch's total sales increased by only CHF 16 mln in Greater China. Given the bleak sales and rising inventories, we think retailers will cut purchases and some will exit the business as the year continues.

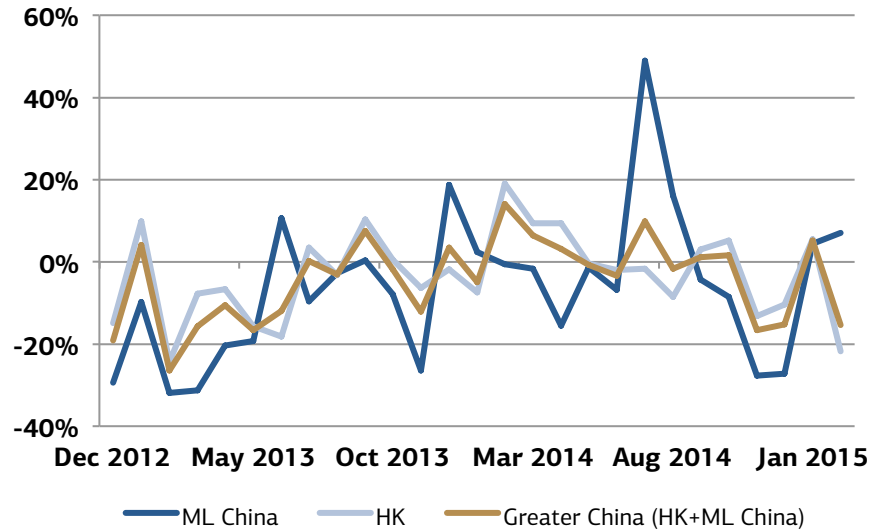
Greater China Winding Down

FHS (Federation of the Swiss Watch Industry) statistics show that Swiss watch exports to Mainland China rose 5.7% YoY in the first two months of 2015, but we view this as a distortion: Chinese Customs data indicate that Swiss watch imports were down 1.7% YoY in January-February. We believe these distortions are created by:

- Inventory piling up at port bonded zones,
- A lag between export data and import data, due to the fact that it takes 5 working days to clear customs, and
- Swatch imports to China come from Switzerland directly or via Hong Kong. If imports of watches to Mainland China fall, while rising in Hong Kong, this could be a signal of increased inventory being held in Hong Kong due to lackluster Chinese demand, rather than surge in Hong Kong demand.

Meanwhile, our checks show that retail sales across categories fell by about 10-30% YoY in 2015 Q1.

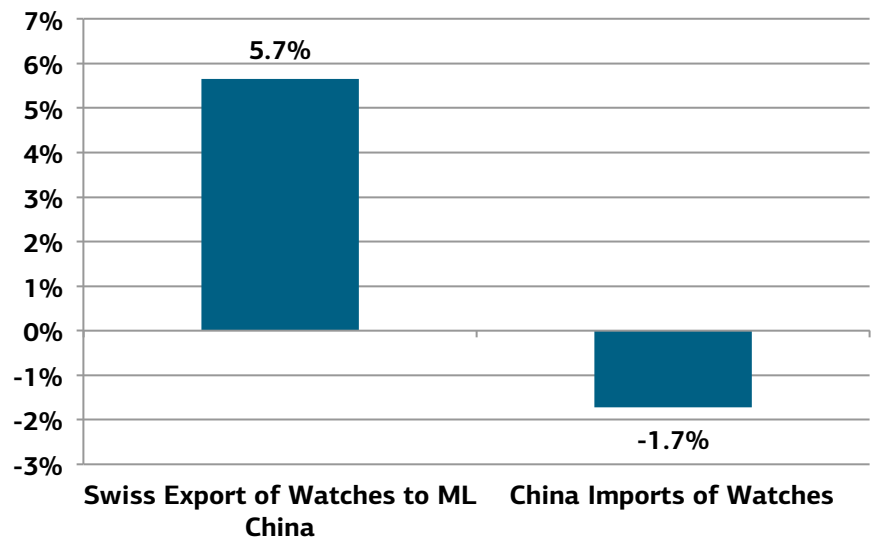
Chart 1. Swiss Watch Exports to Mainland China and HK, YoY



Source: FHS (Federation of the Swiss Watch Industry), J Capital Research

Watch how import data out of China contradicts the Swiss number.

Chart 2. Swiss Exports to China and of China Imports, YoY

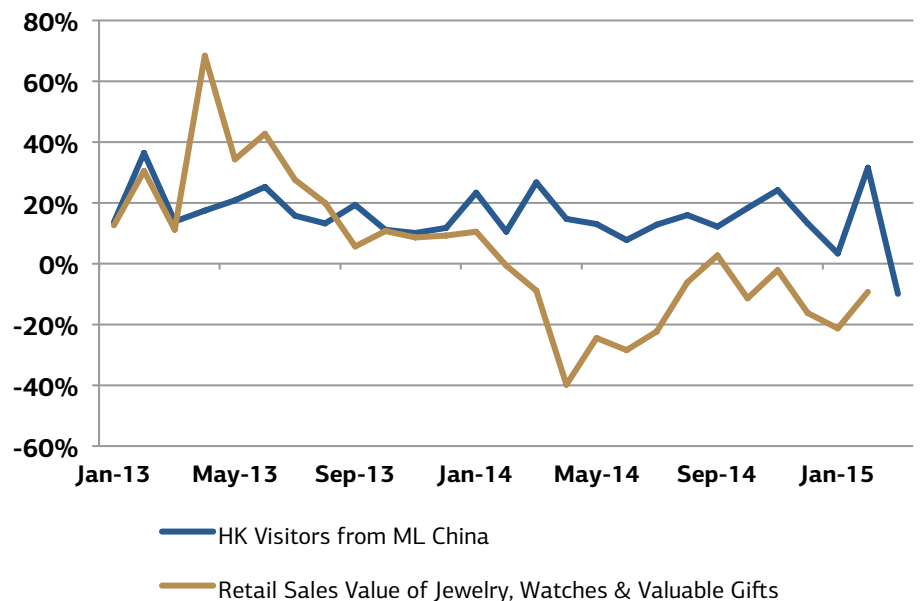


Source: China Customs, J Capital Research

Hong Kong has traditionally been an important region for sales of watches to Mainland customers, given the preferential taxes, but a sharp decline in tourism to Hong Kong has changed that: in the

first two months of 2015, Hong Kong's retail sales of "jewelry, watches & valuable gifts" plunged 16% by value. Mainland visitors to HK decreased 8.7% YoY in March and dropped 12.4% YoY during the Mainland Qingming holiday over the first weekend in April. The new Individual Visit Scheme, designed to reduce the number of Mainland visitors coming from Shenzhen, will deepen the retail gloom.

Chart 3. Mainland Visits to Hong Kong and Retail Sales Value of Jewelry, Watches & Valuable Gifts, YoY



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

Source: Hong Kong Census and Statistics Department, J Capital Research

Buying Own Sales

The retailer Hengdeli raised its contribution to Swatch sales in Mainland China from 67% in 2013 to 71% in 2014, and in the recent quarter, Hengdeli is buying more watches from Swatch than it seems able to sell. Hengdeli represented about 14.5% of Swatch's worldwide sales in 2014.

Table 1. Hengdeli Purchases from Swatch

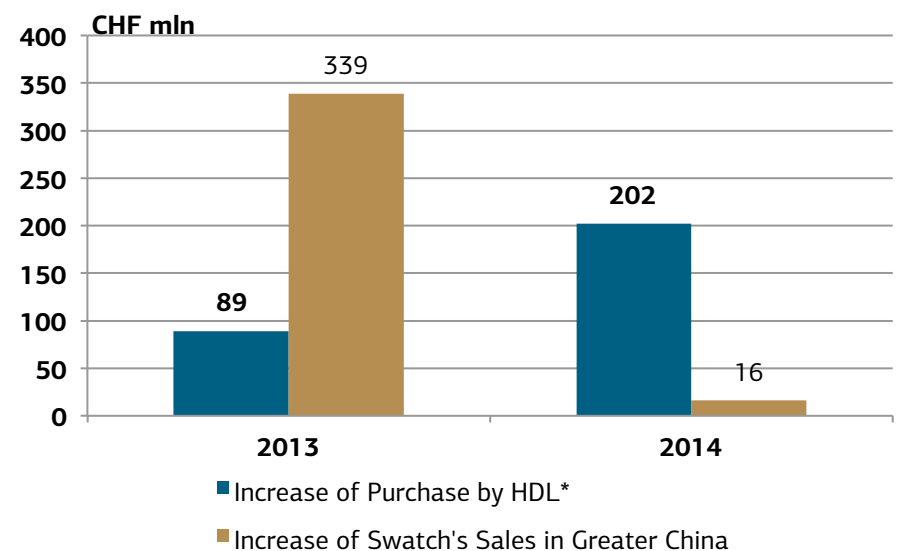
In RMB mln	2012	2013	2014
Opening Inventory	4,521,297	5,569,961	6,328,722
Closing Inventory	5,569,961	6,328,722	6,612,693
Change	1,048,664	758,761	283,971
COGS	8966015	9,731,808	10,539,538
Purchases	10,014,679	10,490,569	10,823,509
% of HDL's Purchase from Swatch	64%	67.00%	71%
HDL's Purchase from Swatch	6,409,395	7,028,681	7,684,691
YoY Change		9.70%	9.30%
HDL's Purchase from Swatch (CHF mln)	939,532	1,028,547	1,230,123
YoY Change		9.50%	19.60%
As % of Total Swatch Sales	13.90%	13.20%	14.50%
As % of Swatch Sales in Greater China	33%	32%	38%

Source: Company data, J Capital Research

*Applying the exchange rate of Dec 31, 2013 and Dec 31, 2014 to the financials of 2013 and 2014 respectively

We estimate that Hengdeli spent CHF 202 mln more in 2014 on procurement from Swatch, compared with an increase of CHF 89 mln in 2013 after the exchange rate effect. How did Hengdeli achieve this? We blame excess investment in new stores. In 2014, the total number of Hengdeli retail stores increased from 470 to 513, and most of those were in Mainland China.

Chart 4. Swatch sales and purchasing in China



Source: Company data, J Capital Research

*Applying the exchange rate of Dec 31, 2013 and Dec 31, 2014 to the financials of 2013 and 2014 respectively

While 2014 was a tough year for watch sales in the entire Greater China region, Hengdeli managed to record 9.5% YoY growth. Other listed watch distributors all reported negative growth in the same period.

Table 2. Distributors' Watch Sales Comparison

In millions	2013	2014	YoY
Hengdeli (RMB)	13,097	14,336	9.5%
Emperor (HKD)	5,320	5,143	-3.3%
Oriental* (HKD)	1,710	1,532	-10.4%
Harmony of FYD (RMB)	1,371	1,363	-0.6%

Source: Company data, J Capital Research

Inventory Pressure At Store

Our interviews with dealers and retailers indicate that inventories have not declined in Q1. The dealers who are willing to discuss inventory say that they are holding 10-20 months of product, against a normal level of around six months. Longines and Tissot all have large inventories at both wholesalers and retailers. In part, this reflects rules made by the brand owners, who require the retailers to accept the inventory they specify. The Chinese press has reported that 30-40% of watch types¹ are not selling.

Potential Pricing Adjustment

Price differentials across borders continue to incentivize Chinese buyers to purchase overseas. We estimate that 80% of the luxury watches bought by Mainland residents are bought overseas. That rate has grown, because a reduction in watches purchased as bribes means that buyers are using their own money and are more price-sensitive. All the retailers we talked with said that they are having a hard time selling high-end watches.

To attract more Mainland buyers, Patek Philippe and Tag Heuer lowered most selling prices by 20% and 8-13% respectively in the last quarter. For some of Tag Heuer's watches, price cuts are as much as 40%.

Swatch Group has been slow to make cuts and offers only 5-10% discounts at the owned stores, but we expect to see Swatch capitulate to the pressure in the future.

¹ <http://business.sohu.com/20150325/n410270623.shtml>

Apple Watch or Swiss Watch?

On April 10, Apple began to accept online preorders of the new Apple watch. According to Slice Intelligence, order volume rose to more than 1 mln units on the first day, exceeding the total annual sales volume of 720,000 units of Android-based smart watches in 2014. In China, most models for pre-order were sold out by April 24, 2015, including five Edition models with selling prices ranging from RMB 74,800 to RMB 126,800. The delivery time for current pre-orders is after June. Apple Watch Sport and Apple Watch contributed to the majority of orders.

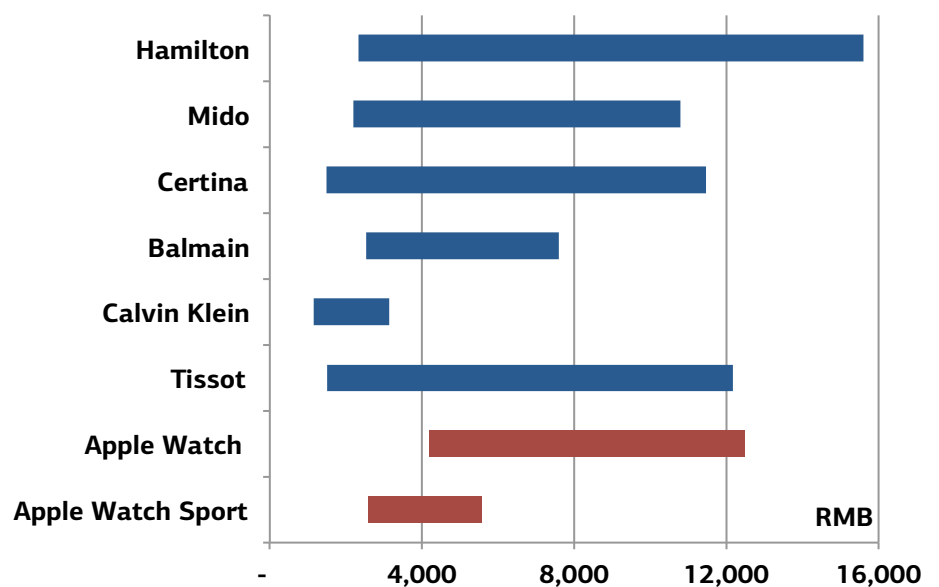
Table 3. Selling Prices of Apple Watch in China

in RMB	Selling Prices
Apple Watch Sport	2,588-2,988
Apple Watch	4,188-8,288
Apple Watch Edition	74,800-126,800

Source: apple.com.cn

Considering the strong sales of the Apple Watch, we think sales of Swatch's mid-range brands will be affected in the short term, including Tissot, Balmain, Certina, Mido, Hamilton, and Calvin Klein, which cost about the same as the Apple Watch. Balmain and Certina, with very small markets, should not be much affected, but Tissot is very exposed.

Chart 5. Comparison of Selling Prices (In RMB)



Source: Jd.com, J Capital Research

The Swatch Group Ltd. (UHR VTX)

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We do not think smart watches will have a long-term impact on Swiss watches. Retailers are confident in Swiss-made traditional watches. In the meantime, Swatch is developing its own smart watch and plans to launch the model in 2015.

Valuation

Based on our most recent checks, we believe Greater China will see watch sales fall sharply this year, especially in Hong Kong, where dealers have started to exit the business and sales have plunged. But Chinese tourists are diversifying their travel destinations. Chinese visitors to Japan rose 94% YoY in 2014 Q4, while tourists visiting the US are up 19.3% YoY. France, Germany and Australia also all show increasing volumes of Chinese tourists. In particular, Chinese tourists benefitting from the depreciation of the Euro, and are increasingly traveling to Europe as a result.

Table 4. Sales Estimates

In CHF mln	2014	2015e	2016e
Total Sales	8,709	8,759	8,846
<i>YoY Change</i>	<i>3.0%</i>	<i>0.6%</i>	<i>1.0%</i>
Sales from Greater China	3,224	2,881	2,558
<i>YoY Change</i>	<i>0.5%</i>	<i>-10.6%</i>	<i>-11.2%</i>
EBIT	1,752	1,714	1,691
<i>EBIT Margin</i>	<i>20.1%</i>	<i>19.6%</i>	<i>19.1%</i>

Source: Company data, J Capital Research

We adjust our target price from CHF 409.6 to CHF 381.2 by applying a DCF model with WACC of 8.7%

Table 5. WACC for Swatch

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)	3.0%
Cost of Debt (After tax)	2.4%
Target Debt weight	0.7%
Target Equity weight	99.3%
Tax Rate	19.8%
WACC	8.7%
Terminal Growth	2.0%

Source: Company data, Bloomberg, J Capital Research estimates

Table 6. Sensitivity Analysis (in CHF)

Sensitivity Analysis		WACC				
		7.7%	8.2%	8.7%	9.2%	9.7%
Terminal Growth Rate	1.0%	397.7	372.6	351.2	332.7	316.6
	+1.5%	417.7	389.3	365.2	344.5	326.7
	+2.0%	441.3	408.6	381.2	358.0	338.1
	+2.5%	469.3	431.2	399.8	373.4	351.1
	+3.0%	503.2	458.2	421.6	391.3	365.9

Source: Company data, Bloomberg, J Capital Research estimates

Risks

1. Aggressive build-up of inventory by distributors and retailers such as Hengdeli
2. An ending to the anti-corruption campaign would drive up watch sales
3. Reduction of luxury tax could increase the sales of imported watches in Mainland China
4. Other geographic regions could grow faster than we expected
5. Mainland visits to Hong Kong may revive.

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