22nd July 2016

Luxury & Consumer Goods

The Swatch Group

Price CHF261.00

Hopes for better sales momentum in H2 but still low visibility on EBIT!

Fair Value CHF270 (+3%) **SELL**

Bloomberg	UHR VX
Reuters	UHR.VX
12-month High / Low (CHF)	432.9 / 260.6
Market Cap (CHF)	14,394
Ev (BG Estimates) (CHF)	12,909
Avg. 6m daily volume (000)	270.4
3y EPS CAGR	-5.9%

	1 M	3 M	6 M	31/12/15
Absolute perf.	-10.9%	-21.9%	-18.3%	-25.5%
Pers & H/H Gds	0.6%	2.2%	10.2%	2.2%
DJ Stoxx 600	0.2%	-2.6%	3.7%	-6.9%

YEnd Dec. (CHFm)	2015	2016e	2017e	2018e
Sales	8,451	7,760	7,860	8,080
% change		*-8.2%*	*1.3%*	*2.8%*
EBITDA	1,817	1,410	1,510	1,680
EBIT	1,451	1,035	1,130	1,301
% change		*-28.7%*	*9.2%*	*15.1%*
Net income	1,089	790.0	850.0	993.0
% change		*-27.5%*	*7.6%*	*16.8%*

	2015	2016e	2017e	2018e
Operating margin	17.2	13.3	14.4	16.1
Net margin	12.9	10.2	10.8	12.3
ROE	10.0	7.0	7.4	8.1
ROCE	12.2	8.1	8.3	8.8
Gearing	-14.4	-12.6	-10.8	-8.2

(CHF)	2015	2016e	2017e	2018e
EPS	20.11	13.34	14.35	16.76
% change	-	*-33.7%*	*7.6%*	*16.8%*
P/E	13.0x	19.6x	18.2x	15.6x
FCF yield (%)	4.5%	2.3%	2.3%	2.3%
Dividends (CHF)	7.50	7.88	8.27	8.68
Div yield (%)	2.9%	3.0%	3.2%	3.3%
EV/Sales	1.5x	1.7x	1.7x	1.7x
EV/EBITDA	7.0x	9.2x	8.7x	7.9x
EV/EBIT	8.8x	12.5x	11.6x	10.3x

During yesterday's conference call, Swatch Group's CEO, Nick Hayek, highlighted that he was more confident in H2 2016 sales momentum but prefered to give no guidance or forecasts for EBIT. We expect 2016 FY sales to decline by 7% (-4% in H2), while 2016 FY EBIT should be down by 560bp (-300bp in H2 alone). Given the lack of visibility on the short term, we remain at Sell on the stock with an unchanged FV of CHF270.

ANALYSIS

- During the conference call held yesterday afternoon by The Swatch Group's management, CEO, Nick Hayek was confident that H2 sales momentum should be far less negative than in H1. Nevertheless, he was much more confused concerning EBIT margin for which he gave no guidance, stating that, for him, the most important thing is market share gains (hence very limited price increases) and volumes, and clearly not profitability levels. The Swatch Group is and will remain a verticalised company with a high proportion of fixed costs. Even if the strategy is only a long term one, management also tried to optimise costs and production processes without cutting any jobs. Furthermore, retail sales (25 to 30% of total sales) were globally well oriented (up slightly), while wholesale sales were clearly negative, particularly in HK.
- The Swatch Group was clearly penalised by three countries in H1, Hong Kong (#2 world market), Switzerland (#3) and France (7#), which together account for around one third of group sales. We estimate that revenues in these three countries were down by around 20%. In other countries, the situation was better, even in some European countries, and more importantly in Mainland China. For instance, Omega's H1 retail sales (sell out) in Mainland China were up more than 30% and the trend in July was similar. For Blancpain and Longines, momentum was also very positive. Nevetheless, retailers are far more cautious and are not ordering as they are afraid the products will not be sold in their stores. One of the catalysts for MC is the still growing middle class. On the other hand, in the US, the middle class is clearly suffering and did not benefit from positive GDP momentum. In H1, the situation in the US was mixed and remains so. While the West Coast is faring well, New York is suffering due to a lack of tourists as is the case for Las vegas. The US remains a volatile market. All group brand sales suffered in H1, except Harry Winston whose sales grew double digit, particularly thanks to an exceptional sale in Mainland China for a piece of jewellery (USD20m).
- We expect FY 2016 to be down 7% at same forex, implying -3% in H2 alone after -12% in H1. The main reason for the relatively better trend is a much less demanding comparison basis (-5.6% in H2 2015 vs +3.6% in H1 2015). Despite some encouraging figures in the first days of July, in some countries (even in France) and for some brands, management did want to give any global information for this period. Furthermore, following the attacks in Nice, a further deterioration can be expected in France and even in Germany in late July and in August. Nevertheless, H2 profitability should remain under pressure albeit to a lesser extent than in H1. FY 2016 EBIT margin should be down 560bp to 11.6% (it was down close to 290 bp in 2015), implying a decline of around 300bp in H2 alone (13.4%). During the conference call, Mr Hayek prefered not to give any forecast or guidance for FY profitability, as he wants to keep higher flexibility to invest than initially expected in marketing. Furthermore, H2 margin should also be affected by investments linked to Rio Olympic games (around CHF60m to CHF70m, implying around CHF100m for FY).

VALUATION

- We remain at Sell on The Swatch Group which is trading at a 5% premium (unwarranted) vs the peer average.

NEXT CATALYSTS

- FY 2016 results to be reported at end-January 2017.

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