

October 20, 2015

**Qin Shengxian**

qin@jcapitalresearch.com

**Anne Stevenson-Yang**

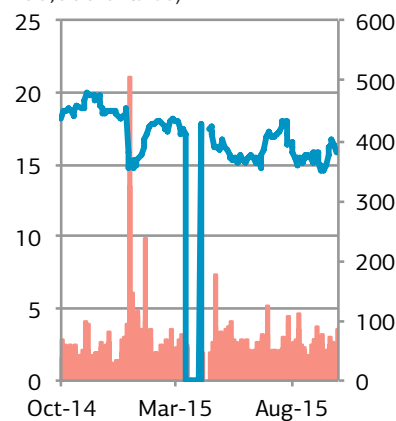
anne@jcapitalresearch.com

+852 2534 7405

## Swatch (UHR VX)

Price	CHF 378.3
<b>Rating</b>	<b>SELL</b>
<b>Price Target</b>	<b>CHF 363.4</b>
<b>Difference</b>	<b>-3.9%</b>
Market Cap	CHF 20.9 bln
Avg. Trading Volume	226,307
Float	98%

Swatch (UHR VX) last share price in CHF (blue) and volume (pink, in 100,000 shares)



Source: Bloomberg, October 19, 2015

## Swatch (UHR VX) Running Slow

### ▶ Hong Kong No Longer Golden

Hong Kong, the biggest destination for Swiss watch exports and at least half of Greater China sales, recorded its first Golden Week decline in retail sales since 2003.

### ▶ Low Touch

Swatch is silent on sales of three new smartwatches even as its competitor Apple recorded 1.07 mln Chinese buyers of Apple Watches as of August, only four months after the official release.

### ▶ Fewer Purchases From Dealers in Greater China

In H1 2015, Hengdeli, Swatch's largest Chinese partner, cut its purchases of watches by about 17.7% YoY and closed three stores that sell the high-end and luxury watches in Mainland China.

### ▶ Falling Margins

China has been Swatch's most profitable region, and a move toward overseas purchasing is driving down margins.

### ▶ Valuation

We see no improvement of Swatch sales in the Greater China and close coverage of Swatch with this report. With updated financials and estimates, we adjust our target price to CHF 363.43 from CHF 381.2 by applying a DCF model with a WACC of 9.5%.

This past Golden Week was disappointing for Hong Kong.

## Not Smart Enough

In Hong Kong, the plunge in watch sales during the October Golden Week, due to lower mainland tourism, was the first decline in more than a decade. We believe the trend will continue through the year. At the same time, our most recent checks on watch sales in Mainland China have confirmed our view that there is no improvement in the sale of luxury and high-end watches, which are still declining by up to 30% for some dealers. We adjust our previous estimate of 5.5% YoY growth to a 6.5% YoY decline in Mainland China and lower our Hong Kong YoY estimate to -25% for 2015 from -15%.

The past Golden Week was disappointing for Hong Kong. According to a survey conducted by Hong Kong Retail Management Association, Hong Kong recorded the first drop of retail sales during the Golden Week since 2003, when visas were restricted. The 30 retailers interviewed by the HKRMA reported that jewelry and watches sales plunged 28-45% YoY in the first week of October. A few small watch stores reported an 80% decline YoY.

The overall economic decline has been exacerbated by the Mainland's anti-extravagance campaign and by Hong Kong's anti-Mainlander sentiment, which has inhibited tourism. Hong Kong's retail sales value of jewelry, watches, and valuable gifts fell by 13.8% YoY in the first eight months of 2015, according to the Hong Kong Census and Statistics Department. Hong Kong is the No. 1 region for Swiss watch exports, accounting for over 15% of total Swiss watch export value, and at least 50% of the total consumption in Greater China, so the decline brought no good news for Swiss watch manufacturers.

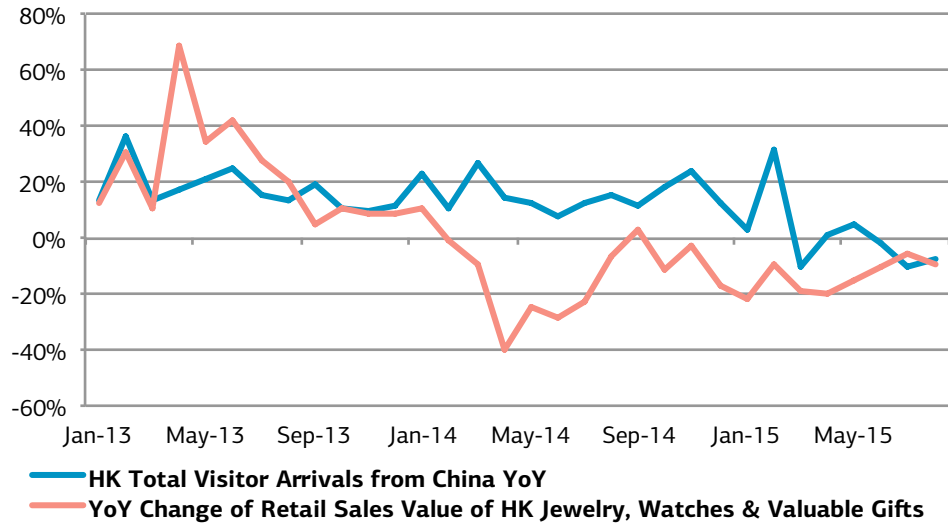
## Wishful Thinking

Swatch expects falling rental costs in Hong Kong to help them improve profitability. But this is hardly the right time to expand a retail network. Jaeger-LeCoultre, a Richemont luxury brand, recently closed a store at Causeway Bay, and many other luxury brands, including Coach, Prada, and Gucci, are demanding lower rents. Given the bleak sales, we think more retailers will cut purchases and exit the business.

Bulls may point to strong growth in outbound tourism. In this case, there may be little correlation between tourism and Swiss watch sales. Japan, for example, is now the top tourist destination for China, yet watch exports to

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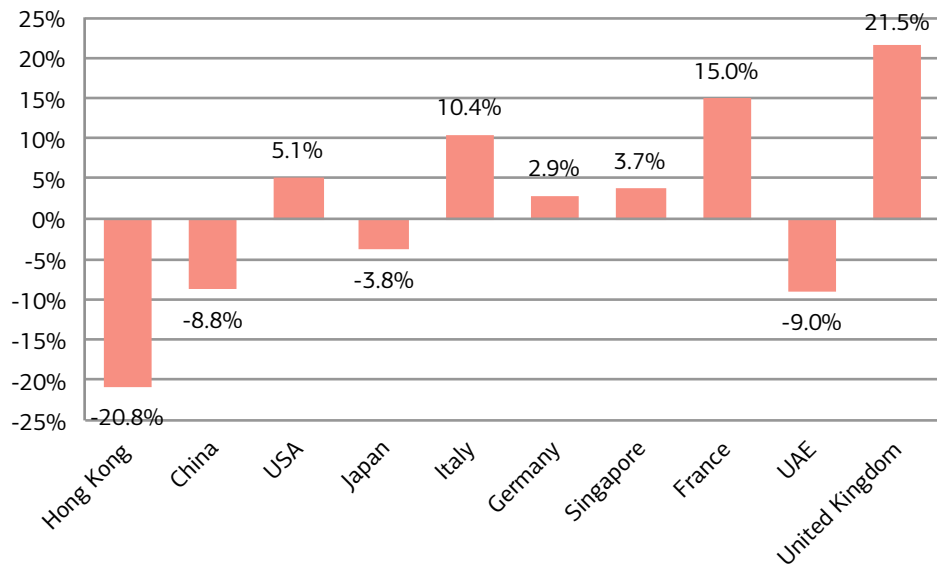
**Chart 1. HK Mainland Visitors & Retail Sales Value YoY**



Source: Hong Kong Tourism Board, Hong Kong Census and Statistics Department

Japan declined 3.8% in the first eight months of the year. Meanwhile, Italy, France, and the United Kingdom reported double-digit growth, at 10.4%, 15.0% and 21.5% YoY respectively during the same period. Even as depreciation of the Euro drove strong watch sales in Europe, the total export value of Swiss watches fell 1.2% YoY in the first eight months of 2015, the worst performance in memory. We believe that Chinese customers overseas tend to be dealers and that they purchase wherever they can find good prices for watches.

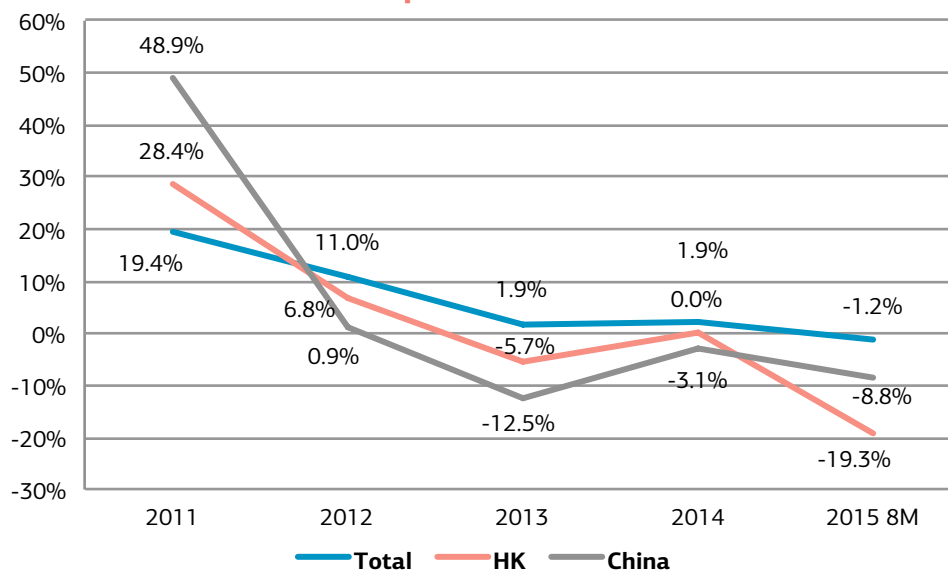
**Chart 2. Swiss Exports by Value Jan - Aug YoY**



Source: FHS, J Capital Research

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### Chart 3. Swiss Watch Exports YoY



Source: FHS, J Capital Research

### Chinese Dealers Buy Less

Dealers are tightening their expansion plans. Hengdeli Group, Swatch's largest partner in Greater China, is cutting purchases from Swatch. As of 2014, 71% of Hengdeli's watches were supplied by Swatch, and we estimated the total purchase value at CHF 1.23 bln, up 19.6% YoY and representing 38% of Swatch's total sales in Greater China in 2014. However, in the first half of 2015, the company has encountered an inventory problem. We estimate that Hengdeli bought 17% less in watches from the Swatch Group in the half.

### Table 1. Est Hengdeli Purchases from Swatch

In RMB mn	2013	2014	H1 2014	H1 2015
<b>Opening Inventory</b>	5,569,961	6,328,722	6,328,722	6,612,693
<b>Closing Inventory</b>	6,328,722	6,612,693	6,649,153	6,292,273
<b>Change</b>	758,761	283,971	320,431	-320,420
<b>COGS</b>	9,731,808	10,539,538	5,146,163	4,693,152
<b>Purchases</b>	10,490,569	10,823,509	5,466,594	4,372,732
<b>% of HDL's Purchase from Swatch</b>	67.0%	71.0%	69.0%	71.0%

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<b>HDL's Purchase from Swatch</b>	7,028,681	7,684,691	3,771,950	3,104,640
<b>YoY Change</b>	9.7%	9.3%	15.1%	-17.7%
<b>HDL's Purchase from Swatch (CHFmn)*</b>	1,028,547	1,230,123	570,696	473,147
<b>YoY Change</b>	9.5%	19.6%	15.1%	-17.1%
<b>As % of Total Swatch Sales</b>	13.2%	14.5%	13.1%	11.3%
<b>As % of Swatch Sales in Greater China</b>	32.1%	38.2%	35.2%	30.9%

Source: Company data, J Capital estimate

In addition, Hengdeli is closing stores. Based on the H1 report, Hengdeli has closed Elegant stores and now has 14 instead of the 17 reported in 2014. The company also has stopped expanding its Prime Time/Hengdeli chain, selling the mid-tier brands like Longines and Tissot. The competing chain Emperor also reported net closure of one watch store in Mainland China. Both dealers are seeing a decline in watch sales, down by 7.4% YoY and 21.9% YoY respectively.

### Table 2. Watch Sales by Dealers YoY

YoY Change in Watch Sales	H1 2014	H1 2015
<b>Hengdeli*</b>	13.8%	-7.4%
<b>Emperor</b>	-2.1%	-21.9%

\*Watch sales include wholesale. Source: Company data, J Capital Research

### Falling Margins

We believe that, in the near term, there won't be any improvement in watch sales in Mainland China or Hong Kong. Customers purchase basic and mid-tier brands like Tissot in Mainland China and Hong Kong but buy high-end and luxury watches overseas, where they can always find good deals. Demand still exists, as indicated by higher sales in France, Italy, and the UK.

However, a change of location means lower margins. Luxury goods companies have always priced higher in Mainland China than in other countries. Correcting for the higher taxes, we calculate that Swatch still enjoys price premiums of between 23-48% in Mainland China even after two price increases in Europe. Once Chinese stop buying on the Mainland, those extra margins will disappear.

We believe that, in the near term, there won't be any improvement in China watch sales.

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### Table 3. Price Comparison

	Omega 424.13.40. 20.02.001	Blancpain 6654-3642- 55B	Longines L2.628.4.78.3
Europe Price (Euro)	2,700	23,950	1,500
Europe Price (Euro) After Discounts	1,890	16,765	1,050
Europe Price + Tax (Euro)	2,509	22,257	1,394
CNY Price + Tax (RMB)	18,274	162,097	10,152
China Retail Price (RMB)	26,600	198,500	15,000
China Price After Discounts (RMB)	21,280	178,650	13,500
Premium (RMB)	3,006	36,403	628,063
Premium (Euro)	413	4,998	69,316
Margin to Europe Price	21.8%	22.5%	47.8%

Source: www.xbiao.com, J Capital Research

### Discounting in China

In Mainland China, our checks with retailers indicate that discounts are higher than before. For Longines, some dealers are offering discounts of 15%, versus 5-10% in 2014.

Dealers' margins are also falling. In H1 2015, Hengdeli and Emperor saw their gross margin decline 0.9% and 0.7% YoY respectively. Additionally, there is a shift toward cheaper new models with lower prices, often 10-20% lower than the prices of old models.

### Table 4. Falling Gross Margins of Dealers

Gross Margin	H1 2014	H1 2015	YoY
Hengdeli	31%	30%	-0.9%
Emperor	25%	24%	-0.7%

Source: Company data

### Too Late for the Smart Watch Business

Like many listed companies, Swatch needs a good story. When the market came to understand that watch sales were declining, Swatch changed its

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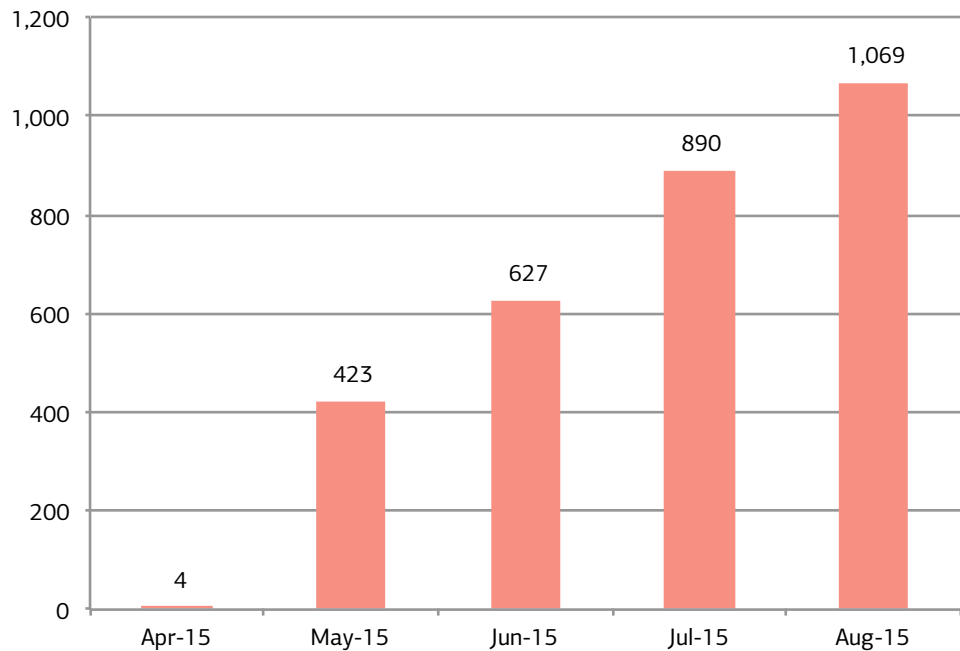
attitude toward the smart watch.

Back in 2014, we remember Swatch expressed more than once its dubiousness that Apple and the smart watch market would be threats. But the company nevertheless delved into R&D and unveiled three models in 2015: the Swatch Touch One, the Tissot Touch, and the Swatch Bellamy.

Even though this is an ambitious move, we believe the two new models under the basic brand Swatch may replace older traditional watches but are unlikely to compete head to head with smart watches that function with phones.

Unfortunately for Swatch, the selling prices of Apple watches are in the same range as Tissot, which is the most popular brand in the Mainland retail network, and we believe that the iWatch took some market share from Tissot starting in April. Tissot customers tend to be careful spenders and, once they buy an Apple watch, they give up the Tissot. As of August, only four months from the official launch, users of Apple watches reached 1.07 mln in Mainland China, according to Talking data. As of 2014, there were 1.06 bln smart phone users in China, of whom 340 mln, or 32%, were iPhone users. This large user base gives Apple a very big head start. Entering the smart phone business is not a smart move for Swatch.

**Chart 4. Apple Watches in China April 24 – Aug 23 ('000)**



Source: Talkingdata

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### Valuation

We see no improvement for Swatch sales in the Greater China and close coverage of Swatch with this report. With updated financials and estimates, we adjust our price to CHF 363.40 from CHF 381.20 by applying a DCF model with WACC of 9.5%.

**Table 5. Sales Estimates**

in CHF mln	2014	2015e	2016e
<b>Total Sales</b>	8,709	8,428	8,501
<b>YoY Change</b>	3.0%	-3.2%	0.9%
<b>Sales from Greater China</b>	3,224	2,692	2,513
<b>YoY Change</b>	0.5%	-16.5%	-6.6%
<b>EBIT</b>	1,752	1,714	1,691
<b>EBIT Margin</b>	20.1%	20.0%	19.9%

Source: Company data, J Capital Research

**Table 6. WACC**

WACC	
<b>Risk Free Rate</b>	0.5%
<b>Market Risk Premium</b>	8.6%
<b>Equity Beta</b>	1.05
<b>Cost of Equity</b>	9.5%
<b>Cost of Debt (Pre-Tax)</b>	3.0%
<b>Cost of Debt (After Tax)</b>	2.4%
<b>Target Debt Weight</b>	0.7%
<b>Target Equity Weight</b>	99.3%
<b>Tax Rate</b>	20.0%
<b>WACC</b>	9.5%
<b>Terminal Growth</b>	1.5%

Source: Company data, J Capital Research



**Table 7. Sensitivity Analysis (in CHF)**

		WACC				
		8.50%	9.00%	9.50%	10.00%	10.50%
Terminal Growth Rate	0.50%	383.6	349.9	320.3	294.1	270.9
	1.00%	411	373.4	340.6	311.8	286.4
	1.50%	442.3	400	363.4	331.6	303.6
	2.00%	478.4	430.4	389.3	353.8	322.8
	2.50%	520.6	465.6	419	379	344.5

Source: Company data, J Capital Research

## Risks

- ▶ Aggressive build in inventory by distributors and retailers such as Hengdeli
- ▶ Reduction of luxury tax and adjustment of pricing strategy could increase the sales of imported watches in Mainland China
- ▶ Other geographic regions could grow faster than we expect
- ▶ Mainland visits to Hong Kong may revive
- ▶ Strong rebound of the Chinese economy

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