24th May 2016

Luxury & Consumer Goods

The Swatch Group

Price CHF289.90

More cautious view on The Swatch Group prospects

Fair Value CHF370 vs. CHF410 (+28%) **NEUTRAL**

Bloomberg	UHR VX
Reuters	UHR.VX
12-month High / Low (CHF)	432.9 / 289.9
Market Cap (CHF)	15,949
Ev (BG Estimates) (CHF)	14,274
Avg. 6m daily volume (000)	265.1
3y EPS CAGR	1.2%

	1 M	3 M	6 M	31/12/15
Absolute perf.	-11.8%	-13.0%	-19.9%	-17.2%
Pers & H/H Gds	-0.1%	2.3%	-5.5%	-1.0%
DJ Stoxx 600	-3.4%	2.7%	-11.5%	-8.0%

YEnd Dec. (CHFm)	2015	2016e	2017e	2018e
Sales	8,451	8,470	8,870	9,280
% change		*0.2%*	*4.7%*	*4.6%*
EBITDA	1,817	1,735	1,880	2,022
EBIT	1,451	1,360	1,500	1,643
% change		*-6.3%*	*10.3%*	*9.5%*
Net income	1,089	980.0	1,090	1,236
% change		*-10.0%*	*11.2%*	*13.4%*

	2015	2016e	2017e	2018e
Operating margin	17.2	16.1	16.9	17.7
Net margin	12.9	11.6	12.3	13.3
ROE	10.0	8.5	9.1	9.4
ROCE	12.2	10.0	10.7	11.0
Gearing	-14.4	-14.0	-13.8	-12.8

(CHF)	2015	2016e	2017e	2018e
EPS	20.11	16.54	18.40	20.86
% change	-	*-17.7%*	*11.2%*	*13.4%*
P/E	14.4x	17.5x	15.8x	13.9x
FCF yield (%)	4.0%	3.2%	3.5%	3.5%
Dividends (CHF)	7.50	7.88	8.27	8.68
Div yield (%)	2.6%	2.7%	2.9%	3.0%
EV/Sales	1.7x	1.7x	1.6x	1.5x
EV/EBITDA	7.9x	8.2x	7.6x	7.0x
EV/EBIT	9.9x	10.5x	9.5x	8.7x

Given the very poor Swiss watch industry (-9.5% YTD) and the clearly tough environment for the luxury industry, we have decided to be more cautious on The Swatch Group's prospects. Following this review, we have lowered our 2016-2017 EBIT by 9% implying further margin erosion (-110bp to 16.1%), hence our new CHF370 FV versus CHF410 previously. Neutral recommendation reiterated.

ANALYSIS

- **The Swiss watch industry is clearly under pressure** and is undoubtly the sector the most affected by the very challenging environment within the entire luxury industry. On first 4m 2016, Swiss watch exports fell 9.5% including -16% in March and -11% in April. Unsurprisingly, exports to Hong Kong and Mainland China were down respectively 7.4% and 31% (-25% for Greater China) over the first three months of the year and the trend is going on in April (-36% in China). HK accounted for 15% of the Swiss watch industry in 2015 while the weight of Mainland China was around 6%. Nevertheless, Asia is not the only issue currently, and indeed the US (11% of Swiss watch exports) is in no better shape with a 15% decline in exports in Q1. The reasons for such a soft US market are i/ low tourism levels given the strong USD; ii/ a challenging situation in US Department stores given e-commerce development and iii/ poor local consumption in an election year.
- **In this context of poor visibility, we prefer to be cautious on Swatch Group** and consequently expect almost no sales growth for FY 2016 versus +3% anticipated previously, which was even less dynamic than CEO Nick Hayek's initial guidance ("at least 5% sales increase"), after he has often proven to be overly optimistic in the past. In 2015, Greater China accounted for 33% of Swatch Group sales (37% in 2014), of which almost 20% in MC and 13% in Hong Kong, while the Americas represented 8%. Nevertheless, Europe (33% of The Swatch Group sales) is also beginning to suffer from a much more difficult situation given the lack of tourists after the terrorist attacks in Paris and Brussels as Global Blue figures highlight (Chinese tourist spending dropped more than 25% in March 2016 and 18% in April 2016). Swiss watches exports to France declined 31% in April. Eastern Europe accounts for around 3-4% of Swatch Group sales and the Middle East for close to 5%.
- **Furthermore, note that The Swatch Group is mainly wholesale driven** as retail accounts for less than 30% of sales and therefore, it is much more sensitive than other luxury groups to destocking movements in the trade and to the risk of suffering from excessively high inventory levels, particularly in the US and Hong Kong. Nevertheless, the group's management has clearly stated that it does not intend to buy back watches inventories as Richemont has announced recently.
- **For H1 2016, it is fair, to assume a 4% sales decline in our view,** with perhaps an end of the half-year with a less negative trend than in Q1 (it seems that April and May saw a slight improvement albeit still negative) and with some recovery in H2 (+3%). Comparison bases are less demanding in H2 with a 5% decline in H2 2015 compared to +3.6% in H1 2015.
- **Consequently, we lower our 2016-2017 EBIT by 9%** and we currently expect a 2016 FY EBIT at EUR1.36bn, down 6% vs 2015, implying a further profitability deterioration (-110bp to 16.1%) which leads to a 840bp decline since 2013. The Swatch Group is less reactive in implementing a cost restructuring plan than others peers (50% of total group employees are located in Switzerland with half in production), hence the new margin decrease expected which should be more significant in H1 than in H2.

VALUATION

- The Swatch Group share price has lost 17% YTD and 11% over the last month and is trading on an 8% discount vs the peer average. Following our new results assumptions, we lower our FV from CHF410 to CHF370. Neutral recommendation reiterated.

NEXT CATALYSTS

- H1 results due out end of July 2016

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