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# Richemont (CFR VX)*
# Easy Come, Easy Go

- **We believe Richemont** is entering a long period of slow growth, dragged down by a contracting consumer economy in China. We estimate that China contributes ~45% of Richemont's total revenue once Greater China sales and gray-market sales from overseas are factored in.

- **Richemont is reporting** that Chinese sales are recovering. But our checks say they're not. Richemont is trying to lure them back by dropping prices by 10-20% in Greater China, but we think this is not working.

- **Richemont is facing** a significant currency headwind in 2016 due to a strengthening Euro and a weaker RMB. A 5% depreciation in the RMB would mean a -12% decline in China and Hong Kong revenue and a -3.3% decline for the entire group.

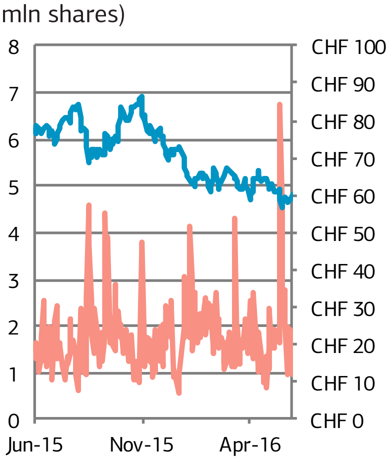
- **Richemont has experienced** declines in all product segments. As consumers switch to less-expensive products and the expanding retail network adds costs, the group will continue to see deteriorating margins. In addition, we think there is still inventory pressure at both the corporate level and in the retail chain.

- **Our target price** of CHF 52.29 is based on a DCF model with a WACC of 9.4% and terminal growth of 2.0%. We apply the sum-of-parts method to estimate future revenues from main geographic regions and add the impact from an estimated 5% depreciation of RMB in H2 2016.

**Richemont (CFR VX)***

| | |
|---|---|
| Price | CHF 61.60 |
| **Rating** | **SELL** |
| **Price Target** | **CHF 52.29** |
| Difference | 15.1% |
| Market Cap | EUR 34.77 bln |
| P/E | 18.41x |
| Avg. Volume | 1.835 mln |

Richemont (CFR VX) last share price in CHF (blue) and volume (pink, in mln shares)




Source: Bloomberg

* Note: This report has been updated to correct a currency error. The original version, dated June 7, gave price information in Euros rather than CHF.

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# The End of the China Story

## The Basics

Richemont is a victim of its own success.

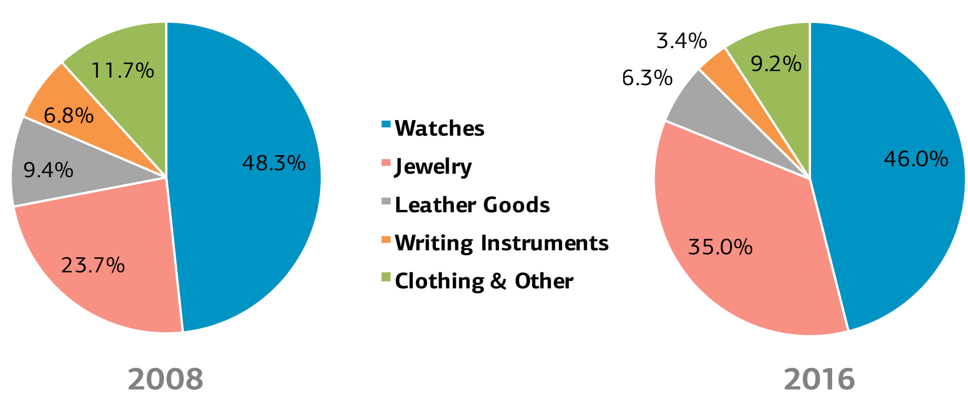
Of all the multinationals operating in China, Richemont is among the most visible victims of their own success. The company executed brilliantly on its plan to increase its access to the China market, and the proportion of sales coming from Greater China rose from 15% in 2008 to 27% in 2012. A still higher percentage of sales comes from Chinese nationals buying Richemont products all over the world; we estimate that 45% of total sales may come from Chinese buyers.

Skyrocketing Chinese consumption growth drove the share gain. But just as leverage accelerates growth, so will deleveraging lead to a contraction in the Chinese economy and Richemont's China sales. Right now, that process is beginning.

Richemont is among the world's leading luxury groups in jewelry as well as high-end watches, manufacturing and selling premium jewelry, watches, leather goods, writing instruments, and clothing and accessories.

Richemont derives most of its revenue from watch sales. In FY 2016, which ended on March 31, 2016, the group reported total revenue of EUR 11.1 bln, of which 46% came from watches and 35% from jewelry. Watches remain the top category for the group in terms of total revenue, but Richemont has had success in expanding the portion of revenue from jewelry, which has become the biggest division by revenue. Richemont operates the prestigious jewelry "maisons" Cartier, Van Cleef & Arpels, and others.

### Chart 1. Sales by Product in FY 2008 and FY 2016




Source: Company data

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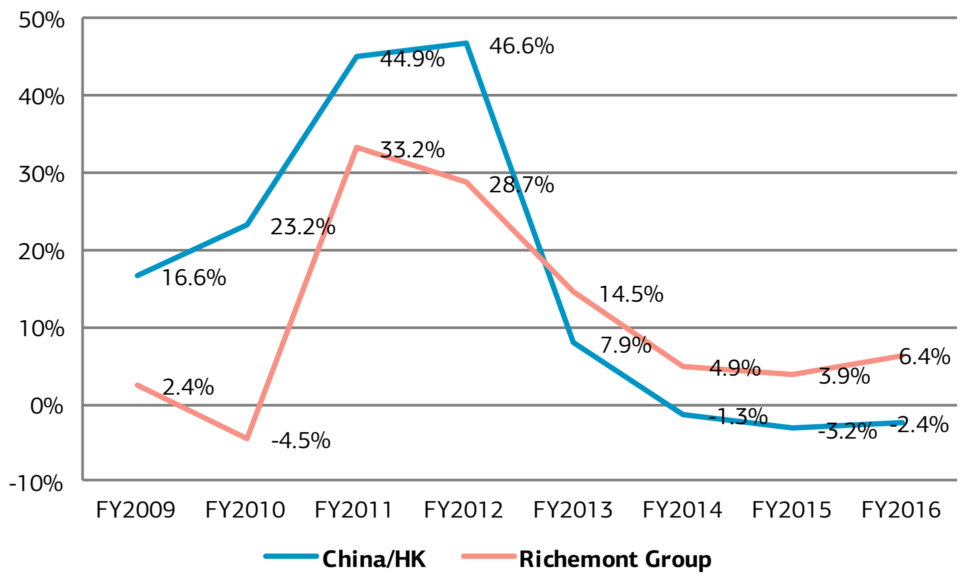
Revenue contribution from Greater China increased from 4.9% in FY 2008 to 21.6% in FY 2016, already down from the peak of 27.2%, in FY 2012. Since 2012 as well, the fast growth in the contribution from Hong Kong sales slowed and went negative in FY 2013.

By 2013, China had become a drag on Richemont's growth.

## Chart 2. YoY Change in Total Sales and in Greater China Net Sales




Source: Company data

## 45% of Sales to Mainland Customers

While the Asia region is 44.9% of the group's total revenue and China/ Hong Kong over 21.6%, we believe China is actually much bigger than these numbers suggest. Richemont offers prestige and luxury watches that sell for over USD 2,000 each and jewelry with a unit price of over USD 800. Those price points make it desirable to purchase outside of China, where import and luxury taxes can be avoided. According to Bain Research, about two-thirds of luxury goods purchased by Chinese people are bought within China and one-third are bought overseas. we believe the luxury segment is more lopsided toward overseas purchasing, which represents around 50% of the total.

## Table 1. Est. Real Sales from Chinese Customers (EUR mln)

| | |
|---|---|
| **Sales in China/Hong Kong in FY2016** | 2,392 |
| **Estimated Sales in Other Regions** | 2,653 |
| **Europe** | 959 |

| | |
|---|---|
| **Middle East/Africa** | 390 |
| **Other Asia Countries** | 1,030 |
| **Americas** | 274 |
| **Estimated Sales from Chinese Customers** | 5,045 |
| **As % of Total Group** | 45.6% |

In total, we estimate that about 45% of Richemont's sales come from Mainland China.

## No Signs of Recovery

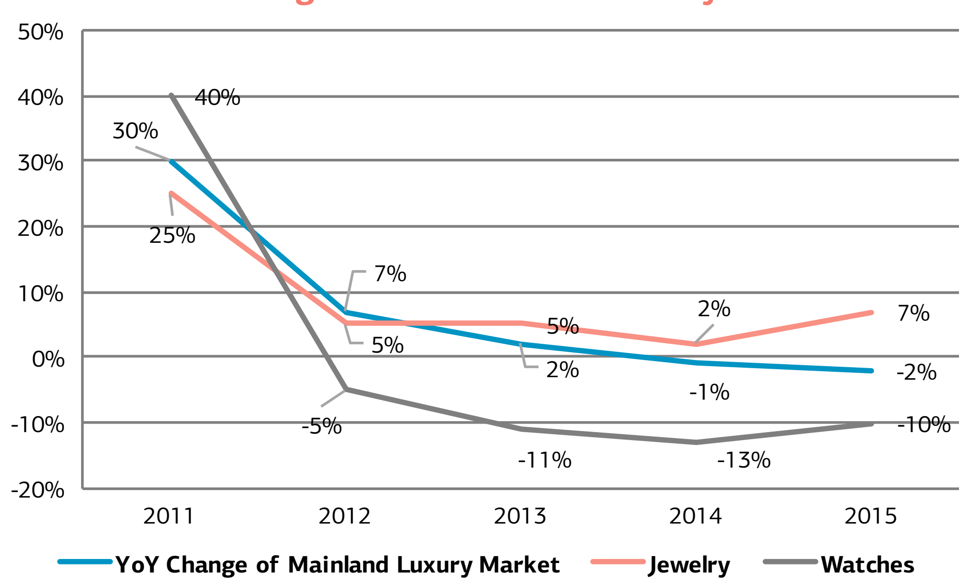
The luxury industry has been on the decline in China.

In years past, exposure to China was a positive thing for any ambitious luxury company. That started to change in 2012, when the anti-corruption campaign began. The restrictions on government purchasing triggered a continuous decline in the luxury industry. Luxury watches have seen the most dramatic change, from 40% YoY increases to double-digit declines. As go luxury watches, so goes jewelry. Originally, jewelry sales seemed to be recovering, rising 16.7% YoY in 2015, but our checks do not support Richemont's positive story.

### Just Not Buying Anymore

Less purchasing can no longer be blamed on the anti-corruption campaign. Chinese people are more aware of a slowing economy and are less willing to spend. Richemont reported a single-month increase of 26% YoY in April

### Chart 3. YoY Change in the Mainland Luxury Market




Source: Bain Research

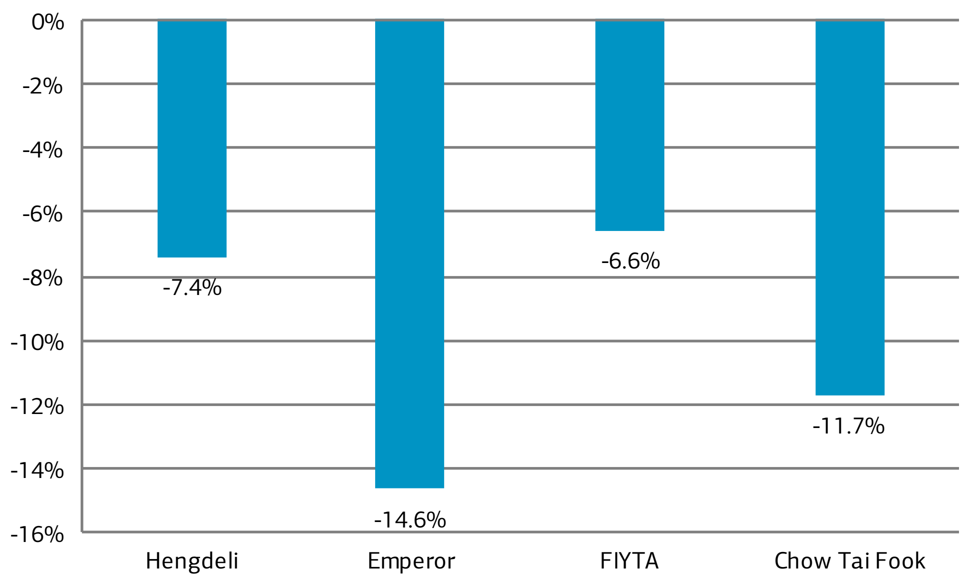
sales, but we think that was from the wholesale channel rather than consumers and represented one more effect of swelling assets prices following the burst of credit in Q1.

Our checks with dealers and retailers offer no reason for optimism.

**Watches:** Four listed watch dealers, Hengdeli, Emperor, FIYTA Holdings, and Chow Tai Fook all reported negative growth in watch sales in Mainland China in 2015, ranging fromm-6.6% (Fiyta) to -14.6% (Emperor). Customs data show that the import value of watches to China fell by -10% for the year to March 31.

In April, things got worse: the import value of watches was down 19% YoY.

### Chart 4. YoY Change in Watch Sales in Mainland China




Source: Company data

**Jewelry:** Statistics on jewelry sales in Mainland China are not positive either. China Customs shows that jewelry imports in the 11 months through February 2016 fell by 11% YoY. Even the ever-positive National Bureau of Statistics reports only 0.8% growth in retail sales of gold, silver and jewelry for the Richemont fiscal year, ending March 31. NBS reported that jewelry sales rose 5% YoY, but that was still below the 10% YoY growth of April 2015.

### The April Anomaly

April did see sales growth in jewelry, but our checks indicate that this was

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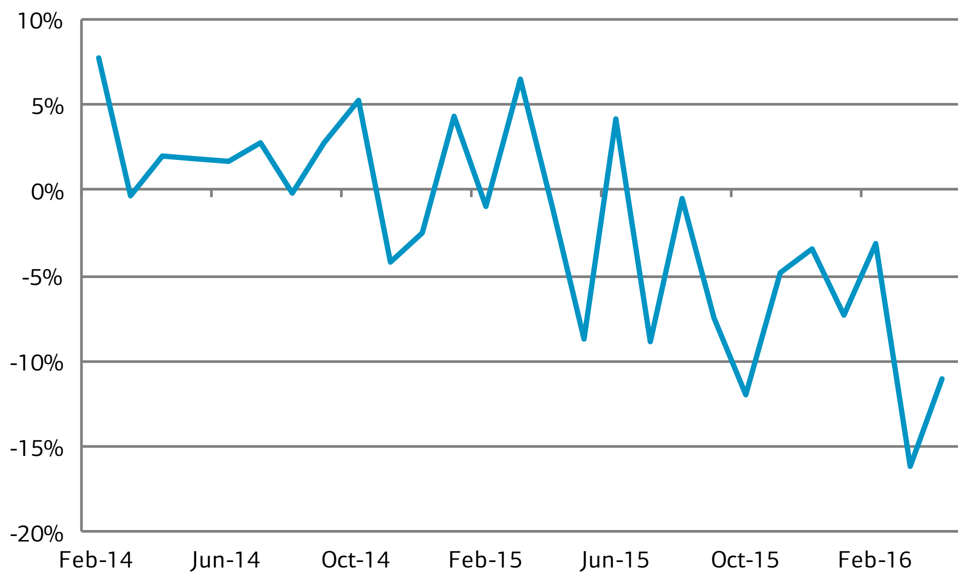
speculation on the price of gold. Richemont does not benefit much from gold fever because of the premium paid for the brand, worth much less on the secondary market. In the past, Richemont was able to persuade customers that any luxury product would hold its value, but now luxury brands are all dropping their prices. This includes Cartier, which contributes most of Richemont's sales in the region.

Swiss watch exports reported by the Federation of the Swiss Watch Industry recorded a double-digit drop of- 11.1% by value in April exports to China, the tenth consecutive monthly decline.

### Chart 5. YoY Change of Monthly Export Value by FHS




Source: FHS

The decline was mainly due to a drop in the export of precious watches costing more than CHF 3,000 each. There was slight export growth to the U.S., UAE, and the UK butother countries suffered major declines: Hong Kong (-17%), China (-36%) but also Italy (-12%), Germany (-11%), and France (-31%). Even Japan, which emerged as the most popular destination for Chinese tourists, also fell by 5.9% YoY. Since Richemont sells about 22% of all Swiss watches, it should be heavily impacted.

Richemont sells about 22% of all Swiss watches.

## Bitter Competition

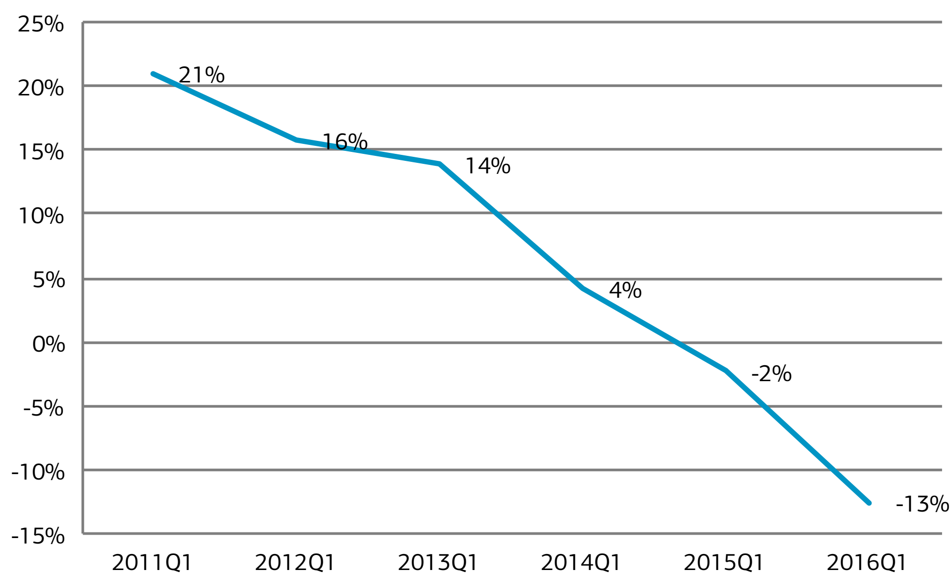
Chinese customers at the moment have little brand loyalty: according to Bain Research, about 50% of Chinese customers frequently switch luxury brands. Although watches and jewelry might be relatively better off than clothing, the luxury companies still contend with brutal competition in the China market. Cartier, for example, is competing in China directly with Swatch's Omega for watch sales and with Bvlgari and Tiffany for jewelry sales.

## The Great Fall in Hong Kong

Q1 2016 was a terrible quarter for the Hong Kong retail industry. According to the Hong Kong Retail Management Association (HKRMA), retail sales in Q1 fell by 12.5% YoY. Jewelry, watches, and valuable gifts performed even worse, down 18.3% YoY.

Policy changes will have a further negative impact. Chinese Customs is watching the border with greater care because of concern about capital flight, there are new visa restrictions, and it is becoming harder to buy items brought in from Hong Kong by agents. Luxury jewelry and watches will bear the brunt of these rules since these items are often carried across the border by individuals.

### Chart 6. YoY Change in Q1 Retail Sales in Hong Kong




Source: HKRMA

The Q1 results were a miserable showing even compared with Q1 2015, when protests against the Mainland spilled over into hostility toward Mainland shoppers. Hong Kong continues to suffer from its hostile image after several reported clashes with Mainland tourists. Among the top 12 destinations of Chinese outbound tourists, Hong Kong remains No. 1, but its contribution dropped to about 30% in Q4 2015 from over 40% in Q4

2013. In Q1 2016, Chinese travelers to Hong Kong declined by 15.1% YoY.

Despite the 7.1% YoY improvement in the number of visitors during the May Day holiday, we believe there is shift in the way Chinese tourists spend their time in Hong Kong. They make shorter visits and use the region as a transit hub to other countries, since Hong Kong is a cheap relay point. Tourists visiting Hong Kong also spend less than they used to. This may be because visitors are younger and have less purchasing power. The Hong Kong dollar has also appreciated against the RMB, and the region no longer seems to offer great deals for luxury goods. When Disneyland Shanghai opens June 16, we expect a further drain on tourism from Hong Kong.

## Lower Selling Prices

Luxury groups like to dream of the potential rise of the Chinese middle class, but they forget that the middle class cares about prices. E-commerce has meant more transparency on selling prices, and Chinese customers can compare prices in different regions and distribution channels. This tends to turn retail stores of prestige and luxury brands into showrooms for customers who actually order on the internet.

Sales are mainly driven by mid-end products and from regions that offer better selling prices. The same trend happened in 2009, but at that time, Richemont still had a Chinese market to explore. Now, relying on middle-class Chinese customers, Richemont will have to face more pricing adjustments and more offshore purchases rather than from the profitable Mainland China region.

To bring sales back to the Mainland, Richemont lowered selling prices by 10-20% in April 2015, but it did not help very much. The price differential is still significant too.Take Cartier's Ballon Bleu: current prices of the two best-selling models are still about 21% higher than the price in Germany. And overseas dealers often provide more generous discounts.

### Table 2. Price Comparison: Mainland, Hong Kong and Germany (RMB/unit)

| Model | Mainland Price | HK Price | Variance | German Price After Tax Refund | Variance |
|---|---|---|---|---|---|
| **W69017Z4** | 40,900 | 34,440 | -15.8% | 32,350 | -20.9% |
| **W69010Z4** | 33,700 | 28,476 | -15.5% | 26,659 | -20.9% |

Source: Cartier, iwatch, J Capital Research

### Table 3. Price Range of Main Watch & Jewelry Brands in Mainland China

| Main Brands of Watches & Jewelry | Price Range (RMB) |
|---|---|
| **Specialist Watchmakers** | |
| **Roger Dubuis** | 99,000-7,850,000 |
| **Vacheron Constantin** | 88,000-10,234,000 |
| **A. Lange & Söhne** | 145000-3,950,000 |
| **Jaeger-LeCoultre** | 31,500-6,300,000 |
| **IWC Schaffhausen** | 24,800-2,550,000 |
| **Officine Panerai** | 30,000-1,260,000 |
| **Baume & Mercier** | 12,800-699,000 |
| **Jewelry Maisons** | |
| **Cartier** | |
| Watch | 17,500-4,350,000 |
| Jewelry | 4,150-1,670,000 |
| **Piaget** | |
| Watch | 52,000-16,378,200 |
| Jewelry | 6,300-605,000 |
| **Van Cleef & Arpels** | |
| Watch | 364,000-890,000 |
| Jewelry | 5,800-614,000 |

Source: J Capital Research, Xiaobiao.com

We believe dealers go shopping around the world.

In addition to the better deals offered to individual customers in overseas markets, we believe dealers go shopping around the world for the best wholesale prices, especially when currencies fluctuate a lot. We are not able to give a precise estimate of the gray market for watches and luxury products, but Swiss exports to other parts of Asia are very sensitive to tariffs in China.

## Currency Fluctuation

Richemont faces a significant currency headwind in 2016 due to a strengthening Euro and a weaker RMB. Last year, a weaker Euro helped boost Richemont's sales around the world. And this also attracted global tourists, driving up sales in Europe by 10% in FY2016 compared with 6% in FY 2015. But this year, we take a further 5% depreciation in the RMB as our base scenario for H2 2016. The downside FX impact on Richemont's revenue in Greater China (China & Hong Kong) would be -12.0% and -3.3% for the entire group.

## Table 4. YoY Growth of Sales in FY2016 by Region

| YoY Growth of Sales in FY2016 by Region | at Constant Rate | at Actual Rate |
|---|---|---|
| **Europe** | 10% | 10% |
| **Middle East/Africa** | 2% | 16% |
| **Asia Pacific** | -13% | -4% |
| **Americas** | -1% | 10% |
| **Japan** | 20% | 27% |

Source: Company data

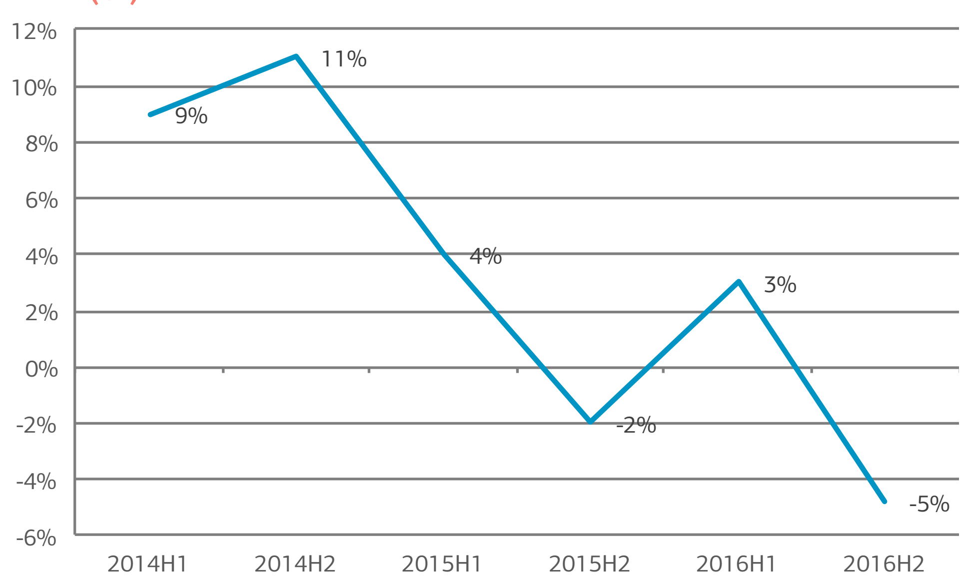
With more visa relaxation and more holiday, Chinese are more willing to travel. In 2015, total outbound Chinese tourism grew 14.5% YoY. Chinese tourists to Japan doubled, thanks to a weak Yen. Chinese tourists to France and Germany increased by 37.7% and 29.6% respectively in 2015. That helped Richemont sales in those regions.

## Table 5. Outbound Chinese Tourists to Europe (000s)

| Outbound Chinese Tourists to Europe (In 000s) | 2014 | 2015 | YoY |
|---|---|---|---|
| **France** | 1,900 | 2,462 | 29.6% |
| **Germany** | 988 | 1,361 | 37.7% |

Source: China Outbound Tourism Research Institute (COTRI)

## Chart 7. YoY Richemont's Half-Year Sales at a Constant Rate (%)

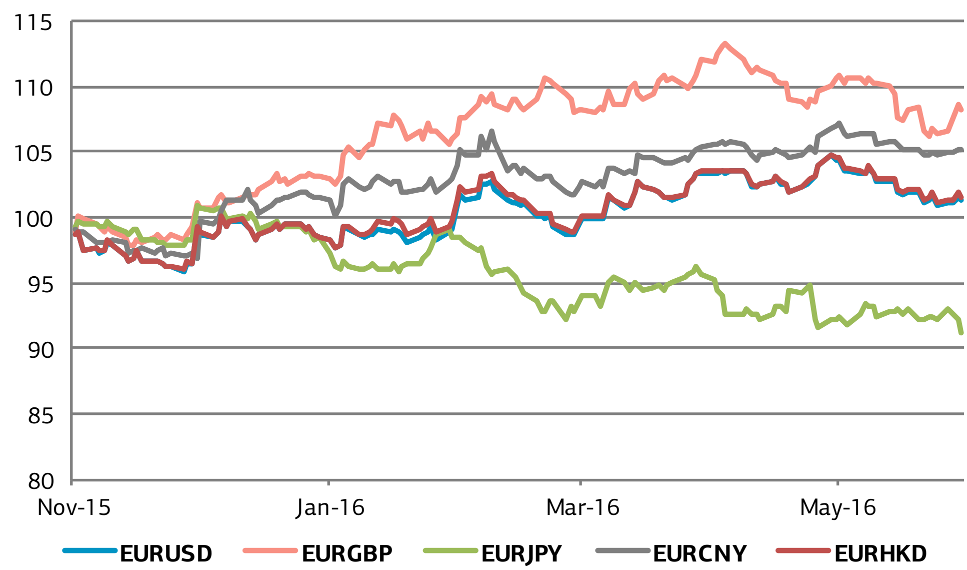



Source: Company data

With the help of fluctuating currencies, Richemont managed to maintain the growth of reported revenues, but at a constant rate, top-line revenue was actually down -1% YoY in FY 2016 and -5% YoY in H2 2016.

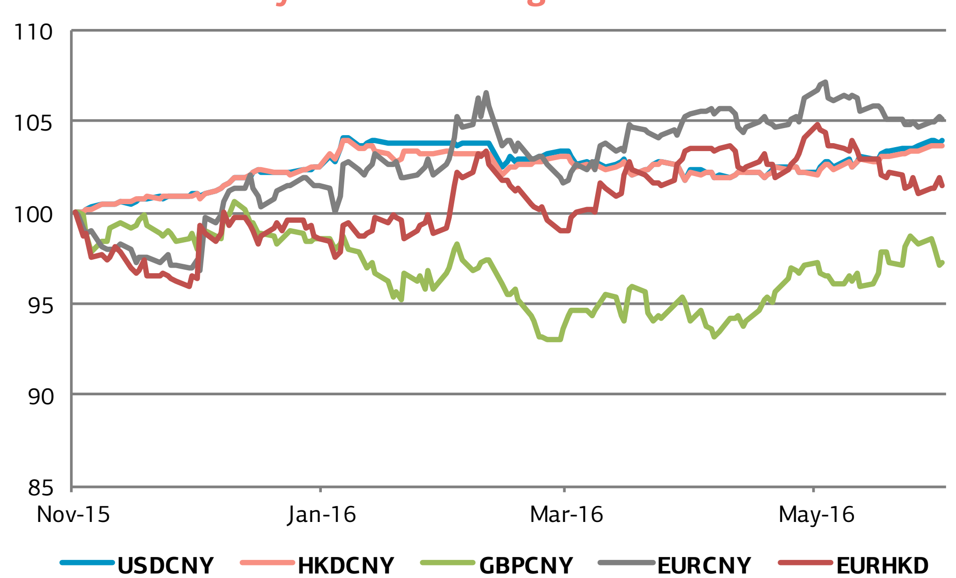
This bonus is ending due to a stronger Euro. Since the end of 2015, the Euro has appreciated against the USD by 5%, the GBP by 10%, the Chinese

## Chart 8. Comparison of Currency Movement of EURO Against USD, GBP, JPY, CNY and HKD




Source: Bloomberg

## Chart 9. Currency Movements Against the CNY




Source: Bloomberg

Yuan by 9%, and the Hong Kong Dollar by 6%. The strengthening Euro will force Chinese tourists to spend more for luxury products in Europe and thus will hurt the sales of luxury goods. Since Richemont generates the majority of its net sales from regions where local currencies are weakening against Euro, the group will have to see its reported sales negatively impacted.

### Table 6. Our Estimate of Currencies and Sensitivity of Net Sales in FY2017E

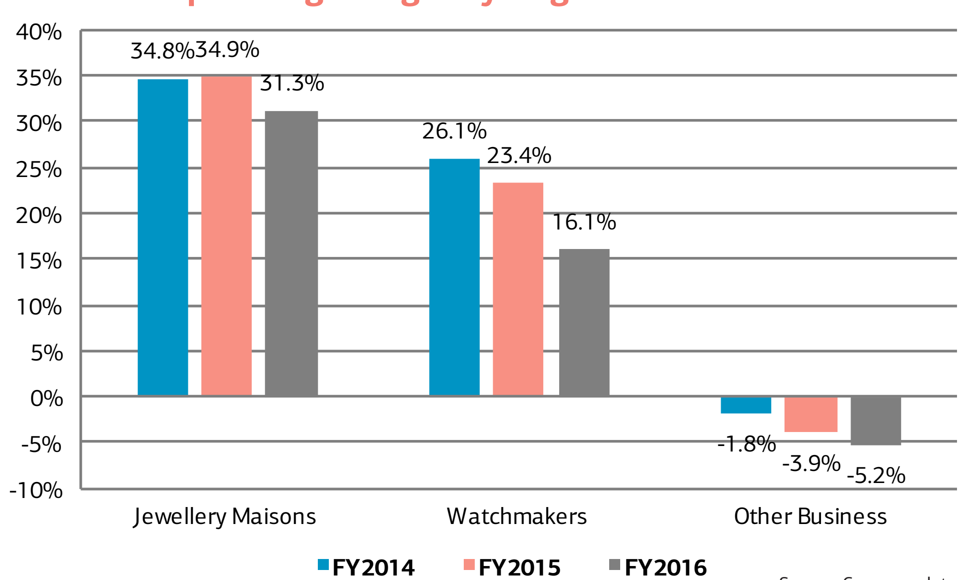
| (EUR mln) | Bull | Base | Bear |
|---|---|---|---|
| **% of RMB Depreciation** | 0% | -5% | -10% |
| **Total Sales** | 10,949 | 10,589 | 10,242 |
| **Sales from Greater China** | 2,238 | 1,969 | 1,709 |
| **Greater China as % of Total Group** | 20.4% | 18.6% | 16.7% |

Source: Company data, J Capital Research

## Deteriorating Margins, Over-Investment

Richemont has improved its gross margin thanks to the expansion of its own retail network and price declines for gold and diamonds. However, in FY 2016, gross margins fell 1.8% to 64.3%, from 66.1% and operating margins declined to 18.6% from 23.4%. Although restructuring and one-

### Chart 10. Operating Margin by Segment

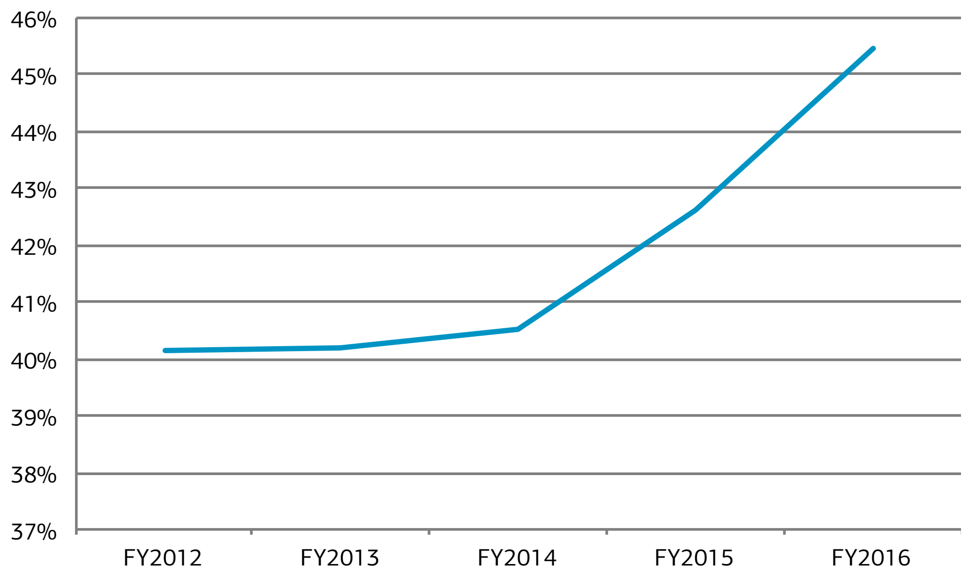



Source: Company data

off charges of EUR 97mln were partly to blame, the major product categories of Richemont all showed declining operating margins despite top-line growth.

With more retail stores owned by Richemont itself, there will be more operating expenses and capex to support.

### Chart 11. Operating Expenses as % of Total Sales




Source: Company data

An owned retail network is good for generating higher margins and better-managed sales. But Richemont's excessive optimism is saddling the company with too many outlets and high operating costs. Even as the group maintains high capital expenditure, the EBIT margin has been falling for three years.

### Table 7. Capex & EBIT Margin

| | FY2014 | FY2015 | FY2016 |
|---|---|---|---|
| **EBIT Margin** | 24.2% | 23.4% | 18.6% |
| **Capex of Retail Network (EUR mln)** | 257 | 326 | 312 |
| **Capex of Retail Network as % of Retail Sales** | 4.4% | 6.0% | 5.1% |

Source: Company data

# Build-Up of Inventory

By expanding its own retail network, Richemont has incurred a significant inventory problem in both watches and jewelry. We calculate that FY 2016 inventory days climbed to 662 days, up from 382 before the start of anti-corruption campaign in 2012. Of all inventories, finished goods contributed the majority, 66%.

## Table 8. Inventory Days

| Days of Inventories | FY 2011 | FY 2012 | FY 2013 | FY 2014 | FY 2015 | FY 2016 |
|---|---|---|---|---|---|---|
| **Days of Inventories before Provisions*** | 399 | 382 | 429 | 537 | 637 | 662 |
| **Days of Inventories** | 369 | 366 | 402 | 454 | 511 | 497 |

Source: Company data, J Capital Research | * Days of Inventory before provisions are calculated by average reported inventories before provisions over cost of inventories recognized as an expense and included in cost of sales during the fiscal year.

Richemont regularly buys back inventory from its third-party partners. The company records a provision against its inventory for damaged and non-salable items and gradually writes down inventories. For FY 2016, Richemont's write-down of inventory as percentage of the cost of inventories grew to 7% from 5%, and we believe that represents the purchase of inventories from dealers.

## Table 9. Inventory

| (EUR mln) | FY 2014 | FY 2015 | FY 2016 |
|---|---|---|---|
| **Inventory** | 4906 | 5952 | 5908 |
| **Provision** | -451 | -514 | -563 |
| **Net Inventory** | 4455 | 5438 | 5345 |

Source: Company data

## Table 10. Write-Down of Inventory

| (EUR mln) | FY 2012 | FY 2013 | FY 2014 | FY 2015 | FY 2016 |
|---|---|---|---|---|---|
| **The cost of inventories recognized as an expense and included in cost of sales** | 3217 | 3631 | 3532 | 3534 | 3958 |
| **Write-down of inventory as a charge to cost of sales** | 115 | 127 | 163 | 159 | 232 |
| **As % of total cost of inventories** | 3.7% | 3.7% | 5.2% | 5.1% | 7.1% |

Source: Company data

In addition to its own inventory problem, inventory in the third-party distribution channels still needs time to fix. In past years, to capture the fast-growing demand for luxury jewelry and watches and gain market share in China, Richemont leaned heavily on distributors and retailers. Thanks to the expansion needs of large distributors such as Hengdeli, Richemont managed to generate strong revenue growth by building up inventories in the trade channels. However, gradually falling sales are forcing distributors to reduce their inventories. And it turns out, the whole process has lasted longer than the market expects.

### Table 11. Inventories of Large Dealers

| Inventories | 2014 | 2015 |
|---|---|---|
| **Hengdeli (RMB 000s)** | 6,612,693 | 6,376,350 |
| **Emperor (HKD 000s)** | 3,838,528 | 3,219,196 |

Source: Company data

To promote its lower-priced watch brand Baume & Mercier in Mainland China, Richemont established a JV company with Chow Tai Fook in 2013. It does not seem very successful. Baume & Mercier are obscure brands compared with Swatch's Longines. CTF isn't positioned to help: its 2015 retail revenue from watches fell by 11.7% YoY.

### Table 12. YoY Change in Revenue of Richemont's Dealers

| | Revenue Growth in 2015 |
|---|---|
| **Emperor** | -25.2% |
| **Jewelry** | -19.2% |
| **Watch** | -26.6% |
| **Hengdeli** | -9.9% |
| **Fiyta: Sales of high-end watches** | -6.6% |
| **Chow Tai Fook's watch business in ML China** | -11.7% |

Source: Company data

# Valuation

Our target price of CHF 52.29 is based  is based on a DCF model with a WACC of 9.4% and terminal growth of 2.0%. We apply the sum-of-parts method to estimate future revenues from main geographic regions and add the impact from an estimated 5% depreciation of RMB in H2 2016.

### Table 13. Our Sales Estimate (EUR mln)

| Sales Estimate by Region | FY 2016 | FY 2017 Est | FY 2018 Est | FY 2019 Est | FY 2020 Est | FY 2021 Est |
|---|---|---|---|---|---|---|
| **Europe** | 3,388 | 3,353 | 3,378 | 3,422 | 3,485 | 3,550 |
| *YoY Change* | | *-1.0%* | *0.7%* | *1.3%* | *1.9%* | *1.9%* |

| Sales Estimate by Region | FY 2016 | FY 2017 Est | FY 2018 Est | FY 2019 Est | FY 2020 Est | FY 2021 Est |
|---|---|---|---|---|---|---|
| **Middle East/Africa** | 975 | 1,034 | 1,085 | 1,140 | 1,197 | 1,256 |
| *YoY Change* | | *6.0%* | *5.0%* | *5.0%* | *5.0%* | *5.0%* |
| **Asia Pacific** | 4,968 | 4,544 | 4,321 | 4,214 | 4,230 | 4,291 |
| *YoY Change* | | *-8.5%* | *-4.9%* | *-2.5%* | *0.4%* | *1.4%* |
| **Americas** | 1,745 | 1,658 | 1,665 | 1,684 | 1,711 | 1,738 |
| *YoY Change* | | *-5.0%* | *0.4%* | *1.1%* | *1.6%* | *1.6%* |
| **Total** | 11,076 | 10,589 | 10,450 | 10,460 | 10,623 | 10,836 |
| *YoY Change* | | *-4.4%* | *-1.3%* | *0.1%* | *1.6%* | *2.0%* |

Source: Company data, J Capital Research

## Table 14. WACC

| | |
|---|---|
| **Risk Free Rate** | -0.4% |
| **Market Risk Premium** | 9.8% |
| **Equity Beta** | 1.18 |
| **Cost of Equity** | 11.1% |
| **Cost of Debt (Pre-tax)** | 1.3% |
| **Cost of Debt (After tax)** | 1.1% |
| **Target Debt weight** | 16.5% |
| **Target Equity weight** | 83.5% |
| **Tax Rate** | 18.0% |
| **WACC** | 9.4% |
| **Terminal Growth** | 2.0% |

Source: Bloomberg

## Table 15. Sensitivity Analysis

| Sensitivity Analysis | | WACC | | | | |
|---|---|---|---|---|---|---|
| | | **8.4%** | **8.9%** | **9.4%** | **9.9%** | **10.4%** |
| **Terminal Growth Rate** | **1.0%** | 53.9 | 50.7 | 47.9 | 45.3 | 43.1 |
| | **+1.5%** | 56.7 | 53.1 | 49.9 | 47.1 | 44.7 |
| | **+2.0%** | 59.9 | 55.8 | 52.3 | 49.2 | 46.5 |
| | **+2.5%** | 63.7 | 59.0 | 55.0 | 51.5 | 48.5 |
| | **+3.0%** | 68.2 | 62.7 | 58.1 | 54.1 | 50.7 |

Source: Company data, Bloomberg, J Capital Estimate

# Risks

- Unexpected currency appreciation would increase the purchasing power of Mainland tourists.

- An easing relationship between Hong Kong and Mainland China could attract more Chinese customers.
- A loosening of the anti-corruption movement could strengthen gift demand in China.
- A stronger-than-expected recovery of the world economy would drive up sales of luxury goods.
- Loosening control of China Customs or a lower import tax rate would spur more spending on luxury watch and jewelry.

# Disclaimer



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