SINGULAR DILIGENCE

Swatch

(Swiss Exchange: UHR)

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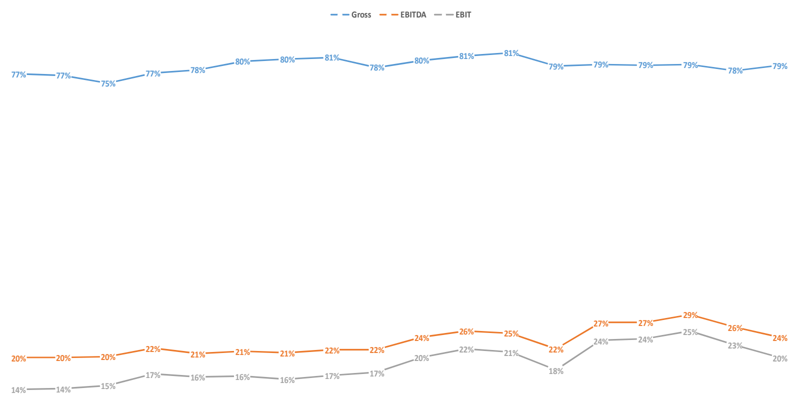
Stock Price: 387.70 CHF



	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Seiko	0.71	2.13	8.39	15.71	14.21
Movado	0.79	1.47	5.49	6.62	6.62
Citizen	0.90	2.34	7.34	11.76	10.07
Fossil	1.32	2.31	8.06	8.30	8.30
LVMH	2.82	4.36	11.35	15.12	15.12
Richemont	3.95	6.22	15.24	17.37	17.37
Minimum	0.71	1.47	5.49	6.62	6.62
Maximum	3.95	6.22	15.24	17.37	17.37
Median	1.11	2.32	8.23	13.44	12.14
Mean	1.75	3.14	9.31	12.48	11.95
Standard Deviation	1.33	1.80	3.47	4.33	4.24
Variation	76%	57%	37%	35%	35%
Swatch	2.25	NMF	9.30	11.20	9.61

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Minimum	Maximum	Median	Mean	Standard Deviation	Variation
Sales	2,970	3,185	3,518	4,131	4,048	3,933	3,845	3,981	4,292	4,820	5,646	5,677	5,142	6,108	6,764	7,796	8,456	8,709	2,970	8,709	4,556	5,168	1,775	34%
Gross Profit	2,291	2,449	2,651	3,194	3,159	3,137	3,082	3,206	3,369	3,852	4,564	4,623	4,048	4,834	5,342	6,162	6,586	6,866	2,291	6,866	3,611	4,079	1,410	35%
EBITDA	596	641	715	908	845	842	810	863	934	1,168	1,440	1,422	1,123	1,658	1,843	2,245	2,218	2,110	596	2,245	1,029	1,243	556	45%
EBIT	408	442	511	694	656	644	608	660	735	973	1,236	1,202	903	1,436	1,614	1,984	1,914	1,752	408	1,984	819	1,021	521	51%
Receivables		522	606	680	691	675	666	654	677	729	813	804	747	739	805	977	1,067	1,091	522	1,091	729	761	155	20%
Inventory		1,027	1,106	1,163	1,289	1,402	1,462	1,548	1,670	1,801	2,075	2,506	2,741	2,806	3,270	4,039	4,917	5,685	1,027	5,685	1,801	2,382	1,387	58%
PP&E		907	994	1,019	1,043	1,063	1,079	1,123	1,157	1,179	1,281	1,411	1,463	1,474	1,577	1,794	2,097	2,641	907	2,641	1,179	1,371	454	33%
Working Liabilities		377	368	521	644	602	573	579	618	666	786	787	678	719	858	1,005	1,157	1,220	368	1,220	666	715	238	33%
Net Tangible Assets		2,079	2,338	2,341	2,378	2,537	2,634	2,747	2,886	3,043	3,383	3,934	4,273	4,300	4,794	5,805	6,924	8,197	2,079	8,197	3,043	3,799	1,759	46%
MARGINS																								
Gross	77%	77%	75%	77%	78%	80%	80%	81%	78%	80%	81%	81%	79%	79%	79%	79%	78%	79%	75%	81%	79%	79%	2%	0.02
EBITDA	20%	20%	20%	22%	21%	21%	21%	22%	22%	24%	26%	25%	22%	27%	27%	29%	26%	24%	20%	29%	22%	23%	3%	0.12
EBIT	14%	14%	15%	17%	16%	16%	16%	17%	17%	20%	22%	21%	18%	24%	24%	25%	23%	20%	14%	25%	17%	19%	4%	0.20
TURNS																								
Sales/Receivables		6.11	5.81	6.08	5.86	5.83	5.77	6.09	6.34	6.62	6.95	7.06	6.88	8.27	8.40	7.98	7.93	7.99	5.77	8.40	6.62	6.82	0.95	14%
Sales/Inventories		3.10	3.18	3.55	3.14	2.81	2.63	2.57	2.57	2.68	2.72	2.27	1.88	2.18	2.07	1.93	1.72	1.53	1.53	3.55	2.57	2.50	0.57	23%
Sales/PPE		3.51	3.54	4.05	3.88	3.70	3.57	3.54	3.71	4.09	4.41	4.02	3.52	4.14	4.29	4.35	4.03	3.30	3.30	4.41	3.88	3.86	0.34	9%
Sales/NTA		1.53	1.50	1.76	1.70	1.55	1.46	1.45	1.49	1.58	1.67	1.44	1.20	1.42	1.41	1.34	1.22	1.06	1.06	1.76	1.46	1.46	0.18	12%
RETURNS																								
Gross Profit/NTA		118%	113%	136%	133%	124%	117%	117%	117%	127%	135%	118%	95%	112%	111%	106%	95%	84%	84%	136%	117%	115%	14%	0.12
EBITDA/NTA		31%	31%	39%	36%	33%	31%	31%	32%	38%	43%	36%	26%	39%	38%	39%	32%	26%	26%	43%	33%	34%	5%	0.14
EBIT/NTA		21%	22%	30%	28%	25%	23%	24%	25%	32%	37%	31%	21%	33%	34%	34%	28%	21%	21%	37%	28%	28%	5%	0.19
GROWTH																								
Sales		7%	10%	17%	-2%	-3%	-2%	4%	8%	12%	17%	1%	-9%	19%	11%	15%	8%	3%	-9%	19%	8%	7%	8%	1.20
Gross Profit		7%	8%	20%	-1%	-1%	-2%	4%	5%	14%	18%	1%	-12%	19%	11%	15%	7%	4%	-12%	20%	7%	7%	9%	1.25
EBITDA		8%	12%	27%	-7%	0%	-4%	7%	8%	25%	23%	-1%	-21%	48%	11%	22%	-1%	-5%	-21%	48%	8%	9%	16%	1.85
EBIT		8%	16%	36%	-5%	-2%	-6%	9%	11%	32%	27%	-3%	-25%	59%	12%	23%	-4%	-8%	-25%	59%	9%	11%	20%	1.91
Receivables		13%	19%	7%	-3%	-1%	-1%	-2%	9%	6%	17%	-16%	4%	-6%	25%	19%	1%	3%	-16%	25%	4%	5%	11%	1.94
Inventory		16%	1%	10%	12%	6%	3%	9%	7%	9%	21%	20%	0%	5%	28%	20%	23%	10%	0%	28%	10%	12%	8%	0.72
PP&E		18%	2%	3%	2%	2%	1%	7%	-1%	5%	13%	8%	0%	2%	12%	15%	18%	32%	-1%	32%	5%	8%	9%	1.09
Working Liabilities		-10%	6%	75%	-5%	-8%	-2%	4%	9%	6%	29%	-22%	-3%	15%	23%	13%	17%	-5%	-22%	75%	6%	8%	21%	2.55
Net Tangible Assets		22%	5%	-4%	8%	6%	2%	6%	4%	7%	15%	17%	1%	0%	23%	20%	19%	18%	-4%	23%	7%	10%	9%	0.87

SINGULAR DILIGENCE

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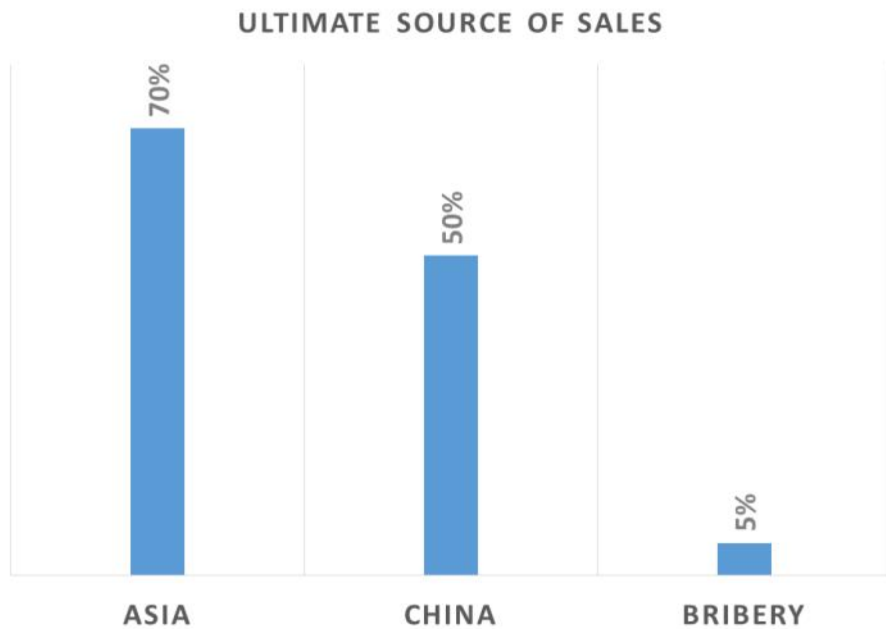
Swatch (Swiss Exchange: UHR) Gets Most of its Profits from Asia – Especially China

OVERVIEW

Swatch is a Swiss watchmaker. It gets 97% of its sales from watches. So it is definitely correct to call the company a watchmaker. Whether it is correct to call the company "Swiss" is a little more complicated. Let me explain. Swatch is definitely Swiss in the sense that it is 40% owned by a Swiss family, it uses Swiss labor, and it assembles its watches in Switzerland. Many of the company's brands are also historically Swiss brands. So, it is in almost every sense a completely Swiss company. The one sense in which it is not an especially Swiss company is in its sales. As will be explained in greater detail later – Quan and I estimate that Swatch may get as much as (or more than) 70% of its sales and profits from customers who live in Asia. That means Asians are the cause of 70% of the demand for Swatch products. More importantly, Swatch may get more than 50% of its sales and profits from people living in China. Some of these people live in Hong Kong. But a great many more live in the mainland of the People's Republic of China. No official numbers from Swatch give estimates this high. However, the evidence supporting this at first shocking statement that China accounts for a majority of Swatch's profits is strong. An HSBC research report claims that 50% of the watch sales Swatch generates in Western Europe are from foreigners (that is, people who are not Western Europeans). The people buying luxury goods in Europe are not Americans or



Our best estimate is that 5% of Swatch's profits are made on the sale watches that are eventually given as bribes to Chinese officials

Canadians. People from these countries spend less on luxury goods relative to their income than people from Europe and Asia. Also, watches are not expensive in the U.S. North Americans do not buy a lot of luxury goods when travelling overseas. They don't face high import taxes or value added taxes in their home countries. You can buy high end watches as cheaply – or more cheaply – in the U.S. than you can in other countries. This is not true of people in Asian countries. Many Asian countries have high consumption taxes. They tax actual goods heavily. Asians also – relative to their income and the GDP of their economies – spend quite a lot on luxury goods. In fact, as will probably be mentioned several times in this report – Americans don't buy a lot of luxury watches. They don't buy a lot of luxury goods. The relative importance of U.S. spending on luxury goods is much, much smaller than the relative economic importance of the U.S. Meanwhile, the relative importance of the People's Republic of China in luxury spending is much, much greater than that country's actual economic weight in the world. There are several reasons for this. A small – but meaningful – part of the explanation is certainly corruption. Corruption is present in many economies. But most very large economies score quite low on relative corruption. If you look at G8 countries – the U.S., U.K., Canada, France, Germany, Italy, Russia, and Japan – you can see that only two of those countries (Italy and Russia) can be called in any sense "corrupt". Corruption is not a major part of the economies of the U.S., U.K., Canada, France, Germany, or Japan. It is also an infinitesimally small part of the Swiss economy. But it is not a meaningless part of Swatch's business.

We are starting our discussion of Swatch with a discussion of corruption – and even harping on it – because this is likely a blind spot for most of our readers. Before you opened this report – you probably had no idea that Swatch may actually get a majority of its profits from sales to Chinese watch wearers. And although you have certainly heard that China is corrupt – the economic scope of that corruption in an area like high end watches is probably not something you've ever given a moment's thought to. There are no official estimates on any of this. There never can be a well audited trail of evidence when we are talking about corruption. It is as much a guess as any estimates you see of the size of the marijuana industry in the U.S. Remember, we are talking about something that is not only immoral but that is technically illegal. Corruption – when we say corruption here we are talking about graft and bribery – is often unenforced in the People's Republic of China. But not always. Corruption charges are frequently brought against officials. But in most countries throughout much of history – and here we assume the PRC is no exception – corruption charges are really a way of purging officials who are out of favor with those in power. From outside of China, we really can't tell whether arrests and sentences for corruption are genuinely meant to reduce corruption or are also meant to serve some internal political purposes. So, we won't be discussing any such crackdowns in this report.

With those caveats out of the way – let's do some speculative, admittedly arbitrary math. We have already said that Swatch may get more than half its profits from sales to Chinese end customers. Some of these sales are made to European retailers but those retailers are selling them to Chinese customers on vacation or business in Europe. So, we start with 50%. That is our estimate for the share of Swatch's profit that comes from Chinese customers. A Merrill Lynch report estimates that one-third of all luxury goods sales in China are ultimately meant as gifts. The same report estimates that one-third of all gifts are given to officials. We can safely assume that all gifts of a luxury good to an official would certainly meet the definition of "a bribe" as understood by the people reading this report. If Swatch gets at least 50% of its profits from China and at least one-third of Chinese watches are given as gifts and at least one third of Chinese luxury good gifts are given to officials as bribes – then it follows that Swatch gets at least 5% of its profits from watches ultimately given as bribes to Chinese officials. This may be distasteful to say. It is impossible to prove. But I think the number I just gave you is a very good estimate.

So, Swatch depends on Chinese corruption specifically for 5% of its profits. It depends on China generally for 50% of its profits. And it depends on Asia overall for 70% of its profits. None of these numbers are stated directly by Swatch. But they are our best estimates of the actual situation. And we need to make that situation very clear before continuing. An investment in Swatch is a bet on two things. One, Swiss watchmaking. Two, Chinese watch buying. The importance of markets outside of Asia is not very great to Swatch. The U.S. really doesn't matter to Swatch. And the importance of Swatch's competitors who are not Swiss watchmakers also doesn't matter much. Most of Swatch's "competitive position" is its brand position versus other Swiss made watches in the minds of Asians. That is what I want you to focus on in this report. Yes, Swatch is a Swiss watchmaker. Yes, it sells a variety of brands all around the world. But, if you are – as many of our readers might understandably be doing right now – picturing the Swatch brand watch on the wrist of some American, please remember that the Swatch brand and the U.S. market aren't all that important to this company. Swatch the company does not live and die with Swatch the brand. Swatch could do without the American market. It can't do without the Chinese market. So, when I say "Swatch" I want you to imagine two things. One, "Swiss made". Two, "Chinese". If you can keep those two concepts crystal clear in your mind at all times – you can really digest what this report is all about. Swatch owns a portfolio of brands that depend entirely upon the image of Swiss craftsmanship. And the company depends more on the Chinese watch buyer than on anyone else. So, when you think "Swatch" I want you to think "Swiss craftsmanship" and "Chinese watch wearer". The mindshare of the Swiss name in the heads of Chinese consumers is what matters most to Swatch's long-term health.

With that long digression on the paramount importance of China to Swatch out of the way – let's talk about the brands Swatch owns. Swatch is a collection of 18 brands. They are Swiss made brands now. A very few – like the American brand Hamilton – are not originally associated with Switzerland. Some of the most important brands in Swatches portfolio in terms of competitive position within their price range are: Swatch is the #1 brand for watches under $300, Tissot is the #1 brand for watches between $300 and $800, Longines is the #1 watch between $800 and $4,000, Omega is the world's #2 watch behind Rolex in the $3,000 to $10,000 price range, and Bregeut is the #2 watch behind Patek Philippe in watches that retail for more than $10,000. Swatch does not give any exact breakdowns of sales by either brand or price range. However, it is possible to triangulate various sources both given by the company itself and from reports on the Swiss watch industry to give you good estimates of sales figures for brands and price ranges. We will do that throughout this report. I'm about to do this for the first time now. Please remember what I just said – all these sales percentages are guesstimates. They are some of the best guesstimates out there. And I think it is better for you to rely on these guesstimates than to not know what brands and what price categories of watches Swatch depends on for its profits. But, like my statements that Swatch gets at least 70% of profits from Asia and 50% of profits from China and 5% of profits from Chinese bribery – I can't prove any of these numbers. And Swatch doesn't want to put out exact numbers.

Now to those guesstimates. The luxury category consists of watches costing $10,000 or more. This contributes about 18% of Swatch's sales. It probably contributes more than 18% of Swatch's profits. We will be using sales breakdowns because it is easier to develop a sales mix estimate than a profit mix estimate. However, there are two rules to keep in mind when thinking about the profitability of sales. One, more expensive watches tend – all other things being equal – to have higher profit margins than cheaper watches. And two, bigger brands tend to have higher profit margins than smaller brands. So, the biggest luxury brand – something like Patek Philippe (a competitor) or Swatch's own Bregeut brand – should tend to have some of the highest profit margins in the business. We know for instance that Omega – which is a much more highly prized brand in China than it is in the U.S. – has EBIT margins in the 25% to 30% range. Omega is a pretty expensive brand. It's a pretty big brand. It's in China. And it's considered pretty much the equal of Rolex in China (which is not true elsewhere in the world). So, Omega sometimes hits a 30% EBIT margin. Smaller and cheaper brands would tend to have lower EBIT margins. So, one would assume – but we can't tell you for sure – that something like the smaller, cheaper historically American brand of Hamilton would have a much lower EBIT margin than Omega because it's a small brand, it sells for a lower retail price, and its country sales mix may be less favorable than a super strong brand in China like Omega. Watches between $3,000 and $10,000 are called "high end" watches. They contribute 28% of Swatch's sales. Watches between $1,000 and $4,000 are upper mid-range watches and contribute 22% of sales. Watches in the $300 to $1,000 range are mid-range watches and they contribute 20% of sales. Watches under $300 are low end watches. They contribute less than 12% of Swatch's total. So, working our way from least expensive to most expensive we have: low end (12%), mid (20%), upper mid (22%), high (28%), and luxury (18%). We can now see that Swatch gets just under half of all its sales – and quite possibly more than half its profits – from watches that retail for more than $3,000. So, Swatch is largely a luxury watch company. Swatch gets more than two-thirds (68%) of its sales and profits from watches costing more than $1,000. In this sense, Swatch is definitely a luxury goods company despite sharing its name with a brand (Swatch) whose watches retail for under $300. To put this into a perspective easily understood by Americans, Swatch gets close to 70% of its sales and profits from watch brands that generally cost more than a Movado. Again, though, I do want to caution that I'm using Movado as a price reference point – Swatch's position in the U.S. is not especially strong. And you must always remember that Swatch's sales are coming mostly from China specifically then from Asia generally and finally also from Europe. North and South America, Australia, and Africa all together barely add up to 10% of Swatch's sales. So, 90% of this company is Asia and Europe. And most of that is what we'd call luxury. So, yes, Swatch is a Swiss watchmaker. But it doesn't compete equally in all watch price categories and in all countries. It is best to think of Swatch as mainly a seller of premium priced watches to Asia and Europe.

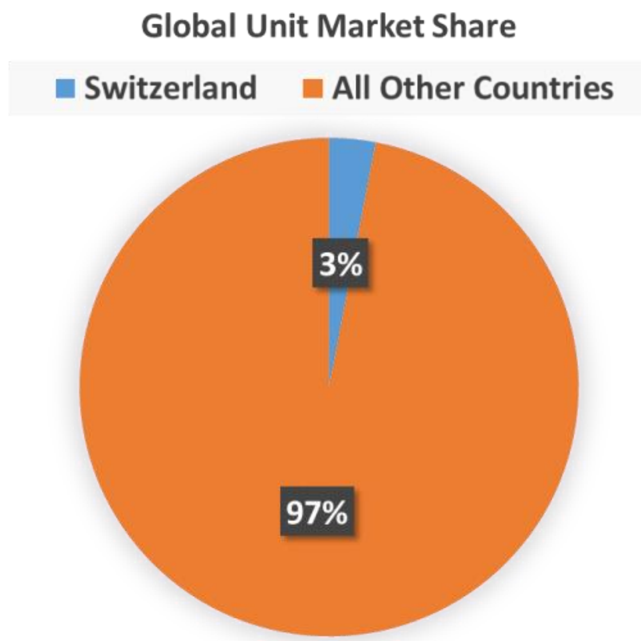
For the rest of this report, we will mostly be talking about watches that retail for more than $1,000. We have a good reason for this. Swatch is the leading Swiss watchmaker. It has about a 40% market share in the market defined as "Swiss made" watches. Swiss watches account for just 2.5% of total unit volume of annual worldwide watch production. That's almost nothing. If you see a watch on someone's wrist – anywhere in the world – the chances are very, very good it's not a Swiss watch. So, Swiss watches are less than 3% of all watches. That's a startling stat. Here's an even more startling stat: 95% of all watches that sell for more than $1,000 are made in Switzerland. In other words, 97% of watches are made outside Switzerland. But 95% of watches that sell for over $1,000 are made in Switzerland. Almost all Swiss watchmakers focus on making watches that can sell for more than $1,000. And almost everyone who wants to spend more than $1,000 on a watch wants to make sure it's a Swiss watch. So, Swatch doesn't compete in watches generally. It competes specifically in a special category. That category has two features. One, a price tag over $1,000. And two, the words "Swiss made" can be applied to it. We'll talk about this concept of "Swiss made" in our next section on durability.

DURABILITY

The Greatest Threat to Swatch's Durability is Chinese Consumers – Not Wearable Gadgets

Some investors are worried that watches will be threatened by the Apple Watch. Since the introduction of cellphones, watches have become a pure jewelry item. People no longer wear watches to tell time. They already carry a device on them that can do that. So the greatest threat to watch sales was during the technological change that took place over the last 20 years. The next 20 years should not be as risky for watchmakers generally.

But Swatch is not just a watchmaker. It is a Swiss watchmaker. Even if the Apple Watch and similar products introduced by other companies in the years ahead replace a lot of the unit volume of watches – they will not eat into the sales of Swiss watches. Switzerland has less than 3% of the worldwide share of total watches made each year. In other words, 97% of all watches sold each year are not Swiss watches. Switzerland focuses on the high end of the watch market. While 97% of all watches are not Swiss watches – 95% of all watches that retail for more than $1,000 are Swiss watches. So, the issue for Swatch and other Swiss watchmakers is not what percent of the total watch market wearable gadgets like the Apple Watch might one day replace – it's what share of the market for watches that cost more than $1,000 wearables might take.



Switzerland makes 95% of all watches that retail for more than $1,000 U.S. – but just 3% of all watches

Watches that cost more than $1,000 are jewelry. They are not used to tell time. Any electronic device (like a cellphone) or quartz watch can tell time more precisely than an expensive mechanical watch. The movements in Swiss watches that cost more than $1,000 are mechanical movements. From a time telling perspective, these watches are poor. The mainspring can power the watch for up to 60 to 100 hours without wearing it. But this means the watch can lack power if it is not worn for say one full week. This is not a problem that quartz watches and electronic timekeeping devices have. And they cost much less than mechanical watches. Watches powered by mechanical movements are also inaccurate. They can lose several seconds a day. Assume a watch loses 3 seconds per day. In one month, it will be off by a minute and a half. In one year, it will be off by 18 minutes. For these reasons, mechanical watches are not ideal for precise timekeeping needs. And they require maintenance. They are prized as jewelry items for their design, engineering, craftsmanship, and as luxury items. They are an example of conspicuous consumption. People buy an inferior timekeeping device – a device that does its job worse than cheaper alternatives – and spend many times more for the device. Mechanical watches are intentionally antiquated. They are a throwback to another time when this was the most practical and precise way of telling time. People have completely different reasons for buying an Apple Watch and a Swiss watch.

Swatch does have one low end brand. The namesake Swatch brand is targeted at 18 to 25 year olds. It sells about 12 to 13 million watches per year. The Swatch brand has an unusual design for a Swiss watch. Collections are replaced rapidly. So it is a "fashion" watch. Colors are often brash and intense. We estimate that Swatch gets less than 5% of its total operating profit from the namesake Swatch brand. So, even if the Apple Watch does great harm to the Swatch brand, 95% of Swatch's corporate profit comes from other brands. For this reason, devices like the Apple Watch are not a threat to the durability of Swatch as a corporation.

A bigger risk to the durability of the Swiss watchmaking "monopoly" on a reputation for craftsmanship is Asian competition. Japanese companies like Citizen, Seiko, and Casio make some mechanical watches. They often outsource the production of mechanical movements to countries like Thailand, Malaysia, and China. These countries have lower labor costs than Japan. The biggest Chinese maker of mechanical watches is Sea-Gull. Sea-Gull is a state owned company. It makes 5 million mechanical movements a year. It sells these movements to other mechanical watch assemblers. The company also sells about 300,000 of its own Sea-Gull brand watches. These watches retail for $400 to $500 U.S. They are aimed at 25 to 30 year olds. Considering watch prices are often higher in China, these are lower end mechanical watches. But the scale advantages in watch assembly are small. There are scale advantages in two areas of watchmaking: 1) A big brand 2) Manufacturing of key components like the mechanical movement. Experience in manufacturing comes from the unit volume of production – not the dollar volume.

So, Sea-Gull can gain a lot of experience from producing 5 million mechanical movements every year.

Sea-Gull specifically and China generally are not threats to Swatch outside of Asia. For example, the "Swiss Made" label is a big plus in selling luxury watches into the U.S. A "Made in China" label would be the biggest negative a watch could have on it. Japan has been making watches for a very long time. And yet Japan has not built watch brands that – in the West – command anywhere near the prices of good Swiss watches. In the past, the U.S. also produced a lot of watches. Many American brands were eventually bought by Swiss or Japanese companies. Japan is a high skilled labor country. The "Made in Japan" label is not a negative. And yet in over half a century of competing in industries like watchmaking – Japanese companies have built very few brands that travel well outside of Asia. China has very little history of brand building. Many watch brands are centuries old. It can take a decade or more just to revive the image of a once great watch brand. So, competition on the brand building side is not the greatest threat. But Chinese companies may provide a source of mechanical movements that allows other watchmakers to survive. Because of the low unit volumes in high end watches, there are very few sources of mechanical movements. Most Swiss watchmakers buy movements from Swatch. Many depend on one of only two possible sources for their movements. Swatch's "ETA" subsidiary makes mechanical movements. Many makers of high end watches depend on supplies of movements from ETA. For example, Movado explains in their 10-K that "A majority of the Swiss watch movements used in the manufacture of Movado…watches are purchased from two suppliers". We believe one of these suppliers is ETA and that this reliance on two suppliers – one of which is ETA – is typical of almost all Swiss watchmakers. ETA has been trying to reduce the amount of movements it supplies to competitors since about 2002. However, there were complaints by customers who buy the movements from Swatch who are also competitors when it comes to the sale of finished watches. This resulted in cartel investigations, agreements with Swiss regulators, and a delay in the reduction of supply to competitors. The main problem for competitors is that they would need to invest in significant property, plant, and equipment to be able to supply themselves with movements. Only the largest owners of the largest brands – like Richemont – can afford investment in manufacturing that rivals Swatch. The more components need to be supplied in house, the more consolidated the watch industry would become. Watch assembly can be a very fragmented business. Watch manufacturing – especially mechanical movement manufacturing – cannot be. Swatch, Richemont, and Rolex have about 85% market share in Swiss watches. Swatch has historically supplied movements even to companies as large as Richemont. If Swatch cut off the supply of movements to all other Swiss watchmakers, it is possible that big companies like Richemont and Rolex would have to increase their levels of investment in manufacturing and all of the other little companies would have to try to consolidate amongst themselves or sell out to Swatch, Richemont, or Rolex – or simply go out of business. The size of companies other than Swatch, Richemont, and Rolex is not large enough to make in house vertical integration an economical prospect. Without the supply of movements from someplace like ETA, the Swiss watchmaking industry would likely be an oligopoly of just these 3 companies. It is close to that now anyway though. It is possible that if ETA cuts off supplies to other Swiss watchmakers – a lot of companies will turn to someplace in Asia for their supplies. This could scatter the most fragmented part of the industry. It is unlikely to change the business much for Swatch, Richemont, and Rolex. The durability of these 3 Swiss watchmakers is much higher than the durability of their many smaller competitors.

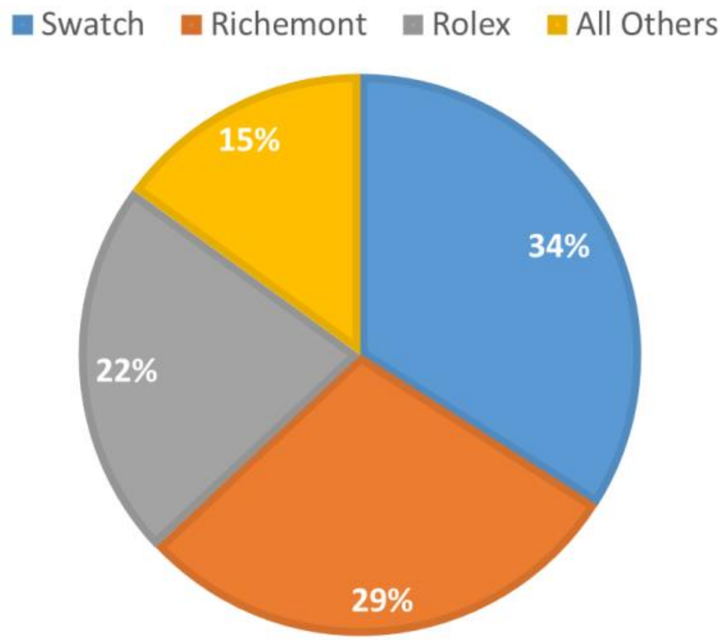
The greatest risk to Swatch's durability is a change in Chinese watch buying habits. The most likely reason for this would be a decrease in corruption. From time to time, the Chinese government cracks down on corruption. As discussed earlier, Swatch may get as much as 5% of its operating profit from watches that are eventually given as bribes to Chinese government officials. In a larger sense, changes in China regarding corruption and consumer spending on luxury items could hurt Swatch. Swatch is extraordinarily dependent on China. It is fair to say the majority of Swatch's future profits could come from Chinese consumers (buying either in China or abroad). So, Swatch is a Swiss company on the production side and a Chinese company on the consumption side. The durability of Switzerland's competitive position is high. The durability of China's appetite for watches may be harder to judge.

MOAT

Swatch, Richemont, and Rolex Will Always Dominate Swiss Watchmaking

Swatch's moat varies depending on the price category. Swatch's moat is widest for brands that retail between $800 and $10,000. The moat is narrower for watches that cost more than $10,000 or less than $800. This is because there are several distinct sources of moat in the watchmaking business. The greatest combination of moats happens in the watches in the middle price categories. These watches are expensive enough that the "Swiss Made" label and the brand name are important. However, they are inexpensive enough that manufacturing still involves mass production in some sense for some of the parts. This is not true of very expensive watches. Some watchmakers who focus on watches over $10,000 can make very, very few watches each year. So there are few production advantages in this category. The watches are also so expensive that a boutique mono brand store can be opened in just a few high end retail stores in cities around the world. So distribution power is not as important. Swatch has more production advantages than any other Swiss watchmaker. Rolex also has strong production capabilities as will be explained in a moment. Some other companies – like Richemont – have some production capabilities. They are much more than mere assemblers. But they are not as self-sufficient as they might appear. Swatch is vertically integrated. It does not need any outside company to exist for it to be able to produce its brands.

Let's start with production. There are no production advantages in low-end mechanical movements that are not "Swiss Made". A Japanese or Chinese company or a manufacturer of licensed brands that does not care if the watch carries a "Swiss Made" label can easily get a supply of foreign (non-Swiss) mechanical movements. The governments of both China and India encouraged the production of mechanical movements in the hopes of stimulating a domestic watchmaking industry. So, if a watchmaker does not care about the "Swiss Made" label they can buy movements from a Japanese company like Seiko or Citizen or from a movement maker in China or India. As a result, there is no production advantage – no moat for Swatch – in watch categories that do not rely on the "Swiss Made" label. For watches that do rely on the "Swiss Made" label, Swatch has a big production moat. To earn the "Swiss Made" label a watch must meet several requirements. One of these requirements is that the movement must be made in Switzerland. There are very few Swiss movement makers. It is difficult to get information on mechanical movement market share in Switzerland. But a 2011 analyst report provides a good guess. That report estimated that the market is about 5.5 million mechanical movements. Swatch's ETA makes about 55% of those movements. Sellita has an 18% share. Sellita uses a lot of expired



Swatch, Richemont, and Rolex Will Always Dominate Swiss Watchmaking

ETA patents. It also uses parts it gets from ETA in about half of its movements. So, ETA's indirect share of the market – based on everything it provides critical supplies for – might be closer to 65% than 50% of the market. Rolex has a 16% share. However, Rolex uses its movement manufacturing for internal supply purposes. Rolex is supplying its own watches. It is not selling to outside companies. Soprod has 4% of the market. Everyone else combined would have something like 5% to 10% at most. So, ETA supplies about half to two-thirds of all movements in the sense that watches using these movements include parts from ETA. Rolex is actually vertically integrated and separate from the rest of the industry in this particular aspect of watchmaking. So, the 55% estimate of ETA's role in mechanical movement making is actually an understatement in two respects. One, Sellita uses ETA as a supplier. Two, Rolex supplies itself – not external customers. If you take half of Sellita's supply out and all of Rolex's – you are left with Swatch being the key supplier of movements.

And movements are actually easier to make than assortments. The technical requirements of movement making is minimal. Technical knowledge is not the barrier to entry. Most watchmakers don't make their own movements because it is too much overhead to absorb. It's a volume based business. So, the cost of having the capability to produce good movements is similar regardless of how many movements you are making. There is an initial investment requirement for even a small manufacturer. The more volume a company does, the lower its per unit cost for movements will be. So, it would cost a small watchmaker more per unit to make its own movements and there would be no quality improvement. Mass production is helpful in movement making because it reduces cost without reducing quality. If a company like ETA is willing to sell you mechanical movements – it is in the interest of everyone except those companies of the size of Swatch, Richemont, and Rolex to buy the movements. You can make your finished watch for less. And you couldn't build a better movement yourself.

The technical bottleneck is in assortments. Swatch has another subsidiary called Nivarox that makes assortments. Nivarox's share of assortments is greater than ETA's share of movements. And unlike movements, the barrier to entry here is not just an initial investment in property, plant, and equipment. Even other movement makers like Jaeger-LeCoultre and Patek Philippe get assortments from Swatch. Rolex is one of the very, very few companies that makes assortments like the hairspring. Assortments are regulating elements like the balance wheel, hairspring, escapement, and pallets. A watch's accuracy depends on these regulating elements. For example, the hairspring is what causes the balance wheel to oscillate. The constant rhythm of the oscillation is what ensures the accuracy of the watch. Swatch makes assortments which it sells to others. Rolex makes assortments. And then some small manufacturers make only tens of thousands of assortments a year.

Swatch's use of its market power was restrained through much of the 2000s by Swiss regulators. In 2011, Swatch was finally allowed to reduce deliveries of finished movements to 85% of its 2010 levels and bring that number to as low as 0% in 2019. So, Swatch will be allowed to completely cut its competitors off from their supply of ETA movements by 2019 if it wants to. Swatch was also allowed to cut its supply of assortments by 5%. This change will be tough on Sellita. The difficulty in obtaining assortments will probably be more of a problem than the difficult of obtaining movements. Movements just require some sort of alliance that provides for sufficient scale in production to spread the costs for the customers of that manufacturer to a level that would be lower than if each company went it alone. Assortments actually require technical knowledge. The problem is more than one of cost. It can mean that the supply is not of sufficient quality. Overall, the future is likely to be grimmer for Swiss watchmakers other than Swatch, Richemont, and Rolex once Swatch is allowed to cut its supply of movements and assortments as low as it wants to.

The three biggest players in Swiss watches are: Swatch (34% market share), Richemont (29%), and Rolex (22%). All other companies have just a 15% share. Swatch has strong production capabilities. Rolex is capable of supplying itself better than any other company besides Swatch with everything it needs. So both of those companies have certain vertical integration strength. Brand strength is also important. But distribution is about more than just having strong brands. These three companies – Swatch, Richemont, and Rolex – have the greatest distribution power of any watchmakers.

Distribution is less important at the highest and lowest ends. Cheap watches can be sold around the world online and in department stores. One reason Swatch is weak in the U.S. is probably because of the power of department store chains and online outlets for affordable luxury watches. A company like Movado is simply better at selling to Americans than Swatch is because it is not focused on a different model in the rest of the world. So the $800 to $10,000 categories are where Swatch's moat is greatest. This is where brand, distribution, and production capabilities are all important. Watches in this price range need a lot of points of sale. Tissot has 13,500 points of sale. Longines has 4,000. Omega has 1,800. Big groups like Swatch, Richemont, and Rolex have power over distributors and retailers. LVMH has trouble getting distribution equal to these companies because it does not have as big a watch business. These companies usually ask retailers to carry multiple brands from the same group. Having several strong watch brands at different price levels can be an advantage. These companies can also offer after-sales services. Quartz watches are easy to repair (you just replace the battery). Mechanical watches using ETA movements can also be easier and cheaper to maintain. The less common the parts in a watch are the more expensive it can be to maintain. Longines has over 1,000 service centers. Omega has 450. Very high end watches have very few service centers. Patek Philippe has 57. Bregeut has 45. And Richard Mille – a super expensive brand – has just 3 service centers. Swatch's moat in true luxury watches is not as great. Each brand has a moat around it. But the distribution moat is narrow. And there is no production moat. The $800 to $10,000 category is the widest moat part of the business. In this category, Swatch has a wide moat in production, brand, and distribution. It has strong brands. It can mass produce the parts – movements and assortments – needed in these brands. And it has the distribution clout of a Richemont or Rolex. For these reasons, it is likely that the fattest Swiss watch companies – Swatch, Richemont, and Rolex – will get fatter over time in the $800 to $10,000 price category. It is less clear what will happen in the under $800 category. In the over $10,000 category, old brands with a strong heritage should continue to do well. But it is possible for new brands to pop up and get distribution as Richard Mille proves. Hublot is another example of a successful entrant into very high end watches. This category does not require either mass distribution or mass production. The hardest category to enter and succeed in is $800 to $10,000. This is where Swatch excels. And it should now be able to use the market power from its production monopolies or near monopolies in movements and assortments to squeeze competitors. So, this is a wide moat business. And the moat could get wider if regulators allow it.

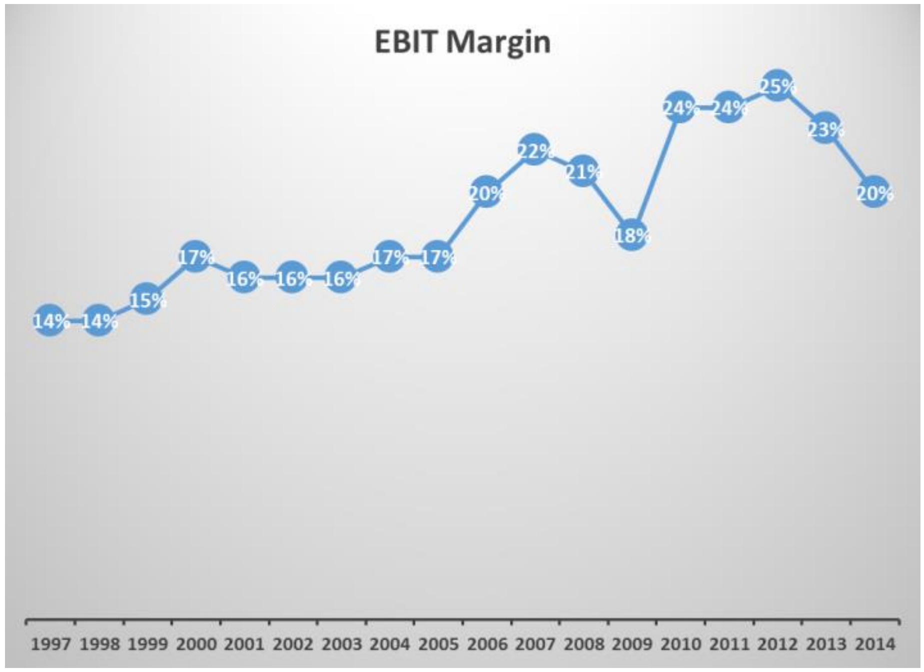
QUALITY

Swatch Can Earn a 20% After-Tax Return on Equity Year after Year

Swatch has high returns on its net tangible assets. From 1998 through 2014, Swatch's pre-tax return on net tangible assets ranged from 21% to 37%. The median return was 28%. Even if the company were to pay U.S. type corporate tax rates (some of the highest in the world) on all of its profits, a 21% to 37% pre-tax return on net tangible assets would translate into a 14% to 24% unleveraged return on equity. Swatch does not pay U.S. level tax rates. It only gets a small portion of its income from high tax countries. Swiss corporate tax rates are about 18%. So, the pre-tax returns if taxed entirely in Switzerland would result in unleveraged returns on equity of between 17% and 30%. It is safe to say that Swatch can return about 20% a year on its equity after taxes without using debt. This makes it an above average company.

Swatch's EBIT margin has risen over the years. It was as low as 14% in 1997 and 1998. By 2012 it had peaked at 25%. It has since declined to 20%. But, the EBIT margin which once averaged about 15% a year in the 1990s has averaged 20% a year over the last decade. However, this increase in the return on sales figure has come at the same time as a decrease in the level of asset turns. Return on assets is a combination of margin (Profit / Sales) and turns (Sales / Assets). Swatch's margin has increased and its turns decreased at the same time. This is probably due to Swatch's expansion into retailing. In 1998, Swatch got 5% of its revenue from its own company owned retail stores. Today, Swatch gets 28% of its revenue from company owned stores. Watch retailers hold inventory for a long time. The margin on watches sold in retail stores is high. But, the length of time it takes to sell a watch is long. This means that each retailer holds a high amount of inventory relative to sales at any one moment. Basically, a jewelry or watch retailer is the opposite of a grocery store. It has very stale inventory that it marks up a lot. Since 1998, Swatch's worst year in terms of EBIT/NTA was 2009. In that year, Swatch earned 21% pre-tax. At Swiss tax rates, that would be equivalent to a 17% after-tax return on equity. Swatch can earn a good return on equity every year without using any debt. It earned a good return even in the middle of The Great Recession.

Swatch's revenue can be broken down by country and region or by brand and price range. As explained in the opening of this issue, Swatch relies on China. It is possible that Asians



Swatch's EBIT margin rose during the 1990s and 2000s despite the strength of the Swiss Franc

generally account for 70% of Swatch's total profit and that Chinese customers specifically account for about 50%. There are no firm numbers on these subjects, because companies do not break down what percent of sales in a country are to tourists and which countries those tourists come from. However, HSBC estimates that 50% of luxury good purchases in Western Europe are made by foreigners. Most of these foreigners are probably Asian. It is certainly true that Asian tourists buy far more luxury goods than tourists from North America for instance.

The revenue breakdown by country that Swatch gives – which does not take a tourist's home country into account – shows 56% of sales come from Asia, 34% from Europe, 8% from North and South America, and 2% from everywhere else. China alone accounts for 38% of sales. So, even without considering Chinese tourists – Swatch gets more sales from China than from all of Europe.

Swatch gets 18% of sales from watches that retail for more than $10,000. Watches that retail for between $1,000 and $10,000 make up 50% of sales. This is the category where Quan and I believe Swatch has the widest moat. It accounts for about half of sales. And perhaps more than half of profit. Although, that is impossible to prove because high end – more than $10,000 watches – may also provide a greater share of EBIT than sales. Watches that cost less than $1,000 account for 29% of sales. Swatch also gets 3% of sales from a low power chip it uses in quartz watches and sells to other watchmakers. Only 3 companies make this part: Swatch, Seiko, and Citizen. All of them make it because they are watchmakers who can use it in a quartz watch. Since the increase in the Swiss Franc has been so high over the last 15 years or so, this segment has started losing money due to an uncompetitive currency. Low-end watches like the Swatch brand have lower margins than watches that cost more than $1,000. So, the combination of the money losing 1.5 volt chip business and low-end watches together contribute far less than 32% of EBIT even though they provide 32% of sales. This means that the vast majority of Swatch's profit comes from watches that cost more than $1,000. Watches that cost more than $1,000 contribute more than two-thirds (68%) of sales. And they have the highest margins. Quan estimates that the luxury segment

– including Omega – would have an EBIT margin of about 30%. The middle segment would be maybe a 20% to 23% EBIT margin. The low end would be a 5% to 10% EBIT margin. We can also compare Swatch's high end segment to Richemont's Cartier business. And we can compare some of the lower end business to Fossil. A statement made by Swatch's CEO can also be interpreted – though he did not say this directly – to mean that the Longines brand has a 27% to 33% EBIT margin. This is consistent with Cartier's business. Cartier watches have about a 35% EBIT margin. The specialist watchmaker part of Richemont's business has a 26% or 27% EBIT margin. Tissot might make something like a 20% margin on the low end and 23% margin on the high end. Swatch's CEO said mid-range brands make 20% to 23% EBIT margin. Fossil's wholesale business has a 23% EBIT margin. Based on all this information, it is possible to conclude that watches which cost more than $1,000 make up well over two-thirds of Swatch's profit. So, the quality of the company is really dependent on the quality of those higher end brands.

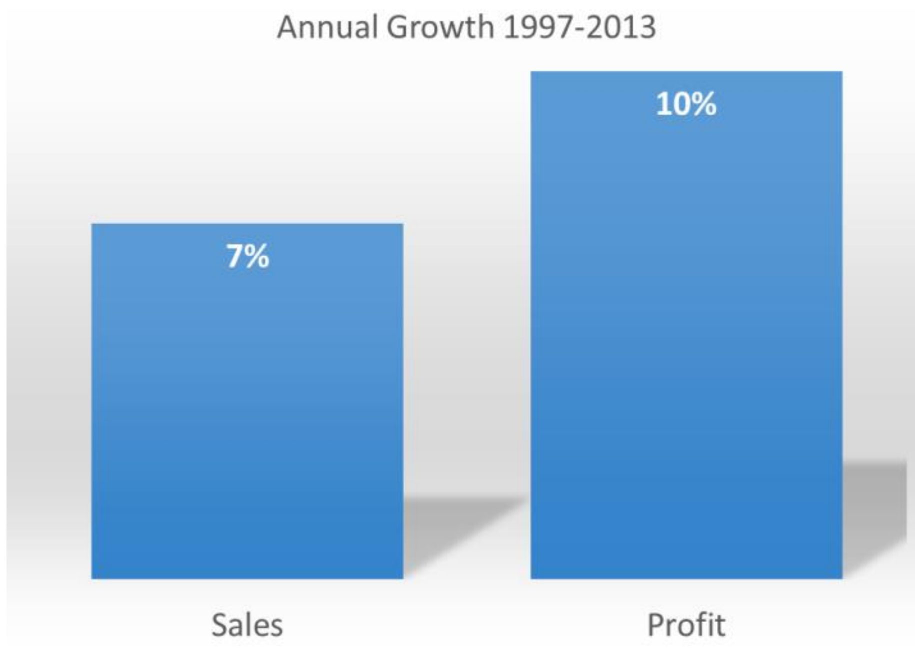
The final question regarding quality is currency valuations. Swatch has the potential to earn more in the future than it does now if the Swiss Franc weakens. The Swiss Franc is vastly overvalued against the U.S. dollar. It might seem odd to bring up the U.S. dollar in a discussion of Swatch because 92% of Swatch's sales come from outside the U.S. However, Swatch gets 38% of its sales from Greater China. And the People's Republic of China and Hong Kong both tie their currencies to the U.S. dollar. So, the key exchange rate for Swatch is the Swiss Franc versus the U.S. dollar. Switzerland has historically had very low inflation. It was about 2% in the 1990s. It was 1% in the 2000s. And it's about 0% now. Going back half a century, it is clear that Swiss inflation has been lower than American inflation. That can explain a discrepancy in the purchasing power parity of the two currencies – investors might legitimately expect the U.S. to have higher inflation than Switzerland and therefore prefer to hold Swiss Francs to U.S. dollars. However, the huge difference between today's exchange rate and purchasing power parity between the Swiss Franc and the U.S. dollar is far too great compared to either the past rates of inflation in these countries or the expected future rates of inflation. For this reason, investors can and should expect the Swiss Franc to decline in value against the U.S. dollar over the next 15 years. This means a buy and hold investor in Swatch should expect to benefit from a weaker Swiss Franc. This will lower the cost per watch for watches sold in the People's Republic of China, Hong Kong, and the United States. It will benefit about half of all Swatch's sales. For this reason, Swatch's quality from 1998 through 2014 understates the company's future quality. Today, Swatch is somewhat handicapped by an irrationally expensive Swiss Franc. There may be some reason for Euro investors to prefer the Swiss Franc over the Euro. There is much less reason for investors to prefer the Swiss Franc over the U.S. dollar. And that is the exchange rate that matters most to Swatch. Investors in Swatch stock can expect a currency tailwind. This will add to Swatch's quality as a buy and hold investment.

CAPITAL ALLOCATION

Swatch Never Uses Debt - So Return on Shareholder's Equity is Always Unleveraged

Swatch's capital allocation is conservative and focused. The company is focused on watches. The acquisitions it makes are related to watches. In 2013, Swatch bought Harry Winston. It paid a very high price. The deal makes good strategic sense. But it is difficult to know whether the price paid was too high. It depends on the way Swatch integrates Harry Winston into its business and uses stores to sell both watches and jewelry together. Swatch has been looking to acquire a jewelry business for a long time. Owning a jeweler can help with distribution. Richemont owns Cartier. And Richemont now gets 50% of sales from its own company owned stores. Swatch gets 28%. That is much higher from the 5% of sales it got from its own stores in 1998. But it is still below Cartier. Owning Harry Winston can help Swatch get distribution power around the world. It can make the same sort of strategic sense as owning a 20% stake in Hengdeli or 58% of the Middle Eastern retailer Rivoli. Rivoli has 360 retail stores in the Middle East. HSBC estimates that Hengdeli has 35% market share in Chinese watches. So, getting distribution relationships in China and the Middle East can be a good strategic reason for these investments in Hengdeli and Rivoli. But it is difficult to analyze the return versus the price paid.

Swatch's acquisition of Harry Winston follows its falling out with Tiffany. Swatch had a 30 year contract with Tiffany. Swatch was excited about the relationship. But later claimed Tiffany blocked implementation of the deal. Swatch complained that Tiffany didn't even show watches in its flagship Fifth Avenue store. Swatch filed a lawsuit and was awarded about $400 million in compensation. The company took a $115 million charge for the Tiffany products it made but could not sell. The lawsuit with Tiffany was resolved in 2013. Swatch bought Harry Winston that same year. So, the company has been pursuing a jewelry presence throughout the period. If the deal with Tiffany worked out, Swatch might never have bought Harry Winston. But it now has the jeweler brand it wanted. Swatch paid $750 million in cash and assumed $250 million in debt for Harry Winston. Harry Winston's operating profit was just $19 million in 2012. Revenue was $412 million. So, Swatch paid 2.4 times sales and 50 times pre-tax profits. The deal will only make sense if Swatch can integrate Harry Winston in a way that greatly increases sales and profits. Swatch's goal is for Harry Winston to hit $1 billion of revenue in 5 years. They also want to achieve $250 million in EBIT. If Swatch hits these goals, the Harry Winston acquisition will have been a great success. If Harry Winston doesn't grow, it will have been a failure. Swatch's past acquisitions in the watch industry were successful. It bought Bregeut in 1999 and Blancpain in 1991. Blancpain cost $30 million. Bregeut cost $60 million. Today, the two brands combine for $1.1 billion in sales. It is possible they provide EBIT of $300 million. So, $90 million spent between 1991 and 1999 bought $300 million of annual earnings in 2015. There are many different ways to calculate what the rate of return on those acquisitions might have been. But no method will give you a rate of return of less than 15% a year. The actual return on investment was probably much, much higher. Basically, Swatch paid $90 million in the 1990s for two brands that might be worth $3 billion today. This was achieved through integrating the acquisitions in a way that let them grow actual unit volume a lot. For example, Bregeut made just 3,000 watches in 1999. Fifteen years later, it produced 30,000 watches. By scaling the brand up, Swatch increased actual production by more than 15% a year in real terms. If a company can do this with an acquisition it makes – it is acceptable to pay a very high price for the target. Swatch's plan for Harry Winston is similar. It actually wants to grow sales faster than 15% a year for the next 5 years. If it can do that, it can justify the purchase price. One possible problem is that Harry Winston is a jeweler rather than a watch brand. Swatch now has quite a lot of retail experience. It gets 28% of sales from its own company stores. But that is different from running a jeweler. This brings Swatch further into retail and further into jewelry. That may not be within Swatch's circle of competence. Over time, Swatch has proven to be very, very good at managing and reviving watch brands. But it is not yet a jeweler. So, this is a definite expansion of what it does. Harry Winston could cause Swatch to have lower return on capital if it is not managed well. A jeweler like Harry



From 1997 through 2013, Swatch grew earnings by 10% a year while paying out dividends

Winston holds quite a lot of diamonds and gold. This can be an asset heavy business. Those are valuable raw materials. If they turn too slowly, it can be a low return on capital business. It is hard to say whether buying Harry Winston was a good idea or not. It makes perfect strategic sense. But the price was high. And it is one step further from Swatch's circle of competence. But it does mirror the way Cartier is run. The combination of jewelry and watch brands in the same company is not unprecedented. It makes sense. And it can increase Swatch's market power. Overall, Swatch is a good acquirer. The original company was formed through business combinations in the wake of the quartz crisis. That strategy was undertaken by the late father of the current CEO. So, Swatch has a long history of mergers. The company was built through them.

Swatch does not use debt. It has $1.4 billion in cash. Until 2010, Swatch usually bought back some stock each year. It tends to raise its dividend every year. From 1997 through 2013, Swatch grew sales by 7% a year and operating profit by 10% a year. Swatch returned just under 40% of after-tax earnings during this same time period. So, the business returned about 11% to 16% a year. It granted stock options of about 1% a year worth of dilution. So, the shareholder return in terms of intrinsic value was in the 10% to 15% range using a combination of profit growth and dividends. The acquisitions made during this time period also turned out well. So, capital allocation appears to be good. It is fairly conservative and conventional. A majority of earnings are retained. Acquisitions are made in cash. The company doesn't use debt. And it doesn't make transformative acquisitions. It simply adds some production capabilities to its watch component manufacturing, invests in retailers like Hengdeli and Rivoli, and buys watch brands it can revive, or (now) buys a jeweler. The acquisition of Harry Winston was not unexpected. And it's not really transformative. Swatch had already done the Tiffany deal. And management has mentioned how eager it was to own a good jeweler for a long time. So, it was an expected move.

One possible concern worth mentioning is the use of debt – or the lack of a use of debt. Swatch not only doesn't use debt – it often has net cash. This means that the unleveraged return on equity mentioned throughout this issue actually somewhat overstates the actual return on equity a shareholder will see. This is due to "anti-leverage". A company that uses debt leverages its equity so the return on equity exceeds what it would achieve without debt. Conversely, a company that hoards cash actually does the same amount of work in terms of the operating business while tying up more equity in the form of idle cash. Swatch does not hoard large amounts of cash. But it doesn't use leverage. So, there is a small amount of anti-leverage present. This means that Swatch's return on equity is likely to be somewhat below the rate suggested by its pre-tax return on net tangible assets. If Swatch can achieve a 25% pre-tax return on net tangible assets, it would have about a 20% return on equity. But, if it has some idle cash – this is not true. However, the actual pre-tax return on net tangible assets that Swatch has achieved over the last 15 to 20 years suggests that an ROE of 20% a year is possible even without the use of debt. So, I still think a 20% ROE expectation is a good guess of what Swatch can achieve for shareholders. Swatch can be an above average buy and hold investment even though it tends to hold a little cash and never uses debt.

VALUE

Swatch Should Have a P/E of 20

Swatch has a combination of "bearer shares" and "registered shares". This causes some websites and other sources to give incorrect information about Swatch's market capitalization and enterprise value. So, let's take a moment to provide the correct information here. As I write this, Swatch shares trade for 394 Swiss Francs. The company has the equivalent – in bearer shares and registered shares – of 54.3 million bearer shares in terms of economic interest. We will not discuss voting interest here. The Hayek family controls Swatch. So, voting interest is not important in determining the value of a share. If you are not a member of the Hayek family, you will not be able to gain control of the company through buying stock. So, the value of stock depends on the economic interest – the right to receive future dividends and other benefits – which we will present here in terms of bearer equivalent shares. So, a price of 394 Swiss Francs per bearer equivalent share times 54.3 million bearer equivalent shares equals a market cap of 21.39 billion Swiss Francs. Swatch has 1.47 billion Swiss Francs in cash and 111 million Swiss Francs in debt. So, that is 1.36 billion Swiss Francs in net cash. The market cap of 21.39 billion Swiss Francs minus the net cash of 1.36 billion Swiss Francs gives you an enterprise value of 20.03 billion Swiss Francs. So, Swatch has an enterprise value of about 20 billion Swiss Francs.

Switzerland's corporate tax rate is 18%. Swatch's historical effective tax rate was less than 20%. So, we will assume future earnings are taxed at 20%.

In 2014, Swatch made 1.75 billion Swiss Francs in operating profit. This is Earnings Before Interest and Taxes (EBIT). That means Swatch has an enterprise value to operating profit ratio – or EV/EBIT – of 11.42. This is misleading for a couple reasons. One, Swatch invested in unusual marketing spending in the U.S., Japan, and People's Republic of China in 2014. This unusual spending cost a full 3 percentage points of EBIT margin. Without the unusual marketing spending in the U.S., Japan, and China – Swatch would have reported 2.01 billion in EBIT for 2014. There are 3 ways of calculating normal earnings at Swatch.

One, we can use peak EBIT margin and apply it to today's sales. Swatch's operating margin has tended to rise over time. This is natural for a company with large brands and economies of scale. In particular, simply raising prices in real terms will tend to cause the EBIT margin to expand. Swatch's peak EBIT margin was 26.5%. If we apply this peak margin to Swatch's current sales we get a normal EBIT estimate of 2.24 billion Swiss Francs. This is the most aggressive approach.

Swatch's margin is somewhat cyclical. In all 5-year periods, Swatch has a higher EBIT margin than it did over the previous 5 years. So, a 5-year average of Swatch's EBIT margin always shows an increase. However, the annual EBIT margin does not always show an increase. This is because Swatch's EBIT margin drops when consumer confidence is low and rises when it is high. Inventory is also an important part of luxury retail. Watches take a long time to sell. Expensive watches can take a very long time to sell. Retailers and wholesalers can cut their inventories when there is a financial panic like in 2008. Swatch's 2009 earnings were poor. This is because Swatch only gets 28% of its sales from its own stores. While actual sales of watches in stores did not drop dramatically during The Great Recession – orders from wholesalers and retailers plunged. This will continue to happen to the extent Swatch sells through retailers it does not own. So, it may make more sense to use a 5-year median EBIT margin rather than a peak EBIT margin. Swatch's median EBIT margin over the last 5 years was 24.2%. Watch and jewelry revenue was 8.44 billion Swiss Francs last year. So, we can apply a 24% EBIT margin to 8.44 billion Swiss Francs in sales and get a normal EBIT estimate of 2.03 billion Swiss Francs. This is a more conservative estimate than the peak EBIT margin approach. And it is still a reasonable approach. So, this is my preferred method for valuing Swatch.

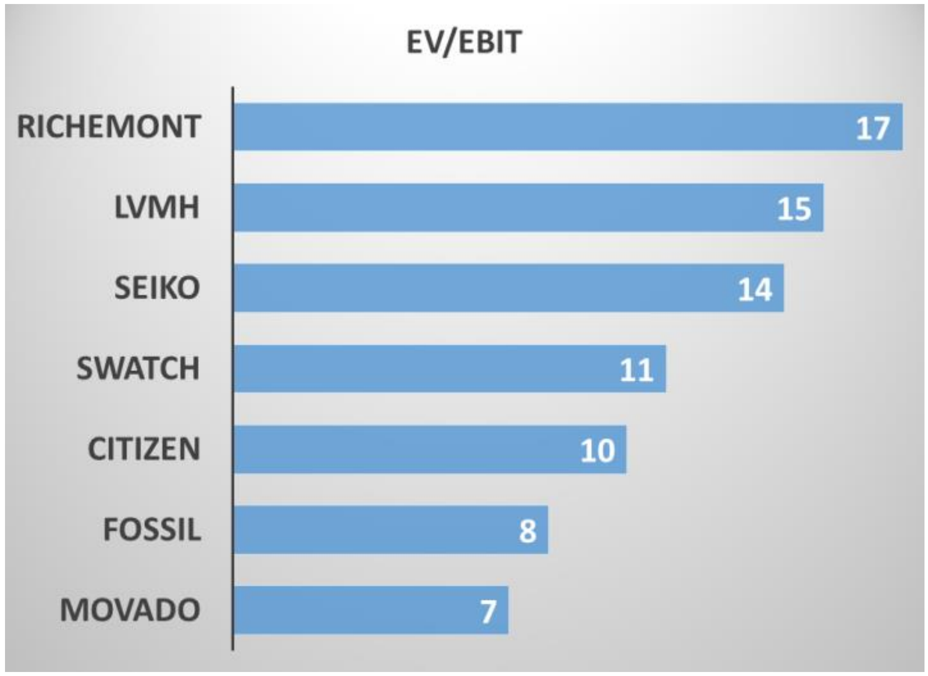
Swatch made 1.75 billion in EBIT in 2014. Management estimates EBIT would have been 2.01 billion Swiss Francs if there had been no extra marketing investing in the U.S., Japan, and China. So, a 2.01 billion EBIT estimate is also acceptable. It makes little difference whether you value Swatch using 2.03 billion as normal EBIT or 2.01 billion as normal EBIT. Either way, Swatch's earning power is at least 2 billion Swiss Francs pre-tax. We can round EBIT off to 2 billion Swiss Francs. If we apply a 20%

tax rate to 2 billion Swiss Francs we get 1.6 billion Swiss Francs in after-tax income. Swatch has 54.3 million bearer equivalent shares. That means normal after-tax earnings per share – EPS – should be no lower than 29 Swiss Francs. Again – as I write this – each Swatch bearer share trades for 394 Swiss Francs. So, the normal P/E of the stock would be 394 divided by 29 or 13.59. The P/E is under 14. And the stock has no debt. A normal P/E for a stock – which often has some debt – is usually around 15. Swatch has no debt. In fact, it has net cash. Swatch is an above average business. And stock prices are higher now around the world than is normal. So, Swatch should have a P/E higher than 14. How much higher?

Let's look at an EV/EBIT comparison between Swatch and its closest peers. Swatch is better than most of these peers. It is also a Swiss company. Several of Swatch's competitors are Japan or U.S. based. Corporate taxes in Japan and the U.S. are higher than just about anywhere else in the world. So, the earnings of Seiko, Citizen, Movado, and Fossil might be worth less than similar pre-tax earnings from Swatch or Richemont. Keep this in mind as we discuss pre-tax numbers. Swatch is worth a higher multiple of pre-tax earnings than its American and Japanese peers.

Swatch's EV/EBIT is no higher than 11.4. LVMH is one possible peer for Swatch. LVMH has a small watch and jewelry business. It is just 5% of profit. Most profit comes from fashion and leather goods. Wine and spirits are also a big business. So is retail. LVMH trades for 15 times EBIT versus 11 times EBIT for Swatch.

Richemont is Swatch's closest competitor. Richemont gets 72% of profit from Jewelry which is mostly Cartier. The specialist watchmaker segment contributes the rest of profit. So, almost all of Richemont is jewelry and watches and all of Swatch is watches and jewelry. Richemont sells



Swatch is 35% cheaper than its closest peer (Richemont)

higher end watches than Swatch. It gets almost all of its profit from watches that are as expensive as the Cartier brand or more expensive. Swatch has a more balanced portfolio of watch brands. Swatch has more market power in watch production than Richemont. But Richemont has very strong brands and distribution. The two companies are probably of fairly equal quality. Richemont trades for 17 times EBIT versus 11 times EBIT for Swatch.

Fossil is an American watch company. It is the strongest company in licensed brands. These include Adidas, Armani, Burberry, Diesel, DKNY, and Michael Kors. Fossil gets 50% of revenue from licensed brands. About half of that – 22% of total sales – is from the Michael Kors brand. So, Fossil depends heavily on the Fossil and Michael Kors brands. Fossil's current EBIT margin may be unusually high. It renewed its licensing agreement with Michael Kors late last year. This renewal may have shifted more profit from the licensee Fossil to the licensor Michael Kors. There is also a risk that if Michael Kors loses any popularity – Fossil's earnings will decline a lot. Fossil trades at 8 times EBIT versus 11 times EBIT for Swatch. Fossil is cheap but speculative. It has more upside than most of the stocks discussed here. But it may be riskier due to reliance on a couple key brands that are unusually hot right now.

Movado is an American watch company. It actually makes its Movado watches in Switzerland. Like Fossil, it makes licensed brands in Asia. But, Movado's management has ties to the U.S. And the company's market position in the U.S. is very strong. The Movado brand – which is "accessible luxury" – is much stronger than Swatch's brands in the U.S. Movado would actually be a very good fit with Swatch if the Grinberg family ever wanted to sell out. Movado's only important owned brand is Movado. It is the leading watch brand in the $300 to $1,000 category in the U.S. It has a strong, durable position in the U.S. But it is weak to non-existent everywhere else in the world. Movado's licensed brands include Coach, Tommy Hilfiger, Hugo Boss, Juicy Couture, Lacoste, and Ferrari. Movado trades for 7 times EBIT versus 11 times EBIT for Swatch. Movado is shockingly cheap.

Seiko is a Japanese competitor. It gets half of sales but closer to 90% of profit from watch and clock brands. Seiko trades for 14 times EBIT versus 11 times EBIT for Swatch. Seiko is an inferior business in a higher tax country. It is priced too high versus Swatch.

Citizen is another Japanese competitor. It gets half of sales and 70% of profit from watches and movements – which as discussed before are like "the engine" of mechanical watches. Citizen trades for 10 times EBIT versus 11 times EBIT for Swatch.

The peers with lower multiples than Swatch: Movado (7 times EBIT), Fossil (8 times EBIT), and Citizen (10 times EBIT) are all inferior to Swatch. Seiko has a higher multiple than Swatch and is a worse business. LVMH and Richemont are comparable in quality to Swatch. They trade for a higher multiple than Swatch. Swatch's closest peer is definitely Richemont. Swatch trades for 11 times EBIT versus 17 times EBIT for Richemont.

A luxury goods company with strong brands like Swatch should have a P/E of 20 to 25. A P/E of 20 is not aggressive at all. Swatch uses no debt. Many companies of Swatch's quality can command a P/E of 20 even with debt. Valuing Swatch with a P/E of 20 and no debt seems reasonable. Again, Swatch tends to pay less than 20% of earnings in taxes. So, the formula for translating a debt free P/E of 20 into an EV/EBIT ratio would be 20 times 0.8 equals 16 times EBIT. Swatch's normal EBIT is no less than 2 billion Swiss Francs. So, Swatch's enterprise value should be no less than 32 billion Swiss Francs. Swatch's actual enterprise value is only 20 billion Swiss Francs right now. So, Swatch is quite cheap. The margin of safety is greater than one-third. Note that this is only because a company of Swatch's quality should have a P/E of 20 rather than 15 and Swatch will only ever pay a 20% tax rate not a 35% tax rate like an American company would. This combination means Swatch deserves an EV/EBIT of 16 while many businesses only deserve an EV/EBIT of 10.

GROWTH

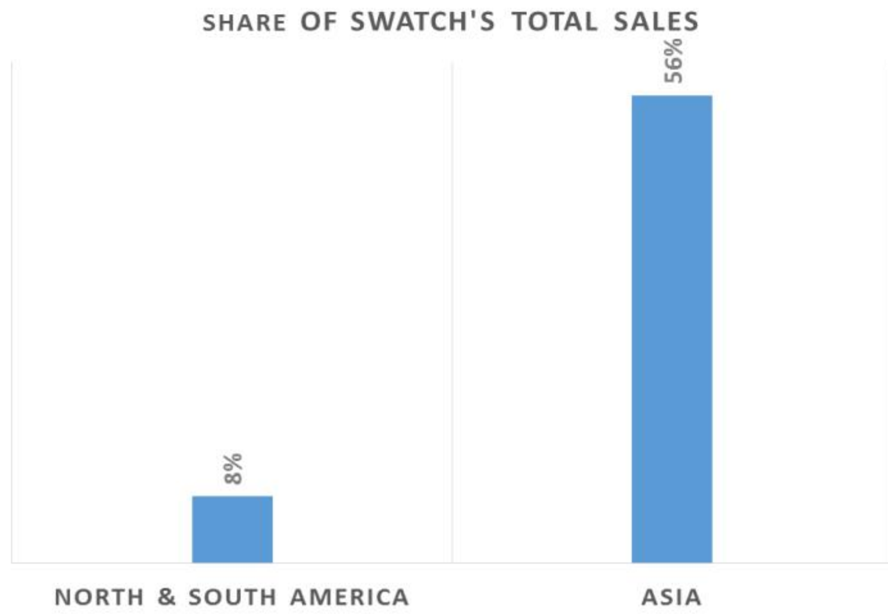
Swatch Can Grow as Fast as the GDP of Emerging Markets

Swatch's growth prospects are surprisingly high. This is potentially a growth stock. The one concern is that it may be more speculative than most consumer goods and luxury goods companies in its dependence on Asia generally and China specifically. A crackdown on corruption in the People's Republic of China caused a 3% decline in Chinese sales in 2013 and another 3% decline in 2014. So, Chinese sales declined by more than 6% purely due to government action. LVMH said that its high end watch sales declined 20% in 2014 in China due to the corruption crackdown. This makes sense. Corruption in China is done largely through gift giving. Watches are a popular gift. The highest end watches make the best bribes because they are one of the few small items that cost a lot and can be given as a gift. Recently, high end watch sales in China have turned up. So, this decline could be temporary. Most sales of watches in China are not directly related to corruption. And Chinese GDP per capita continues to grow faster than the developed world. So, the Chinese appetite for watches can grow faster than the nominal GDP of places like the U.S. and E.U. This means that even with occasional corruption crackdowns – a company like Swatch can grow sales faster than the nominal GDP growth of developed countries. This is because a company like Swatch actually gets most of its growth from emerging markets. Very little growth comes from developed economies.

Now, we have to take up the issue of the Swiss Franc and the U.S. dollar. It is possible to collect historical data on sales growth in Swiss watch exports in terms of watches, Swiss Francs, or dollars. The U.S. dollar is a more important measure of final sales than the Swiss Franc because shoppers pay for the watches in currencies – like the Chinese Yuan and Hong Kong Dollar – that are tied to the U.S. dollar. Swiss watch sales in U.S. dollar terms have grown very, very fast for a very long time. From 2000 through 2014, exports of Swiss watches that cost more than $3,000 grew 16% a year in U.S. dollar terms. They therefore also grew about 15% a year in local (Chinese) currency terms. The actual unit volume grew just 9% a year. Asia accounted for 70% of all growth. This is the price category most susceptible to a corruption crack down. However, the long-term growth prospects in the $3,000 plus category are strong. Exports are to emerging markets. These grow 4% to 6% a year or better in U.S. dollar terms. They have continued to do so through recent years. And Swatch has a brand – Omega – with untapped pricing power in this category. Omega is the number one watch brand in China. In that country – unlike in the U.S. – Omega is considered on par with Rolex in many people's minds. Omega is about 40% cheaper than Rolex. So, Omega can – with sufficient marketing support – raise its prices closer and closer to Rolex's over time. It has been doing this for a long time. Omega has been going up market. And it will continue to do so. In the very long-term, there is room for about a 65% relative price increase in Omega as compared to other watch brands. If Omega was to raise its price closer and closer to Rolex over the next 15 years, it could afford a 3.5% a year price increase just to close that gap by 2030. Omega may never close the gap with Rolex. Rolex may rise its price faster than other watches. Many different things could happen. But it is more likely than might be expected that Omega could actually increase its price in real terms by about 3% a year for many, many years. This will take a lot of investment in the brand. But Swatch has been able to do this with Omega in the past. If demand for Omega type watches grew at around 6% a year and the real price increased at about 3% a year – that would be a high single digit rate of growth. Also, the Swiss Franc is very overpriced against the U.S. dollar. Over the next 15 years, the U.S. dollar should rise versus the Swiss Franc. This will cause sales in Chinese Yuan to convert into more and more Swiss Francs. For these reasons, a fairly small unit volume growth rate – say 4% a year – in Omega's sales in China could translate into a much larger – even close to 10% a year – sales gains in Swiss Franc terms. This is because the price can rise in Yuan terms as Omega moves up market. And each Yuan can be worth more Swiss Francs. In the very long run, both of these assumptions – that Omega's local price will rise and that the Yuan will rise against the Swiss Franc – are reasonable. It is not reasonable to assume anything like 10% a year growth because there are too many moving parts here. But, it will actually be very easy for a brand like Omega to grow 6% a year in sales. Profit growth usually runs ahead of sales growth for Swatch. So, profits in this category should grow at least as fast as the emerging markets into which Swatch sells its watches. If Chinese GDP grows 6% a year – Swatch's profits in China should rise at least 6% a year in Swiss Franc terms. And possibly a whole lot more. But, Chinese GDP growth is a good proxy to use for future growth.

Longines grew 15% a year from 2007 to 2013. It is harder to be sure of Longines growth numbers in the future. But there are a lot of untapped emerging markets. Again, an estimate of profit growth equaling emerging market GDP growth is reasonable and even somewhat conservative.

Tissot faces a lot of competition. But it's a very strong entry level Swiss watch. There are a lot of emerging markets where Swiss watches are not yet very big: Vietnam, India, Russia, Ukraine, Malaysia, Brazil, Colombia, and Argentina are all possible growth markets. Many have large populations and a growing middle class. There are high tariffs and consumption taxes in some of these countries. Many don't have free trade agreements with Switzerland but could one day have such agreements. Increasing prosperity and decreasing trade barriers could open up markets like these in a big way. Tissot would be one of the first



Swatch Gets At Least 7 Times More Sales from Asia than From North and South America Combined

winners. Swatch is in as good a position as any company to grow with Swiss watches in other countries. Swatch gets a tiny amount of sales from South America and Africa. One day, these can be good markets. They have the potential to grow in future decades the way China did in the last two decades.

Overall, Swatch should be able to grow its profits in Swiss Francs as fast or faster than emerging market GDP. Because real prices of strong brands can rise faster than inflation, because profits tend to rise faster than sales due to economies of scale, and because the Swiss Franc is overvalued – Swatch has a very, very high probability of growing its corporate profit faster than emerging market GDP. There are additional – speculative – opportunities for growth like Harry Winston. Harry Winston is small now. But it's a great platform for growth. Looking out decades – there is the possibility for Harry Winston to be a smaller player in the same league as Cartier and Tiffany. It's also a good growth platform for Swatch in the U.S. But Harry Winston is small right now. It's like a start-up for Swatch.

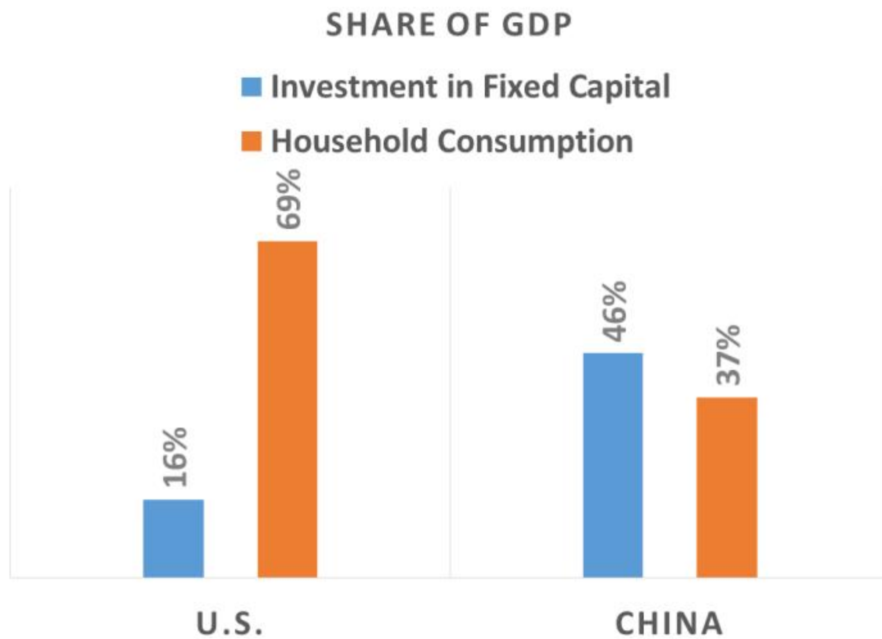
So, Swatch's profit growth should be equal to or greater than emerging market GDP. Since the late 1990s, Swatch grew sales by 7% a year and profit by 10% a year while paying out over one-third of its earnings is dividends. It also bought back some stock. It is reasonable to assume Swatch can grow profit by 7% a year while paying out something like 40% of earnings in dividends and buybacks. Swatch should benefit from currency tailwinds for a long time as well. So, while Swatch's growth prospects may not be quite as rapid as a true growth stock – it has a high probability of long-term growth. It is perfectly reasonable to assume 7% a year earnings growth for the next 15 years. In fact, that kind of performance is probable given the GDP growth rate of the emerging markets Swatch sells into and the need for the Swiss Franc to move closer to purchasing power parity over time.

MISJUDGMENT

Swatch's Growth Depends on China's Growth

The greatest risk of misjudging Swatch is not seeing a prolonged recession or depression coming in China. China is still much, much poorer than many of the markets it trades with. There is a lot of room for GDP per capita to grow over time. That means there is a lot of room for real wages to grow over time. However, China has several features that could be warning signs for a Japan like "lost decade". It is not the point of this issue to speculate on that possibility. But it is rarely talked about by investors. And it is a potential problem. At no point in the last 35 years has Chinese economic growth been poor enough to qualify as anything like a recession. So, the biggest risk of misjudgment is assuming that the trend of the last few decades will always be normal.

Chinese GDP growth has been in the range of 7% to 8% lately. Chinese population growth is only 0.5%. This means that GDP per capita is growing – even now – at 6.5% a year or faster. About 45% of Chinese GDP is investment in fixed capital. Meanwhile, about 15% of U.S. GDP is investment in fixed capital. This makes the risk of an overhang of long-lived assets much higher in China. There is a very high rate of growth in fixed capital per person. This is because Chinese GDP is very fast growing, almost half of Chinese GDP is investment spending, and Chinese population growth is low. As a result, China would be much less able to absorb a glut of long-lived assets. If the country builds too many apartment complexes, factories, airports, power plants, etc. they run the risk of having them be vacant or idle. Industries like construction are important in China. These are long cycle industries. They are susceptible to periods of overbuilding and then periods where they must be idle to absorb the overexpansion of previous years. China has been rapidly expanding since the late 1970s. So, there is always a risk of the sorts of problems Japan had. Although we don't have data on conspicuous consumption of items like the watches that Swatch sells in Japan – it is likely that real consumption of many luxury items are lower now in Japan than they were in the late 1980s. No one would have predicted this in the 1980s. Quan and I have no predictions about the future growth of China. But it's important to point out the impact a stagnant Chinese economy would have on Swatch. In the future – Swatch will likely get both the majority of its profits and the majority of its growth from Chinese consumers. If China's economy has the kind of experience Japan's did over the last 25 years – Chinese consumers will not increase their watch buying. Swatch's growth will decline by at least half. If China is stagnant – Swatch may be stagnant. We have no predictions about when China might experience its first real period of stagnation in many decades. Nor do we have a guess as to how long it might last. But we do need to give you two warnings: One, China has been growing rapidly for 35 years – so most investors are not thinking about what will happen when it stops growing. That part of the story is the same as Japan in the late 1980s. It had been growing quickly for decades. A lot of people would have assumed it would grow faster than the U.S. and Europe over the next decades. It didn't. It grew much, much slower. The second warning is that Swatch depends on China for much of its profits and almost all of its growth. Most of the growth in Swiss watch exports over the last 15 years came from Asia. China was the biggest part of that. Swiss watches are not a growth business in the E.U., U.K., or U.S. They are a mature consumer product in those countries. Sales of Swiss watches don't grow much in the developed world. And without China – Swatch would not grow very much. So, if you are buying Swatch as a growth stock – you are betting on Chinese growth.



Almost half of China's GDP is investment in fixed capital – which is a speculation on future demand

The second risk of misjudgment is less important. It is the currency risk. You may have read about the Swiss National Bank breaking its temporary peg between the Swiss Franc and the Euro earlier this year. It was a big story for currency markets. It was also a big story for Switzerland generally. It is not as big a story – long-term – for the Swiss watch industry as you might think it should be. Pricing power on Swiss watches are high. After the Swiss National Bank made its announcement – Swatch and other Swiss watchmakers announced price increases of between 5% and 7% on their watches. This price increase will keep margins the same if unit sales are not impacted by the price increase. Unit sales may be temporarily impacted by the price increase. Whenever you increase the price of a good that rapidly, people may balk at the suddenly higher price. But a big part of this is the suddenness. Digested over a couple years, a price increase of 5% to 7% is actually pretty tame compared to the price increases in local currency that Swiss watches have experienced over the last 15 years. The Swiss Franc has often appreciated against the currencies used to buy Swatch watches at retail. This means that a stable price in Swiss Francs has always lead to a higher price in local terms. The real price of Swiss watches has increased at a rapid rate – especially at the high end. As discussed earlier, Swiss watches that cost over $3,000 saw about 9% unit volume growth during the 2000s. However, sales figures for this category were up 16% a year in U.S. dollars. In other words, there was a 7% annual growth in nominal sales caused purely by an increase in the price of the watches in U.S. dollar terms. In 2015, the Swiss Franc has not been priced dramatically differently versus the U.S. dollar than it averaged during 2013. Not long after the Swiss National Bank made its move – we are ignoring the immediate aftermath because the move was initially very violent – the Swiss Franc was up 15% against the Euro and 20% against the Yen but actually down 1% versus the dollar when compared to 2013. The Yen and Euro do matter to Swatch. But not nearly as much as the U.S. dollar. Remember, the Hong Kong Dollar and Chinese Yuan are pegged to the U.S. dollar plus the U.S. dollar is the currency used in America – so sales in The People's Republic of China, Hong Kong, and the U.S. are all tied (in terms of affordability of the watch) to the exchange rate of the Swiss Franc and the U.S. dollar. And that rate is not very different from 2013. On top of that, the watch companies then increased prices 5% to 7% in local (U.S. dollar tied) currencies. For the next couple years, the result of these two changes – the Swiss National Bank breaking the peg and Swatch raising its prices – should be to keep EBIT margins fairly similar while causing reported sales and earnings in Swiss Francs to decline by the same percentage amount. Total figures will drop. Margins will hold pretty steady. In the long-run, investors will benefit from the Swiss Franc's initial overvaluation if they buy today. This is because investors benefit to the extent that Swiss Franc appreciation each year is less than the difference in the local inflation rate minus the Swiss inflation rate. This is all Quan and I are saying when we tell you that the Swiss Franc will move closer to purchasing power parity over the next 15 years than where it is today. We are just saying it will "tend" to move in that direction because it will "tend" to be the case that the Swiss Franc will appreciate less in foreign exchange markets than the annual gap between local (U.S. dollar) and Swiss (Swiss Franc) inflation. In the past, it would not have been unusual for U.S. inflation to be 3% and Swiss inflation 1% and yet for the Swiss Franc to increase in price by more than 2% against the U.S. dollar. In the future, we are saying that the tendency will need to be somewhat more in the other direction. There will – from time to time – be years in which Swiss inflation is lower than U.S. inflation and yet the Swiss Franc falls in the foreign exchange market. This is simply an overpricing that exists today and needs to be corrected over time. It will benefit Swatch by either letting it raise prices in local currencies even when costs in Switzerland stay the same or by allowing Swatch to keep its margin stable even while its watches become more affordable locally.

Both Chinese GDP growth and Swiss Franc currency movements are speculative. In the long run, China has a long way to grow real GDP per capita to get anywhere near the developed world. And the Swiss Franc has a long way to fall to get anywhere near purchasing power parity with the U.S. dollar.

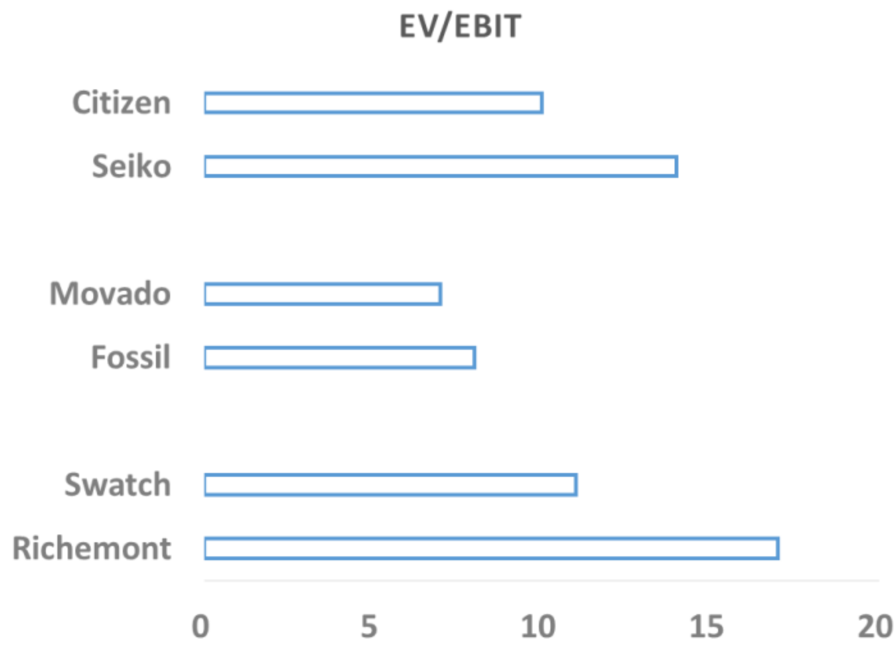
CONCLUSION

Swatch is a Far Above Average Business Priced at a Tiny Bit Below Average Price

Swatch is not a cheap stock. It is not a value stock. It is cheap only for the kind of company it is – which is a very good one. Swatch is an above average business. It is capable of earning a 20% return on equity without using debt. It may be able to grow its earnings at about 7% a year. It can also pay out dividends while it does this. Swatch is headquartered in Switzerland. Switzerland is a low corporate tax country. Swatch usually pays less than 20% of its profits in taxes. A durable luxury good business that can earn a 20% return on equity and grow earnings per share at 5% to 7% a year deserves a P/E of 20. Because Swatch pays such low corporate taxes a P/E of 20 is equivalent to 16 times pre-tax profits. So, Swatch's enterprise value should be 16 times its EBIT. Swatch's normal EBIT is at least 2 billion Swiss Francs. So, Swatch's enterprise value should be 32 billion Swiss Francs. Swatch has close to 1.4 billion Swiss Francs in net cash. It has 54.3 million bearer shares. That means Swatch has about 26 Swiss Francs in cash per share. And the business is worth 32 billion Swiss Francs divided by 54.3 million bearer shares. That is 589 Swiss Francs. So, each bearer share of Swatch should be worth 26 Swiss Francs in cash per share plus 589 Swiss Francs in business value per share. That gives an appraisal of 615 Swiss Francs per share. Swatch would not be a value investment at 615 Swiss Francs per share. It is not even a value investment now. It is a high quality and high durability stock. It is a far above average business trading for a very little bit less than an average price. Such a great business is worth 615 Swiss Francs per share. Meanwhile, the market price of a Swatch share is just 390 Swiss Francs. That suggest Swatch has a margin of safety of about 37%. Put another way, Swatch shares have upside potential of 58%. They can rise from 390 Swiss Francs per share to 615 Swiss Francs per share. Is that the right way to think about Swatch?

I don't think so. It is hard to know how quickly a stock will ascend to what we consider its intrinsic value to be. Swatch doesn't have a catalyst. It has a controlling shareholder – the Hayek family. It will not be sold. The company is not going to take on debt and pay a special dividend. It is not going to spin-off some brands. It will not do anything that might make its value suddenly obvious. So, the stock price will simply creep up over time as investors put a high price on the kind of quality Swatch has. Think of it this way: why is Swatch priced more like Citizen and Seiko than LVMH and Richemont? I can't answer that question. Notice that Fossil and Movado – both good companies that are better in many ways than Citizen and Seiko – trade for very, very low multiples. You can buy Fossil for 8 times EBIT. Movado costs just 7 times EBIT. Concern about Michael Kors could be a reason Fossil is so cheap. There isn't much logic to why Movado is so cheap. It makes sense that Swatch should be valued higher than Movado – but it doesn't make sense that Movado should be valued lower than the average business. All of these watch companies are pretty good businesses compared to the average publicly traded company in the U.S. or Switzerland or Japan. And yet some of them are cheaper than the average publicly traded business. While others are more expensive. Why is this?

I don't know. It's the market's tastes at the moment. Richemont and LVMH are good businesses. But so is Swatch. It is hard to see why Richemont should be valued much differently from Swatch. But it is also hard to see why Movado and Fossil should be valued so much lower than their peers around the world. There can be some negativity about the Swiss Franc. Swatch's very name – Swiss plus Watch equals Swatch – tells you it is a watch company and a Swiss company. Also, the Swatch brand is low end in the U.S. So, U.S. investors can associate Swatch more with low end watches and the Swiss Franc rather than a variety of luxury goods like Richemont and LVMH sell. But, even if that was true – there would be no good reason for Seiko and Citizen being so expensive. In fact, it seems clear that there are two sets of mispriced stocks among Swatch's peer group. Swatch is similar to Richemont and LVMH – especially Richemont. And yet LVMH and Richemont are much more expensive than Swatch. Either Richemont and LVMH are overpriced – or Swatch is underpriced. Or there is some combination of the two happening here. But Swatch is in the same quality class as Richemont and LVMH yet it is not in the same price class. So that is a mispricing. The other mispricing is that two American watch companies – Movado at 7 times EBIT and Fossil at 8 times EBIT – are cheaper than two Japanese watch companies (Seiko at 14 times EBIT and Citizen at 10 times EBIT) despite clearly being better businesses. In fact, in terms of durability – lasting quality – we can separate these 6 watch companies into 3 pairs ranked from highest to lowest. The most durable and highest quality watch companies that you can buy stock in are Richemont and Swatch. The next most durable and highest quality watch companies you can buy stock in are Movado and Fossil. And then the least durable and lowest quality watch companies you can buy stock in are Citizen and Seiko. There can be some argument about which of each pair is better. There can be some argument about the cyclical or speculative upside in some particular company. For example, Fossil might lose a lot of sales and profit if Michael Kors is a fad that will eventually cool. But Fossil is also in the best position of any watch company to sign up new licensors. Richemont has a lot of exposure to the very high end in emerging markets. It is susceptible to corruption crack downs and so on. But it can also grow a lot if emerging markets do well. So arguments like that can be made. And reasonable people can disagree. It is hard to disagree with the pairs as pairs though. Swatch and Richemont – taken together – are the best pair of watch stocks (although Richemont is largely a jeweler.) Movado and Fossil – taken together – are both clearly not as good as Swatch and Richemont and clearly better than Seiko and Citizen. And yet, the market does not price and order these companies as we have



Swatch's business quality is comparable to Richemont – yet its stock price is closer to Citizen and Seiko just done. Swatch sells at a 35% discount to Richemont. In other words, Richemont is priced about 50% higher than Swatch. The market could be right about that. But that's a big premium to justify. Meanwhile, Swatch is priced between Citizen and Seiko. That makes no sense. Swatch is a better long-term investment than either Citizen or Seiko. And Movado and Fossil are priced below Citizen and Seiko when they should be priced above. Fossil is somewhat speculative because of Michael Kors. But neither Swatch (at 11 times EBIT) nor Movado (at 7 times EBIT) are speculative at all. Their pricing both versus stocks generally and watch stocks specifically seems clearly wrong.

I don't think there is a good explanation for this to be found in Swatch being a Swiss company or the Swatch brand (which is a small part of Swatch but shares the company's name) being a low end brand. I think the real reasons are inconsistency in how the market prices watch companies in different countries and overly violent optimism and pessimism toward specific stocks in the short-term. Swatch does not have a volatile business. The company's EBIT margin has as low variation as many consumer products companies. Yet, Swatch's beta is often above 1. It is more volatile than some stock indexes. From 2004 to 2014, Swatch's price varied way too much in any one year to be justified by the facts. Taking the stock's lowest price in any one year and its highest price in that same year would often give a range of 10 times EBIT at the low end to 15 times EBIT at the high end. We are talking about the same year. There is not much logic to that at all. Quan and I would never have valued Swatch at 10 times EBIT at any point in 2004 to 2014 – except maybe during the crisis when other good stocks sold for even less than 10 times EBIT. Huge stock price variations in times of financial crises make sense. Stocks moving a lot in price with the market makes sense – the opportunity cost of owning this stock versus owning other good stocks varies a lot with market prices. But violent changes in the same stock's price in the same year are not justifiable. The market is just erratic in its pricing of Swatch. Much more erratic than the actual business results.

The other point worth making is that investors may not carefully compare watch stocks in different countries. For example, the price of watch stocks that trade in Japan is quite high right now while the price of watch stocks that trade in the U.S. is quite low. There is no justification for this. But there is a simple explanation. American investors who consider buying stock in Movado and Fossil do not spend much time considering whether they should buy Citizen and Seiko. Likewise, Japanese investors who consider buying Citizen and Seiko may not take a serious look at Movado and Fossil. Investors may sometimes pick a country and then a stock. They are not always bottoms up stock pickers in their approach.

Two watch stocks stand out as clearly cheap: Swatch and Movado. Movado is a true value stock. Swatch is not. But a long-term investor should be able to get good results holding either company. This is because Swatch is of comparable quality to Richemont. It is an above average business. And it trades for a merely average price. There is no catalyst. So Swatch is not for short-term value investors. But it is a good purchase for long-term buy and hold investors.

Swatch (Swiss Exchange: UHR)
Appraisal: 616 CHF

Margin of Safety: 40%

Owner Earnings	(in millions)
Pre-tax Owner Earnings	
Watch and Jewelry Revenue	CHF 8,435
* Last 5-year Median EBIT Margin	24.2%
= Pre-tax Owner Earnings	CHF 2,041

Business Value

Swatch' business value is 32,656 million Swiss Francs.

- Pre-tax owner earnings are 2,041 million Swiss Francs
- Fair multiple = 16x pre-tax owner earnings
- 2,041 million Swiss Francs * 16 = 32,656 million Swiss Francs

Fair Multiple

Swatch' business is worth at least 16x pre-tax owner earnings

- Swatch can grow profit more than 5-7% in the long run
- Swatch deserves at least 20x after-tax owner earnings
- Tax rate is about 20%
- 20x after-tax owner earnings equals to 16x pre-tax owner earnings

Share Value

Swatch' stock is worth 626 Swiss Francs a share

- Business value is 32,656 million Swiss Francs
- Net cash is 1,354 million Swiss Francs
- Equity value is 34,010 million Swiss Francs
- 32,656 million + 1,354 million = 34,010 million Swiss Francs
- Equity Value = 626 Swiss Francs per bearer equivalent share
    - 54.3 million bearer-equivalent shares
    - 34,010 million / 54.3 million = 626 Swiss Francs

Margin of Safety

Swatch' stock has a 40% margin of safety

- Business Value = 32,656 million Swiss Francs
- Enterprise Value = 19,698 million Swiss Francs
- Discount = 12,958 million Swiss Francs (32,656 million – 19,698 million)
- Margin of Safety = 40% (12,958 million / 32,656 million)

	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Seiko	0.71	2.13	8.39	15.71	14.21
Movado	0.79	1.47	5.49	6.62	6.62
Citizen	0.90	2.34	7.34	11.76	10.07
Fossil	1.32	2.31	8.06	8.30	8.30
LVMH	2.82	4.36	11.35	15.12	15.12
Richemont	3.95	6.22	15.24	17.37	17.37
Minimum	0.71	1.47	5.49	6.62	6.62
Maximum	3.95	6.22	15.24	17.37	17.37
Median	1.11	2.32	8.23	13.44	12.14
Mean	1.75	3.14	9.31	12.48	11.95
Standard Deviation	1.33	1.80	3.47	4.33	4.24
Variation	76%	57%	37%	35%	35%
Swatch (Market Price)	2.25	NMF	9.30	11.20	9.61
Swatch (Appraisal Price)	3.73	NMF	15.42	18.57	16.00

ABOUT THE TEAM

Geoff Gannon, Writer

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

Quan Hoang, Analyst

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

Tobias Carlisle, Publisher

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).

SINGULAR DILIGENCE

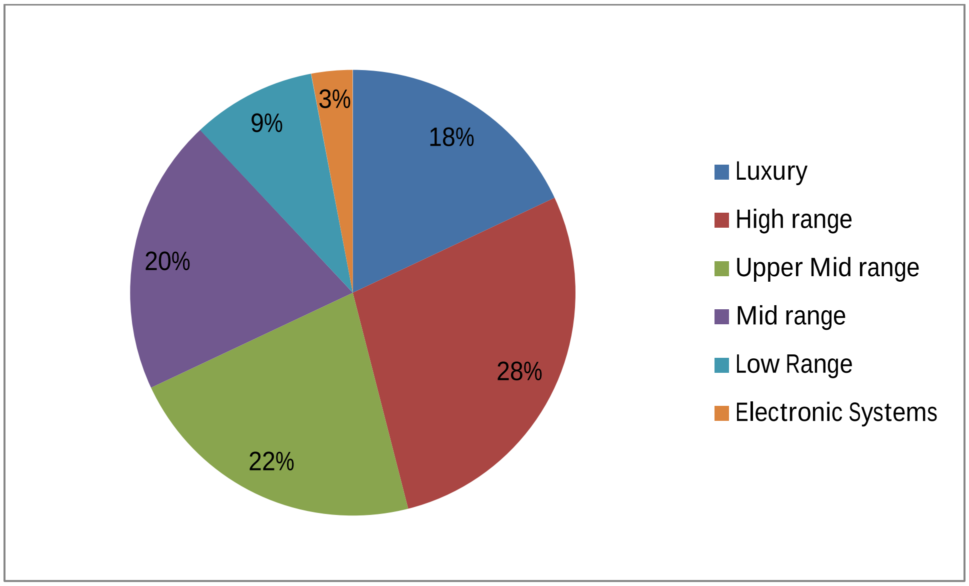
NOTES

Swatch

(Swiss Exchange: UHR)

Overview

Swatch Manages a Balanced Portfolio of Watch Brands



97% of Swatch's revenue is from watches in all price ranges

- Mechanical timekeeping was invented in the 14th century
    - Countries made mechanical watches early included
        - Italy
        - Germany
        - France
        - England
        - The Netherlands
- The Swiss watchmaking tradition only truly began in the latter half of the 16th century[1]
    - Huguenots were fleeing from France
    - As Huguenots, the majority of French watchmakers emigrated to
        - London
        - Geneva, Switzerland
- Up until the 19th century, horological advances were led by
    - Germany
    - England
    - The Netherlands
- The French watchmaker Jean-Antoine invented the Lepine movement
    - In 1770

- Made it possible to produce a thinner pocket watch
- The French watchmaker Frederick Japy adapted the Lepine movement
  - In 1980
  - Set the stage for a new era of mass production
- This development allowed Switzerland to dominate the watch market
  - Switzerland is a very decentralized
    - Every valley has an owner or organization
      - Has a dynamic, small city center
  - Peasants and farmers made watch components
    - During winter months
    - In the Jura mountain region
      - A snow-capped mountainous territory of Switzerland
      - Sit a long a trade route between Germany, France, and Italy
    - They made components for firms in Geneva
    - They were introduced to the craft by Geneva industrialists
      - And French Huguenots
  - This system allowed Switzerland to overproduce their European counterparts
    - These counterparts hadn't grown beyond a cottage industry
  - In 1800
    - England and Switzerland produced 200,000 timepieces each
  - In 1850
    - Switzerland: 2,200,000
    - England: 200,000
- Parisian watchmakers were the leaders in watch innovation through the 19th century
  - But they relied on the craftsmanship of watchmakers in Switzerland
    - Produce their most intricate and complicated timepiece
- Switzerland firms started to make precision timepieces at reasonable prices
- Swiss watchmakers became a serious threat to their French and British rivals
- By 1910, the Switzerland dominated the world watch industry
- By the early 20th century, the Swiss watch industry was comprised of[2]
  - Larger manufactures (etablisseurs)
    - Assembling complete watches from purchased parts
  - Workshops (ateliers)
    - Specialized in making parts or building ebauches

    - Ebauches are unfinished movements without assortments
        - Mainspring
        - Escapement
- Most supplier firms quit making watches during World War I
    - To produce and sell ammunition
- After the world, they returned to making watch components
    - Oversupply
    - They sold to non-Swiss competitor watchmakers
        - Mainly American
        - Led to cheaper watches competing against Swiss watches
- The industry experienced steep decline in revenue
    - Owed CHF 200 million to lenders by mid 1920s
- Led to the founding of the Swiss Watch Federation (FH)
    - In 1924
- Ebauches SA was created
    - In 1926
    - With strong financial support from some powerful Swiss banks
    - By 3 largest movement makers
        - Schild SA
        - Fabrique d'horlogerie de Fontainemelon
        - A. Michel SA
    - These 3 companies made over 75% of ebauches
- These companies co-operated
    - Setting the same prices
    - Standardize the specifications
        - Optimize manufacturing and lower cost
    - Regulate the export of unassembled movement parts
- By 1930s, more than 90% of all ebauche-makers had joined
- Etablisseurs tried to replicate this move
    - SSIH was established by the merger of
        - Louis Brandt
        - Omega
        - Tissot
        - In 1930
    - Was joined by Lemania in 1932
- The Great Depression came
    - 20,000 watchmakers lost their jobs

  - Led to the need of a single management for movement makers
- General Swiss Watch Industry AG (ASUAG) was formed in 1931
  - Was funded by the Swiss Confederation
    - CHF 13.5 million
  - ASUAG took over the majority of the shares of Ebauches S.A.
  - Another goal of ASUAG was to consolidate other essential parts
    - Lever assortment
    - Balance wheels
    - Balance-springs
- In 1932[3]
  - All level assortment manufacturers were united
    - Into ASUAG's sub-holding "FAR"
      - (Fabrique d'Asssortments Reunies SA"
  - All level balance wheel manufacturers were united
    - Into ASUAG's sub-holding "FBR"
      - (Fabrique de Balanciers Reunies SA"
- ASUAG. also took over other factories the same year
- Over the years, various small Swiss brands faltered
  - They went to ASUAG looking for rescue package
  - ASUAG felt a certain responsibility
  - Didn't want to lose its customer base
- By late 1970s, ASUAG owned all kinds of brands, including
  - Longines
  - Rado
  - Certina
  - Mido
  - Etc.
- Seiko introduced the world's first production quartz watch
  - In 1969
- Japanese competitors were able to make cheap and accurate quartz watch
- Strong Swiss franc also hurt the industry
- The Quart Crisis came
- The Swiss Watch Industry declined dramatically
  - 1974: sold 84.4 million pieces
  - 1983: sold 30.2 million pieces
    - A 65% decline
  - Swiss watches market share declined

        - 1970: 80%
        - 1970: 58%
        - 1983: less than 15%
    - The number of employees declined
        - 1970: 89,000
        - 1985: 33,000
- The banks hired a consulting firm to prepare the sale of ASUAG and SSIH
    - Hayek Engineering AG
    - Nicolas Hayek was the president
- He had another idea
    - They can compete with the Japanese if labor is less than 10% of costs
        - Customers are willing to pay 10% premium for a Swiss watch
    - He suggested the merger of ASUAG and SSIH
- ASUAG and SSIH signed a cooperation agreement
    - In 1981
    - SSIH yield its own quartz sector to ASUAG's ETA
- They launched Swatch in 1983
    - A plastic quartz watch
    - Has 51 parts as oppose to 100 need to make a traditional watch
- Swatch became a fashion phenomenon
    - Inexpensive ($40)
    - Witty and outlandish design
        - Bash, intense colors
        - Youthful
        - Provocative
        - Stylish
        - Unpredictable
    - Designed 2 collections each year
        - 70 styles per collection
    - Designs are created in Swatch Design Lab
        - In Milan
        - By artists, architects, and industrial designs
    - 1 million pieces were sold in 1983
        - Increased to 27 million pieces sold in 1993
- SSIH and ASUAG were merged
    - In 1983
    - Into SSIH/ASUAG Holding Company

- Hayek with a group of Swiss investors took over a majority shareholding of SMH
    - Was renamed as SMH
        - In 1986
    - Renamed as Swatch
        - In 1998
- Swatch taught people to wear watch as a fashion statement
    - Not simply as an utilitarian product
- SMH then used cash flow from Swatch to revive and build luxury brands
    - Tissot
    - Omega
    - Longines
    - Blancpain
    - Breguet
- Swatch today has a balanced portfolio
    - 18 brands
    - Has top brands in each segment
        - Swatch
            - #1 for watches below CHF300
        - Tissot
            - #1 for watches between CHF 300 and CHF 800
        - Longines
            - #1 for watches between CHF 800 and CHF 4,000
        - Omega
            - #2 for watches between CHF 3,000 and CHF 10,000
                - Competing with Rolex
        - Breguet
            - #2 for luxury watches
                - Behind Patek Philippe
            - Is the #1 or #2 brand in prestige
- Revenue breakdown by segment
    - Luxury: 18%
        - (watches over $10,000)
    - High-range: 28%
        - (watches between CHF 3,000 and CHF 10,000)
    - Upper mid-range: 22%
        - (watches between CHF 1,000 and CHF 4,000)

- o Mid-range: 20%
  - § (watches between CHF 300 and CHF 1,000)
- o Low-end and others: 12%

- Swatch has
  - o Centralized production
  - o Decentralized marketing
- Swatch has about 40% market share of the Swiss Watch Industry
- Swatch has strong exposure to Asia
  - o Europe: 34%
    - § Switzerland: 12.6%
    - § Other Europe: 21.4%
  - o Asia: 56%
    - § Greater China: 37.9%
    - § Other Asia: 18.1%
  - o America: 8.4%
  - o Oceania: 1%
  - o Africa: 0.6%
  - o It's possible that Asians account for well over 70% of revenue
    - § According to HSBC research
      - · 50% of sales of luxury goods in Western Europe are generated by foreigners
        - o (perhaps by Asians)
        - o Comparable to Hong Kong
        - o Higher than North America
          - § About 20%
- Swatch is in a good position to benefit from growing middle class in
  - o China
  - o Other emerging markets

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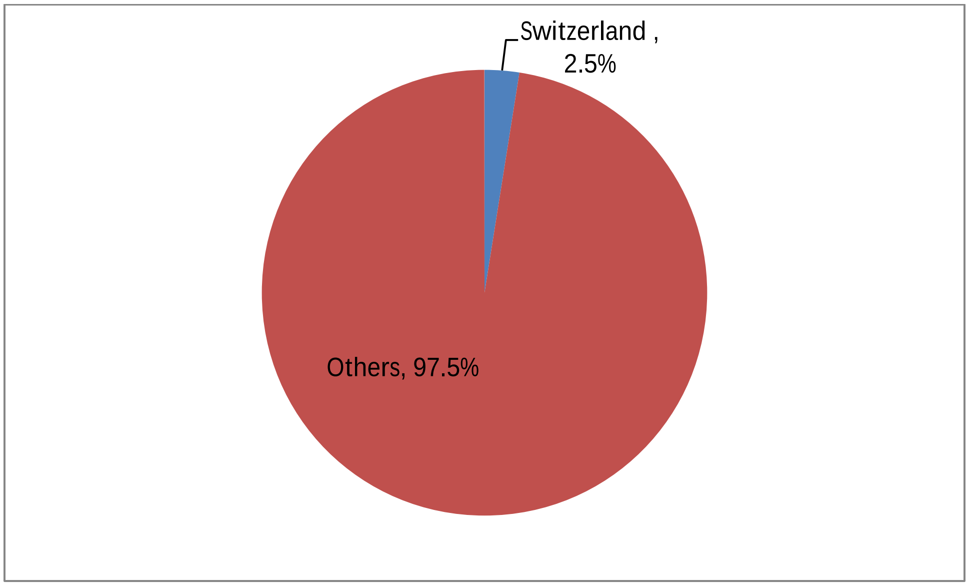
[1] *How Switzerland Came to Dominate Watchmaking*, Victoria Gomelsky, The New York Times, 20 November 2011

[2] *A Brief History of ETA: THE Swiss Watch Movement Maker*, David Bredan, Ablogtowatch.com26 November 2013

[3] *From Ebauches SA to ETA SA: 75 years of Swiss movements*, http://watchescorner.blogspot.com/2007/08/from-ebauches-sa-to-eta-sa-75-years-of.html

Durability

People Don't Wear Swiss Watches to Tell Time



Switzerland has only 2.5% the global watch market share by volume

- The threat from Apple watch is limited
    - Won't impact watches above $300
        - Won't impact Tissot
            - From conversations with Tissot customers:
                - They don't use watches for timekeeping
                    - Watch is one type of jewelry
                - Wearing Apple Watches doesn't look serious
                    - Apple watches are for teenagers
            - Chinese customers are[1]
                - Between 25-35 years old
                - Focus on watch quality than anything
                - Tend to prefer classic, mechanical and round watches
                - Sportier and more active customers buy sports lines
                    - As a way to express personality
        - Wearable gadgets upgrade annually
            - People may not spend $300 on a smart watch
                - Knowing that it won't last
    - Apple watch may have some impact on Swatch (brand)

            - § Swatch is a lifestyle brand
                - · 18-25 years old
                - · Sells 12-13 million watches a year
                - · Swatch feature witty and outlandish design
                    - o Bash, intense colors
                    - o Youthful
                    - o Provocative
                    - o Stylish
                    - o Unpredictable
                - · Collections are replaced rapidly
                    - o Designs are created in Swatch Design Lab
                        - § In Milan
                        - § By artists, architects, and industrial designs
                - · Customers tend to buy many Swatch watches
                    - o From different collections
            - § Apple is good at
                - · Marketing buzz
                - · Design
        - o The impact can be small
            - § Customers buy Swatch watches as a lifestyle brand
            - § Apple watches may not match Swatch's variety of design
            - § Swatch (brand) accounts for only 0.1% of the worldwide volume
            - § Swatch accounts for less than 5% of total EBIT
                - · As estimated in the "Quality" section
- 2 major types of watches
    - o Mechanical watch
        - § Old technology
            - · Doesn't use battery
            - · Energy from hand movement is stored in mainspring
                - o Fully sprung mainspring can power the watch for 60-100 hours without wearing it
            - · Mainspring drives gears and dials
        - § Expensive
        - § Less accurate
            - · Gain or lose several seconds a **day**
        - § Is the mainstay of the traditional Swiss luxury watch industry
            - · A symbol of luxury and fine engineering

    - Quartz watch
        - New technology
            - Was commercialized since 1970s
        - Use battery
        - Accurate
            - Gain or lose several seconds a **month**
        - Cheap
- Japanese watchmakers make both mechanical and quartz watches
    - Three players are
        - Citizen
        - Seiko
        - Casio
    - And sell movements
        - Movement is the engine of a watch
            - Other components of the watch are
                - Dials
                - Window
                - Case
                - Band
    - Japanese watchmakers outsource production to
        - Thailand
        - Malaysia
        - China
- Chinese focus on mechanical watches
    - Sea-Gull is the biggest manufacturer
        - A State-owned company
        - Makes 5 million mechanical movements a year
        - Mostly sell to other mechanical watch assemblers/marketers
        - Sells about 300,000 Sea-gull watches a year
            - About $400-500 per watch
            - Target 25-30 years old customer
- Mechanical watches account for 78% of Swiss watch export revenue
- Switzerland dominates the high-end watch market
    - 95% of watches over $1,000 are from Switzerland
    - Switzerland accounts for **2.5%** of the worldwide market by volume
        - Exported 29.2 million finished watches in 2012
        - 1.2 billion watches were manufactured in 2012

- Switzerland account for about **54%** of the worldwide market by value
  - Source: Federation of the Swiss Watch Industry
- On average, Swiss watches sell for CHF 733 ($733)
  - (Wholesale price)
  - Source: Federation of the Swiss Watch Industry
- On average Swiss mechanical watches sell for CHF 2,143
  - (Wholesale price)
  - Source: Federation of the Swiss Watch Industry

- Switzerland also has top brands in the low end segments
  - Tissot is the number 1 brand in $300-800 segment
    - Customers want affordable quality Swiss watches
    - Revenue: About CHF 1.2 billion
  - Swatch is the number 1 in below $300 segment
    - A fashion brand
    - Revenue: About CHF 700-800 million
  - Citizen
    - Watches and Clocks revenue: Yen 162,061 million
      - (about $1,364 million)
      - Revenue include movements revenue
      - Citizen watches are up to $2,500
  - Seiko
    - Revenue: Yen 150.7 billion
      - (about $1.27 billion)
      - Revenue include movements revenue
    - Seiko watches are available at all price range
    - Seiko does sell some expensive watches
      - Mostly in Japan
    - Its cheap watches hurt the brand
- Low-end mechanical watches are dominated by Chinese and Japanese
  - There are many mechanical watches below $100
    - Low quality part
    - Unadjusted movement
      - Mechanical watch's accuracy varies with positions (orientation)
      - Adjustment is made to optimize accuracy across positions
      - Adjustment can be made to 6 positions
        - (sometimes 8)

        - o Adjusting more positions requires more labor cost
            - § Tend to result in better performance
    - § Low labor cost
- Nothing stop Japanese and Chinese from making good mechanical watches
  - o Sea-Gull makes 5 million movements a year
  - o Experience is gained through volume
    - § Not revenue
- That won't threaten Switzerland's dominance in high-end mechanical watches
  - o Chinese and Japanese are strong when customers care about
    - § Price
    - § Technical specifications
  - o These factors aren't important in watches
    - § Watches can be found in all price ranges
    - § Accuracy isn't very important
      - · Mechanical watches are less accurate but more expensive
      - · People don't wear watch for time keeping
  - o History/brand/positioning are more important
  - o Evidence:
    - § Most watches above $1,000 are from Switzerland
    - § Swatch and Tissot win over Japanese for quartz watches
      - · Tissot enjoys over 20% margin
      - · Citizen and Seiko makes about 7-10% margin
- The threat from Japanese and Chinese is minimal
  - o Brand is the moat
  - o Brand management is more importance to durability
    - § Example of Omega
      - · Up until 1970s, Omega was more prestigious than Rolex[2]
      - · Omega became greedy[3]
        - o Rolex sells 600,000 watches per year
          - § About as many as you can sell before a luxury brand begins to lose its prestige
        - o Omega sold as many in the late 1970s
          - § But Omega wanted to grow more rapidly
            - · Had to lower price radically
            - · There were 2,000 different models
            - · No one knew what Omega stood for
      - · Omega's brand stand for achievement[4]

        - Customers are somebody because they make themselves somebody
            - Not because of inheritance
            - Not because they make money from insider trading
    - Omega's message was lost
    - Reviving Omega took a long time[5]
        - Celebrity endorsement
            - Cindy Crawford
            - Nicole Kidman
            - George Clooney
            - Michael Schumacher
                - A racing champion
            - Michael Phelps
                - A Swimmer champion
            - Rory McIlroy
                - A golf champion
        - Event sponsor
            - Olympic games
            - Golf
                - PGA tour
                - Ryder cup
                - Etc.
            - Sailing
            - Etc.
        - Fine-tuned the distribution networks
        - Enhanced product line
            - More mechanical watches
            - More stainless-steel timepieces
            - Use 18k gold instead of 14k gold
            - Introduced Co-Axial escapement[6]
                - Escapement is the most important part in a mechanical movement
                    - Regulate the watch movement
                - Co-Axial is the a major innovation in 250 years
                - Eliminate the need for lubrication

- otherwise lubricating oil thicken overtime
  - o slowing the movement
- o Omega gradually raised average price overtime with new products
  - § Raised brand perception
- o Omega is now bigger than Rolex in many countries
  - § Especially in China
  - § But still far behind Rolex in the US
- § The risk of mismanaging brand is now minimal
- § Swatch has brands in each segment
- § Swath has 5 strategic brands
  - Swatch
    - o #1 for watches below CHF300
  - Tissot
    - o #1 for watches between CHF 300 and CHF 800
  - Longines
    - o #1 for watches between CHF 800 and CHF 4,000
  - Omega
    - o #2 for watches between CHF 3,000 and CHF 10,000
      - § Competing with Rolex
  - Breguet
    - o #2 for luxury watches
      - § Behind Patek Philippe
    - o Is the #1 or #2 brand in prestige
- § Brands stay within their price range
- o Technical leadership is the shark Swatch throws into the moat
  - § Swatch keeps a strong focus on production
  - § Volume allow Swatch to industrialize innovations
  - § Example
    - Co-Axial escapement
    - Anti-magnetic mechanical movement
      - o Avoid impact of cellphones, iPad, etc.

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[1] "**In China, our customers are relatively young, with most buyers between the ages of 25-35. They focus on watch quality more than anything, and tend to prefer classic, mechanical and round watches. Although sportier and more active customers often like our sporting lines as a way to**

express their personalities." – From an interview of Jing Daily with Yao Zhongwei, Vice President of Tissot China, Swiss Watchmaker Tissot Looks to Innovate in Crowded China Market, Jing Daily, 11 May 2011

[2] "**Up until the early 1970s, Omega was one of Switzerland's most prestigious brands—more prestigious than even Rolex**. But Omega was so successful for so long that it ruined SSIH. The company got arrogant. It also got greedy. It wanted to grow too fast, and it diluted the Omega name by selling too many watches at absurdly low prices." – Harvard Business interview with Nicolas Hayek, former CEO of Watch Group, March 1993 Issue

[3] "Omega is one of the Swiss watch industry's great brands. Its history goes back to 1848. You should visit the watchmaking museums and look at the pieces Omega made 50 or 100 years ago. They are wonderful. **Few brands had or have Omega's potential power**.

The problems started in the early 1970s. There were bad business practices. **The people there became arrogant. They treated their agents and dealers badly**. If an agent from, say, New Jersey needed 200 units of a particular model, Omega would say: "You're crazy! Don't bother us with such nonsense. We'll give you 50."

Second, and much worse, Omega became greedy. Rolex sells 600,000 watches per year. That's about as many as you can sell before a luxury brand begins to lose its prestige. That's about how many Omega was selling in the late 1970s. But Omega wanted to grow more rapidly. So they took the easy route. They figured, "**If we can sell 600,000, why not a million? Or 2 million? Or 3 million?" Which meant, of course, they had to lower the price radically**. A jeweler would say, "Omega is wonderful, but it is too expensive for my clients. How about giving me an Omega that is cheaper?" Now, if you are crazy, or I guess if you are greedy, you agree.

That was the kiss of death. Omega was everywhere: high price, medium price, precious metals, cheap gold plating. There were 2,000 different models! No one knew what Omega stood for. By the end of 1980, the company was again in a deep crisis, its deepest ever." – Harvard Business interview with Nicolas Hayek, former CEO of Watch Group, March 1993 Issue

[4] "**Omega is an elite watch for people who achieve—in sports, the arts, business, the professions—and help shape the world. It is a watch for people who are somebody because they made themselves somebody, not because their grandfather left them a trust fund or because they made money from insider trading**. The astronauts who landed on the moon achieved

something. They were smart, healthy, courageous. They wore Omega. **So did the Soviet cosmonauts. That message had been destroyed.**" – Harvard Business interview with Nicolas Hayek, former CEO of Watch Group, March 1993 Issue

[5] "In recent years, **Omega has enhanced its product lines with more automatic mechanical movements and more stainless-steel timepieces, reinforcing its reputation for world-class technology and innovative designs. The company upgraded to 18k gold watches in the United States, where Omega had been known primarily for its 14k pieces.**" – *Celebrities Power Omega's Revival*, Keith Flamer, JCK Magazine, September 1998

[6] "In the early 1990s, the Swatch Group chairman, Nicolas G. Hayek, acquired the rights from the English watchmaker George Daniels for his prototype of the Co-Axial escapement.

Mr. Hayek then invested years and millions of Swiss francs perfecting the invention before releasing it to the world in 1999 inside the Omega De Ville watch.

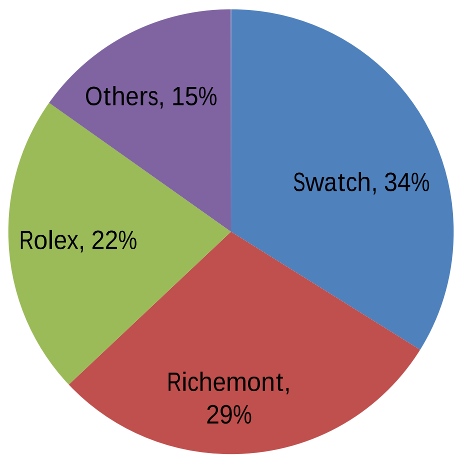
An escapement is the mechanism that transfers energy from the power store to the gear wheels of a watch in precisely timed pulses. Most need to be lubricated to keep running smoothly: but lubricating oil thickens over time, slowing the escapement's movement.

Mr. Daniels's design eliminated the need for lubrication, so ensuring perfect timekeeping.

Mr. Urquhart, the Omega president, said, **"It played an enormous role in putting Omega back on top.""** – A Study in Bringing Back a Brand, Jessica Michault, The New York Times, 08 March 2012

Moat

The Fat Gets Fatter



Estimated market share in 2012

Swatch, Richemont, and Rolex control 85% of the Swiss watch market

- (To keep it simple, assume 1 CHF = 1 $)
- Revenue breakdown & competitors
  - **Luxury: 18%** of 2013 revenue
    - (Watches over $10,000)
    - Swatch's brands in this segment are
      - Breguet
      - Blancpain
      - Jaquet Droz
      - Harry Winston
      - Glashutte Original
      - Leon Hatot
    - Breguet, Blancpain, and Jaquet Droz made **CHF 1.1 billion** in 2013 revenue[1]
      - Whole sale price is about CHF 20,000 per watch
    - Harry Winston's 2012 revenue was **$412 million**
      - 25% of revenue is from watches
      - Harry Winston watches start at CHF 18,000
    - It's safe to expect luxury segment made over **CHF 1.5 billion** in 2013 revenue

        - § Major competitors are
            - · **Patek Philippe**
                - o Make about CHF 1 billion revenue
                - o Makes 55,000 watches a year
            - · Richemont's brands
                - o (using Watch-Insider's estimate)
                - o **Vacheron Constantin**
                    - § 23,000 pieces
                    - § CHF 600 million revenue
                - o **Jaeger-LeCoultre**
                    - § 72,000 pieces
                    - § CHF 680 million revenue
                - o **IWC**
                    - § 90,000 pieces
                    - § **580 million** revenue
                - o **Piaget**
                    - § 24,000 pieces
                    - § **CHF 500 million** revenue
            - · **Chopard**
                - o 85,000 pieces
                - o CHF 650 million revenue
            - · **Audemars Piguet**
                - o 30,000 pieces
                - o CHF 600 million revenue
            - · **Ulysse Nardin**
                - o 27,000 pieces
                - o CHF 250 million revenue
    - o **High range: 28%** of 2013 Revenue
        - § (CHF 3,000 – 10,000 per watch)
        - § Swatch's Omega competes in this segment
        - § Watch Insider estimated Omega's 2011 revenue
            - · 800,000 pieces
            - · **CHF 2.3 billion revenue**
        - § An analyst estimated that Omega makes 35% of watch revenue
            - · **CHF 2.7 – 3 billion revenue**
        - § Let's assume Omega make **CHF 2.4 billion** in 2013 revenue
        - § Competitors are

- **Rolex**
  - Analysts estimate CHF 3.5 – 5 billion revenue
- **Cartier**
  - Make about the same as Omega's revenue
- **Officine Panerai**
  - (owned by Richemont)
  - CHF 300 million revenue
- **Bulgari**
  - Small
  - Makes about CHF 125 million revenue

- **Upper Mid-range: 22%** of 2013 Revenue
  - (CHF 1,000 – 4,000 per watch)
  - Swatch's brands in this segment include
    - Longines
    - Rado
  - Longines made **CHF 1.4 billion** revenue in 2013[2]
  - Watch Insider estimated Rado's 2011 Revenue: **CHF 440 million**
  - Watch Insider estimated 2011 revenue of major competitors:
    - TAG Heuer
      - (TAG Heuer is owned by LVHM)
      - 720,000 pieces
      - **CHF 990 million revenue**
      - En.worldtempus.com estimated TAG's 2013 revenue: **CHF 880 million**
    - Breitling
      - 157,000 pieces
      - **CHF 350 million revenue**
    - Tudor
      - (Tudor is owned by Rolex)
      - 120,000 pieces
      - **CHF 150 million**
    - Baume & Mercier
      - (Baume & Mercier is owned by Richemont)
      - 100,000 pieces
      - **CHF 120 million revenue**
    - Frederique Constant
      - 112,000 pieces

        - **CHF 85 million revenue**
- **Mid-range**: **20%** of 2013 total revenue
    - (CHF 300 – 1,000 per watch)
    - Swatch's brands in this segment include
        - Tissot
        - Hamilton
        - Certina
        - Mido
        - CK
        - Balmain
    - Tissot is the #1 brand in the world in this segment
        - Average retail price is about CHF 430 per watch[3]
    - Tissot's revenue is about CHF 1.2 billion
        - Watch-Inside.com estimated Tissot's 2012 revenue:
            - **3.4 million** pieces
            - CHF 1.01 billion
        - En.worldtempus.com estimated Tissot's 2013 revenue to be CHF 1.06 million
        - Tissot's President said in some interviews
            - Tissot sold **3.4 million** watches in 2011[4]
            - Tissot sold **3.7 million** watches in 2012[5]
        - Tissot revenue exceeded CHF 1 billion in 2012
        - Tissot had double digit growth in 2013
            - Sold over 4 million watches in 2013[6]
        - It's reasonable to expect Tissot made **CHF 1.2 billion** in 2013 revenue
    - Hamilton and Mido made over CHF 100 million revenue
        - Source: Watch Insider interview with Nick Hayek, Swatch CEO
    - Watch-Insiders estimated Certina and CK made over CHF 100 million
    - It's reasonable to expect small mid-range brand made about **CHF 500 million** in 2013 revenue
        - According to Nick Hayek, these brands help protect Tissot
    - Competitors are
        - **Citizen**

            - **Seiko**
            - **Fashion brands**
                - **Fossil**
                - **Michael Kors**
    - **Low end**: **9%** of total revenue
        - **(**Less than CHF 300 per watch)
        - Swatch (brand) competes with many brands from other countries
        - Swatch is the #1 brand in the world in this segment
        - Swatch is a lifestyle brand
            - 18-25 years old
            - Sells 12-13 million watches a year
            - Swatch feature witty and outlandish design
                - Bash, intense colors
                - Youthful
                - Provocative
                - Stylish
                - Unpredictable
            - Collections are replaced rapidly
                - Designs are created in Swatch Design Lab
                    - In Milan
                    - By artists, architects, and industrial designs
            - Customers tend to buy many Swatch watches
                - From different collections
        - Revenue is about CHF 770 million
        - Swatch (brand) has about 600 mono-brand boutiques worldwide
            - Account for about 30-35% of revenue
                - Source: Swatch's 2008 Q2 Earnings Call
    - Electronic systems: **3%** of revenue
        - (doesn't make money)
- Moat comes from
    - Production
    - Brand
    - Distribution
    - After-sales services
- **Production**
    - To make a watch, an entrant needs to have movements
    - Movement is the engine of a watch

        - (sometimes called “calibre”)
        - Other components of the watch are
            - Dials
            - Window
            - Case
            - Band
    - Movement manufacturing is extremely concentrated
        - Switzerland
            - Mostly Swatch
        - Japan
            - Seiko
            - Citizen
        - China
        - India
        - Volume is extremely important to reduce cost
            - Requires a lot of specialized machines and tools
            - Extreme precision
                - A error of 0.002 inch of a tiny part can result in an error of hours a day in a mechanical movement
        - Countries making movements are
            - Those make watches for centuries
                - Switzerland
                - Japan
            - The government wanted to grow the industry
                - China
                - India
    - A watch movement consist of
        - Ebauche
            - Is unfinished movement with basic elements like
                - bridges
                - wheels
                - plates
        - Assortments
            - Regulating elements like
                - Balance wheel
                - Spring
                - Escapement

    - How a mechanical watch work?
        - Mainspring get (and store) power from hand movements
        - Mainspring release power to drive wheels and gears
        - Wheels rotates
            - Dials connected to wheels also rotate
        - Escapement control movements of the wheels
            - Make sure wheels rotate at a certain rate
            - Escapement stop and start movement of the wheels at a constant rate
        - Balance wheel regulate escapement
            - Hairspring cause balance wheel to oscillate at a virtually constant rate
            - Constant oscillation of balance wheel stop and start escapement at a constant rate
- The difference between inexpensive and expensive movements are
    - Precious materials
    - More decorations
        - Handmade decorations are more expensive
    - More adjustment
        - Mechanical watch’s accuracy varies with positions (orientation)
        - Adjustment is made to optimize accuracy across positions
        - Adjustment can be made to 6 positions
            - (sometimes 8)
        - Adjustment is the most difficult part in assembling a movement
            - Small pushes, pulls, and turns of components offer tiny tweaks
                - End up having huge effects on performance
            - Getting the watch accurate in one position can have a large impact on another position
    - More complications
        - Complications are features beyond the display of hours and minutes
        - Example:
            - Perpetual calendars
                - Show day, date, and month

                § Take into account leap years
            · Complication modules are placed on top of base movements
- There's no barrier to making Non-Swiss watches
    - Get movement from Japanese or Chinese
- It's more difficult to make Swiss Made watches
- A Swiss watch must have
    - Its movement is Swiss
        - The movement is assembled in Switzerland
        - The movement has been inspected by the manufacturer in Switzerland
        - The component of Swiss manufacture account for at least 50% of the total value
            - Without taking into account the cost of assembly
    - Its movement is cased up in Switzerland
    - The manufacturer carries out the final inspection in Switzerland
    - 60% of production costs are attributable to operations carried out in Switzerland, including
        - Costs for assembly
        - R&D
        - Legally or industrially regulated quality assurance and certification
    - The Federation of the Swiss Watch Industry prefer the required Swiss portion of the production cost be raised to 80%
- For Swiss Made watches, production moat is different between luxury and lower segments
- There's **no production moat** in the luxury segment
    - Retail price is over $10,000
    - A brand sells fewer than 100,000 watches a year
    - Volume is less important
    - Capital investment is several thousands of CHF per movement
        - Example:
            - Swatch bought Breguet in 1999[7]
                - Invested CHF 15 million to upgrade Lemania
                    - Lemania makes movements for Breguet
                - Capacity increased from 3,000 to 12,000
                - => CHF 1,667 per movement

- Hublot
  - Invested CHF 40 million in production
    - From 2007 to 2011
  - Hublot made 29,000 watches in 2011
    - 37% of watches were in-house
  - => CHF 4,000 per movement

§ Common practice is to buy from some providers
- Buy base movements from
  - Jaeger-LeCoultre
    - Owned by Richemont
    - Provide to other Richemont's brands
      - IWC
      - Vacheron Constantin
      - Piaget
  - Ademars Piguet
  - Vaucher[8]
    - Produces about 22,000 movements a year
      - Clients are
        - Hermes
        - Richard Mille
        - Parmigiani Fleurier
    - Offer movements from **CHF 700 to CHF 4,500**
  - Some movement maker don't sell to external clients
    - Rolex
    - Patek Philippe
    - Frederic Piguet
      - Owned by Swatch
      - Make movements for
        - Breguet
        - Blancepain
        - Omega
- Complicated modules
  - Most brands buy complication modules from Dubois Depraz
  - Lemania is another complication modules manufacturer
    - Owned by Swatch

        - Supply only to Swatch's brands
- There's **significant production moat** in lower segments
    - Cost is important in this segment
        - Volume is important
    - Movement suppliers are
        - ETA
            - Owned by Swatch
        - Sellita[9]
            - Started as an assembler of ETA's movement
            - Then make clones of ETA designs with expired patents
                - With subtle difference in parts and finishing
            - ETA and Sellita parts aren't interchangeable
            - Sellita gets 50% of parts from ETA
            - Is the only viable supplier of low-cost, easy-to-service movement outside of ETA
                - Makes over 1 million movements
        - Soprod[10]
            - A small producer of complete movements
                - Makes just over 100,000 movements a year
            - Generally produce high-grade movements
                - Similar to ETA's second best grade
                    - (ETA movements have 4 grades)
                - For watches above CHF 2,000
    - Kepler Capital Market estimate in 2011[11]
        - ETA: about 55% of 5.5 million movements
        - Sellita: 18%
            - ½ of Sellita movements are made from ebauches Sellita buys from ETA
        - Soprod: 4%
        - Rolex: 16%
        - Smaller vertically integrated brands: 5%
        - Etc.
    - Volume is very important
        - Must produce hundreds of thousands of units just to pay for the infrastructure[12]
        - Need a critical mass to make investment[13]

- TAG Heuer invested into producing their own movements[14]
  - Announced in-house movement CH 80
    - In 2013
  - Quietly announced that they would hold off producing
  - The cost is just very high
    - It's cheaper to purchase from ETA or Sellita
- It's quite easy to make movement
  - Most of ETA designs have patent expired
- It's very difficult to make assortments
  - Assortments are regulating elements like
    - Balance wheel
    - Hairspring
    - Escapement
    - Pallets
  - These are the most important component of a watch
    - Hairspring cause balance wheel to oscillate
    - A watch's accuracy depends on how constant the oscillation is
    - It's extremely difficult to make hairspring
- Swatch makes 90% in assortments[15]
  - Through Swatch's subsidiary Nivarox
  - Other movement makers get assortments from Swatch
    - Jaeguer-LeCoultre
    - Patek Philippe
    - Etc.
  - Rolex is another major brand that can make hairsprings
  - A few other manufacturers just make a few tens-of-thousands assortments per year
- Swatch used to be required by law to provide movements to any Swiss competitors
- In 2011, Swatch was allowed to reduce supply
  - Can reduce deliveries of finished movement to 85% of 2010 level
    - Eventually to 0% in 2019
  - Can reduce deliveries of assortments to 95% of 2010 level

        - Sellita must double production just to offset the movement it gets from Swatch
        - Assortments will be the bottleneck for competitors
        - It's even more difficult to get quartz movement in Switzerland
            - Swatch is the only mass producer of quartz movement in Switzerland
        - **Conclusion**: Swatch will gain market share in this segment
- **Brand**
    - **CHF 300 to CHF 800 segment ($300 - $800)**
        - Tissot
            - Good quality at low price
                - Need volume to make it possible[16]
            - Sell to people who want affordable quality Swiss watch
                - Rely on "Swiss Made"
            - Words of mouth
                - Built over many year
                - Tissot's strategy is to make each customer a brand ambassador
                - 30 million people have bought Tissot for the last 14-15 years[17]
                - Quan's experience:
                    - His friends suggested Tissot as the first Swiss watch to buy
            - **Conclusion**: Quite difficult to replicate the mindshare
    - **CHF 800 – CHF 10,000 segment ($800 - $10,000)**
        - (Longines, TAG Heuer, Breitling, Omega, Rolex, Cartier)
        - This segment is mass luxury
            - Sells hundreds of thousands of watches a year
        - **Brands in this segment all have a legacy**
            - History
            - Story
            - Heritage
        - Example
        - Omega
            - Began in 1848
                - At La Chaux-de-Fonds, Switzerland
            - Sponsors the Olympic games

        - Since 1932
        - With only 3 exceptions
    - Long association with
        - NASA
        - International Space Station
        - The Russian space program
    - Is the only watch on the moon
        - Worn by Buzz Aldrin in July 1969
        - Neil Armstrong was forced to leave his (Omega) watch on-board the Lunar Module
            - the craft's electronic timer broke down
    - The watch is worn by James Bond in movies
        - In Casino Royale
            - Bond was asked "Rolex?"
            - He replied "Omega"
- Rolex
    - Began in 1905
    - Worn by Mercedes Gleitze
        - When she became the first women to swam across the English Channel
        - In 1927
    - Worn by Sir Edmund Hillary and Tenzing Norgay
        - When they became the first to summit Mt Everest
        - In 1953
    - Witness the depth of the sea with Jacques Picard
        - The watch was attached to the outside of a submarine
        - Went down to a depth of 3,048 meters
- **Huge investment in marketing**
    - Omega's
        - Spends hundreds of millions of Swiss franc
            - Associate the brand with
                - Beauty
                - Top of profession
                - Rich
        - Celebrity endorsement
            - Cindy Crawford

            - Nicole Kidman
            - George Clooney
            - Michael Schumacher
                - A racing champion
            - Michael Phelps
                - A Swimmer champion
            - Rory McIlroy
                - A golf champion
        - Event sponsor
            - Olympic games
            - Golf
                - PGA tour
                - Ryder cup
                - Etc.
            - Sailing
            - Etc.
- Rolex
    - Sponsors high end sports events
        - Golf
        - Tennis
        - Yacht racing
        - (Never associated with mass sports like football)
    - Rolex's marketing strategy is built around testimonials of people who are top of their fields
    - Associate the brand with achievements
- Longines
    - Involves in elegant sports like
        - Gymnastics
        - Tennis
        - Horse jumping
        - Horse racing
        - Alpine skiing
    - The brand is associated with elegance
        - Motto: "Elegance is an attitude"
    - Uses brand ambassadors like
        - Andre Agassi

- (former number 1 Tennis player)
   - Jane Richard
      - (a horse rider talent)
   - Mikaela Shiffrin
      - An American ski racer
      - Is the youngest slalom champion in Olympic at alpine skiing history
   - Kate Winslet
      - (movie star)
   - Simon Baker
      - (movie star)

- TAG Heuer
   - The brand is associated with
      - Young
      - Dynamic
      - Determination
   - Actively involves in motor sports
      - Official timekeeper at
         - Formula I
         - INDYCAR
   - Use celebrity endorsement
      - Tiger Woods
         - (Golf legend)
      - Maria Sharapova
         - (tennis player)
      - Racing drivers
         - Fernando Alonso
         - Juan Pablo Montoya
         - Lewis Hamilton
      - Leonardo Dicaprio
      - Brad Pitt
- Breitling
   - Involved in aviation

§ **It's very difficult to build a brand in this segment**
- Need a legacy
- Very expensive marketing

- **Over CHF 10,000 segment (> $10,000)**
  - Advertising is less important
  - Legacy is very important
    - Example
    - Breguet
      - Founded by Abraham-Louis Breguet
        - Is the most reputable watchmaker in history
        - He invented the tourbillons
          - Tourbillons is a special refinement to an escapement
          - The balance wheel not only oscillate
            - But also rotate on itself
            - Cancel out the effect of gravity
      - Breguet watches were worn by
        - Napoleon
        - Queen Victoria
        - Winston Churchill
      - Famous citation written by writer of literature
        - Alexandre Dumas
        - Victor Hugo
        - Honore de Balzac
  - Most brands are old
    - Blancpain: 1735
      - (the oldest brand)
    - Vacheron Constantin: 1755
    - Breguet: 1775
    - Jaeger-LeCoultre: 1833
    - Patek Philippe: 1852
    - Chopard: 1860
    - IWC: 1868
    - Audemars Piguet: 1875
  - But there are some young brands
    - Hublot: 1980
    - Richard Mille: 1999
    - These brands entered through unique designs
      - Mostly built reputation at Basel World
        - The industry's most important trade show

        - Most new brands are very expensive
          - > $100,000
          - Marginal players
      - **Conclusion: Brand building is easier in this segment than the $800 - $10,000 segment**
- Distribution
  - Strong advantage in the $300 - $10,000 segment
    - Need many points of sale
      - Tissot: 13,500 points of sale
      - Longines: about 4,000 points of sale
      - Omega: about 1,800 points of sale
    - Mostly sold through retailers
    - Big groups have power over distributors and retailers
      - Usually ask retailers to carry other brands from the Group
      - Swatch, Richemont, and Rolex account for 45.8% of the global watch market
        - About 85% of the Swiss watch industry
      - LVMH's brands are squeezed out retailers[18]
        - Because of the power of Swatch and Richemont
    - Wholesalers don't want unknown brands[19]
      - It can take up to a hundred days to sell a watch
      - It's safer to sell reputable brands
    - Retailers don't want to hold many brands
      - Limited store space
      - High financial cost
    - Some brands may sell $300-800 watches online
      - But it's difficult to build awareness without retail presence
  - An option is to open mono-brand boutiques
    - It's easier for the high-end segment
      - > $10,000
      - Volume is lower than 50,000 watches a year
    - Nick Hayek said in an interview with Watch Insiders in 2013
      - High-end luxury is the easiest thing to do
        - you can do business with 100 points of sale
- After-sales service
  - Quartz watches need to change battery
  - Mechanical watches need

        - Oil change
        - Water-resistance check
        - De-magnetized
    - Customers are disperse
    - Poor after-sales service will damage the brand[20]
    - Swatch's spare parts for customer service is about **3.5%** of revenue
    - The importance of after-sales service varies by segment
        - Not important for watches below $800
            - Most jewelers, dealers can fix
        - Important for watches $800 - $10,000
            - Customers in this segment want quick service
            - Longines has over 1,000 service centers
            - Omega has 445 service centers
        - It's less important in luxury segment
            - Customers in this segment can be less demanding than lower segments
            - Patek Philippe has 57 service centers
            - Breguet has about 45 service centers
            - Richard Mille has only 3 service centers
                - Richard Mille sells watches over $100,000
    - It's be difficult for non-ETA movements to get service[21]
        - ETA movement is ubiquitous
            - May cost less than $400 per service
        - Other brands' in-house movements are hard to service
            - Independent watchmakers don't have spare parts
            - Standard service jobs may cost $700-$2,000
                - May cost over $10,000 for complicated watches
- Moat is wide for luxury watches
    - Production: No moat
    - Brand: wide moat
    - Distribution: narrow moat
    - After-sales: narrow
        - Still need about 50 service centers
            - (Selling watches over $100,000 is an exception)
    - Conclusion:
        - It's quite easy to be a marginal player
        - It's difficult to be a big player

- Market share is quite even between a number of brands
    - Patek Philippe: Around CHF 1-1.2 billion
    - Breguet + Blancpain: about CHF 1.1 billion
        - Wild guess:
            - Breguet: CHF 700 million
            - Blancpain: CHF 400 million
    - Jaeger-LeCoultre: CHF 680 million
    - Vacheron Constantin: CHF 600 million
    - Chopard: CHF 650 million
    - Audemars Piguet: CHF 600 million
    - IWC: CHF 580 million
    - Piaget: CHF 500 million
- These brands hold most of the market share
    - Switzerland exported CHF 13.5 billion of watches over CHF 3,000
        - Switzerland accounts for 10% of the market
        - => total market is CHF **15 billion**
    - Rolex + Cartier + Omega = about **CHF 9 billion**
    - => the luxury segment (> $10,000) is less than CHF 6 billion
        - Breguet + Blancpain: CHF 1.1 billion
        - Patek Philippe: CHF 1.1 billion
        - Richemont's Specialist watchmaker: CHF 3 billion
            - Assuming CHF 2.5 billion from the luxury segment
        - These 3 companies made about 5.2 billion
        - Adding independent brands like Audemars Piguet and Chopard => they account for most of the market share

- Moat is very wide for watches between $800 - $10,000
    - Production: wide moat
    - Brand: wide moat
    - Distribution: wide moat
    - After-sales: narrow moat
        - Need hundreds of service centers
        - In-house movement is difficult to service
    - Conclusion:
        - Moat is widest in this segment
    - Market share is concentrated in some brands
        - Rolex: CHF 3.5-5 billion revenue

        - Omega: CHF 2.4 billion revenue
        - Cartier: about the same as Omega
        - Longines: CHF 1.4 billion
        - TAG Heuer: CHF 880-990 million
        - Rado: CHF 440 million
        - Breitling: CHF 350 million
        - Officine Panerai: CHF 300 million
        - Other brands makes less than CHF 200 million
- Moat is narrow for Tissot
    - Production
        - Wide moat against Swiss competitors
        - No moat against foreigners
    - Brand
        - “Swiss Made” gives Tissot an advantage
    - Distribution: narrow moat
        - Wide moat in traditional retail channel
        - But competitors can sell online
    - After-sales service: No moat
    - Conclusion
        - Wide moat against Swiss competitors
            - In 2013, Swiss watch industry exported 8.4 million watches between CHF 200 and CHF 3,000
            - TAG Heuer and Longines sold over 2 million pieces
            - => other brands sold about 6.4 million watches
            - Tissot sold 4 million watches
            - => Tissot market share in the CHF 300 – CHF 1,000 segment is over 62.5%
        - Narrow moat against foreigners
        - No pricing power

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[1] “**Marc Hayek's three brands have 2013 showed an above-average performance: The cumulative sales are expected to have risen by around ten per cent to a record high of 1.1 billion Swiss francs (8.8 billion are in the whole group). Good half for Breguet, which has sold more than 30 000 copies, 20,000 are at Blancpain, against 5000 at Jaquet Droz**.” – Translated from an article named ‘*Hüter der Swatch-Kronjuwelen*’, Author: Von Ruedi Mader, Date: 19 March, 2014

[2] "**Longines is one of fastest-growing brands in recent years with a turnover of 1.4 billion Swiss francs in 2013. The aim this year is to pass the threshold of 1.5 million watches sold**. CEO Walter von Känel takes a relaxed view of the future." – From an interview of W The Journal with Longines's CEO Walter von Känel on 04 February 2014, http://www.wthejournal.com/en/news/view/5-questions-for-walter-von-kaenel-ceo-of-longines

[3] "**When Mr Thiébaud took over in 1996, the company made 850,000 watches; 10 years later, output had climbed to more than 2m**, with production rising at double-digit rates until last year's relative slowdown to a "mere" single-digit increase.

Tissot's performance underpins suggestions that mid-market brands have survived the crisis in much better shape than many of their more exalted counterparts.

With an average price of about SFr430 ($408) in Switzerland (excluding its costlier gold range) Tissots remain pretty accessible, even for buyers on straitened budgets." – *François Thiébaud: The comfort of being the man in the middle*, Haig Simonian, Financial Times, 18 March 2010

[4] "Thiébaud and Tissot must be doing something right since one in five exported Swiss watches is a Tissot. "**We sold 3.4 million watches in 2011 and I expect to sell four million watches in 2012**," Thiébaud smiled." – Tissot and Longines Powerhouse Numbers, Kristian Haagen, Worldtempus, 12 March 2012

[5] "I wear two caps. I am president of Tissot. But I am also president of the exhibitors' committee. The Swiss watch industry exported 1,646.7 million Swiss francs (CHF) last year. In the sub-200 CHF segment, there was a decrease in units. But in the 200-500 CHF segment, there was an increase. **Tissot sold 3.7 million watches last year, up from 3.4 million the year before**. We grew! We rule in this segment.

When I took over Tissot 17 years ago, we were selling 840,000 watches. In 17 years, we sell three million more every year. Now the industry sold 29.2 million watches in 2012. Now you take 12-13 million of Swatch watches from this… **Out of the remaining 16 or 17 million watches…traditional watches…we sold 3.7 million. One out of every four or five watches going out of Switzerland is a Tissot. This is the way it is.**" – *François Thiébaud: The Old Innovator*, Sidin Vadukut, Livemint.com, 26 July 2013

[6] "When François Thiébaud arrived at Tissot in 1996, the brand was producing some 840,000 watches annually. **In 2013, the company Le Locle in the hands of the Swatch Group, has reached a new dimension, with a production of over 4 million units**. This is 8.1% more compared to the previous year.And 376% above since the appointment of boss." – Translated from an article named '*Tissot génère 15% de l'ensemble des volumes de l'horlogerie suisse*' from Letemps.ch on 27 March 2014

[7] "Fourth, the Swatch Group, after taKing over, upgraded and reorganised the production facilities at Nouvelle Lémania (renamed Manufacture Breguet in 2003), a sister company of Montres Breguet who supplied Breguet with most of its movements. **After the takeover Hayek spent CHF 15 million to upgrade the plant. The investment yielded a bumper crop of new tourbillon and complicated calibres. Breguet's production soared from around 3,500 units in 1999 to between 11,000 and 12,000 units in 2004.**" – The Great Turnaround, 20 November 2005, http://watchworld.co.in/the-great-turnaround/

[8] "At Vaucher Manufacture it has not yet reached the point where they are considering going down-market to position themselves as an alternative to mass-market calibres: "**To compete with ETA's best-selling movements, we would have to produce hundreds of thousands of units just to pay for the infrastructure investment,**" points out managing director Jean-Daniel Dubois.

Nevertheless, like Technotime, the manufacture is one of the rare companies outside the Swatch Group capable of producing balance springs. And much more besides: via the subsidiaries of Manufactures Horlogères de la Fondation de Famille Sandoz (MHF) – Atokalpa, Elwin, Quadrance, Habillage, Les Artisans Boîtiers – Vaucher has access to dials and cases.

Ninety-five per cent of its movements are produced in-house: "The remaining 5% comprises the rubies, barrel springs and shock absorbers." Such integrated production appears to work. **Offering a price range between 700 and 4,500 francs, the manufacturer has significantly increased movement deliveries, from 6,000 calibres two years ago to 22,000 today**. Vaucher Manufacture produces five families of 'VMF' calibres. "Our aim is to reach 35,000 units five years from now. At the moment, 60% of our production goes to Parmigiani Fleurier and Hermès. Our external clients include Harry Winston, Richard Mille and Corum."" – *Mechanical – Who Will Succeed ETA?*, Serge Maillard, Europa Star WorldWatchWeb, 28 August 2014

[9] "So what is a company to do if it would prefer not to use ETA (or as will soon happen, can't use their calibres)? There are a few other companies that offer complete movements to third parties in Switzerland, but none have anything close to ETA's dominance of the market. **Sellita is one of the largest suppliers at the moment, having begun as an assembly centre for ETA before building complete calibres. Their movements are copies of ETA designs that have expired patents, but with some subtle differences in parts and finishing – ETA and Sellita parts are not interchangeable, despite their similarities in design**. Alpina and Frederique Constant use Sellita automatic calibres in some of their models (aside from the hand-wound, chronograph, and manufacture watches). They also produce a range of semi-complicated models, mostly calendar complications (moonphase, triple-date). **Unfortunately Sellita is having a hard time with the Swatch group at the moment, as it currently gets nearly 50% of its parts from ETA. Sellita was one plaintiff in the class action suit that was filed in 2011**. The company will need to adapt, expand, and integrate more production to remain competitive – and it looks like it will become very competitive in the next few years, as **at the moment it is the only viable supplier of low-cost, easy-to-service calibres outside of ETA**. " – *Watch in Depth – Movement Calibres*, Jason Cornier, Mattbaily.ca, 30 January 2012

[10] "**Soprod is a smaller producer of complete movements, and generally produce higher-grade calibres that are well suited to midrange independent brands**. **They have proprietary designs finished to a high degree, something along the lines of an ETA Top Soigne.** The also produce a range of quartz calibres. Like Sellita, they began as a facility dedicated to finishing and modifying ETA calibres (as well as building complication modules made to bolt onto existing calibres), but have recently begun producing their own designs." – *Watch in Depth – Movement Calibres*, Jason Cornier, Mattbaily.ca, 30 January 2012

[11] "**Sellita says it makes almost 500,000 units a year, while still buying about as many finished movements from ETA**. Soprod provides no data, but is believed to make about 200,000 movements a year.

Together, the three groups account for about 80 per cent of Swiss movement production. **Kepler Capital Markets reckons ETA will account for about 57 per cent of this year's 5.5m total; Sellita for 18 per cent and Soprod for 4 per cent. The rest is split between Rolex (16 per cent) which produces exclusively for its own use, and 5 per cent for smaller, vertically integrated brands such as Patek Philippe.**" – *Movements: Emotions Run High amid Timepiece Turmoil*, Haig Simonian, Financial Times, 09 September 2011

[12] "At Vaucher Manufacture it has not yet reached the point where they are considering going down-market to position themselves as an alternative to mass-market calibres: "**To compete with ETA's best-selling movements, we would have to produce hundreds of thousands of units just to pay for the infrastructure investment,**" points out managing director Jean-Daniel Dubois." – *Mechanical – Who Will Succeed ETA?*, Serge Maillard, Europa Star WorldWatchWeb, 28 August 2014

[13] "**Thanks to Swatch, "there is no other industry with such cheap entry costs,"** said Jean-Claude Biver, who spent 12 years on Swatch's executive committee before becoming chairman of Hublot, which is now part of LVMH Moët Hennessy Louis Vuitton, the world's largest luxury goods company and one of Swatch's main rivals.

Hublot has been using Swatch components, but since 2007 it has invested 40 million francs to develop its own manufacturing capacity. It is on track to ensure that 75 percent of its revenue will come from watches made entirely in-house within three years, compared with 37 percent now.

But, Mr. Biver acknowledged, "**the example of Hublot isn't valid for everybody because you have to have a certain critical mass to justify such a heavy and long-term investment." Hublot makes 29,000 watches a year, sold at an average of $27,000 each.**" – *Swatch, Supplier to Rivals, Now Aims to Cut Them Off*, Raphael Minder, 09 December 2011

[14] "One of the major reasons that TAG Heuer is able to offer lower-priced watches is reportedly greater availability of base movements from third-party suppliers such as ETA and Sellita. For the last several years ETA kept warning brands that they would lose the ability to purchase movements from the Swatch Group owned maker of Swiss movements once relied upon by many watch makers. Thus, TAG Heuer (and many other brands) invested heavily into producing their own movements. **TAG Heuer released its in-house made caliber 1887 automatic chronograph a few years ago and more recently announced the in-house made and designed Caliber 1969 (later renamed to the Caliber CH 80). It look less than a year after the debut of the highly anticipated CH 80 movements for TAG Heuer to quietly announce that they would hold off producing them for the foreseeable future.** It seems as though it would be a most certain shame for TAG Heuer to abandon the CH 80 movements all

together, and we anticipate they they are merely going to be delayed – possibly for a few years.

The production costs of making the caliber CH 80 are very high, and if TAG Heuer is able to simply purchase movements from ETA and Sellita, it makes a lot more economic sense for them in the short and middle term to do so, rather than produce movements in-house. Furthermore, the lower production costs allow them to produce lower price-point watches which is a major reason why they are able to shift their product focus as part of the branding shift. The good news is that consumers have been asking for TAG Heuer to once again offer compelling lower-priced watches in addition to their successful higher-end Carrera and Monaco collection timepieces." – *"Don't Crack Under Pressure" Is New TAG Heuer Brand Message, Hints to Future Company Direction*, Ariel Adams, ablogtowatch.com, 24 August 2014

[15] "OK, so this year you will have 5.5 million mechanical movements produced in Switzerland, of which Swatch Group produce maybe 3-3.5 million. But **when it comes to assortments, they are producing perhaps 4.5 million of the 5.5 million, so you're right that the majority of Swiss movements have Nivarox assortments, with the exception of some *manufactures* who have their own assortments in very small volumes and Rolex [See Rolex's Spiral Parachrom below], which is apparently making 50% of its requirements internally.**

So, Nivarox is the only scale producer- you can find assortments here and there, but they can make maybe a few thousand or a few tens-of-thousands assortments per year." – Jean-Christophe Babin, TAG Heuer CEO, said in an interview with calibre11.com on 17 October 2011, http://www.calibre11.com/tag-heuers-movement-future/

[16] "**At Tissot, we aim for growth through high volumes and not through high prices. The more we sell, the more we can lower our prices. That is our brand's big strength.**" – François Thiébaud told WtheJournal.com on 27 March 2013

[17] "**For the last 14-15 years, some 30 million people have bought Tissot. Every day of every month of every year, these millions of people will say good things about you**. Put any value on this. These ambassadors are doing billions of dollars worth of communication for you. And are you expecting to grow this year as well? We should hit four million pieces. Maybe even 4.2 million." –

François Thiébaud: The Old Innovator, Sidin Vadukut, Livemint.com, 26 July 2013

[18] "Although LVMH is the world's fourth-biggest watchmaker in dollar terms, sales have floundered because TAG Heuer, its biggest brand, has a comparatively low profile in Asia and missed out on the region's luxury watch boom. **LVMH's brands, which include Zenith and Chaumet, are also being squeezed out of independent retailers because other watch groups, like Swatch and Richemont, are demanding more prominent in-store displays.**" – *LVMH to Expand Retail Network for Watch Brands*, John Revill, the Wall Street Journal, 03 February 2014

[19] "The independent brands are interesting, also because they don't have enough resources to behave as the big brands do. For them, the agent and the distributor are the best interlocutors. **For the latter, the risk is immense as he has to finance a stock of hundreds of watches. Thus, he works almost like a bank during the time the orders are being taken, and is paid only when the retailer can remit. This period can last up to a hundred days. This is the reason why distributors like us zero in on independent brands who enjoy a worldwide reputation and proven financial stability.**" – Retailers Need Alternatives to Big Brands, 27 October 2011, en.worldtempus.com

[20] "**Europa Star:** How do you organise customer service for such small production quantities?

Richard Mille: We have set up a sort of "service station" in each of our three main zones. If you look at the statistics, 80 per cent of customer service issues are not serious. It may be a small shaft that breaks, or a hand that comes loose. These are things that can be repaired on site. Only the watches that have stopped and require more complicated work are sent back to the factory. If you think about when you have your car repaired, the garage may keep it for a few days. **But if you send your watch in to be repaired you might not hear anything for months. That's when the love of a brand can suddenly turn to hate**. So we have set up a system on our website where the customer can follow the repair process. We even include photos to explain what we are doing." – *The Audacity of Richard Mille*, Paul O'Neil, Europa Star WorldWatchWeb, 30 October, 2012

[21] "**Question:**

This is very educational, thanks. I own several ETA-based watches (Panerai and Omega) and have been thinking of selling these two and getting a manufacture watch such as JLC ... *[Quan: JLC = Jaeger-Lecoultre, this company is owned by*

Richemont and produce high-end movements for themselves and some other luxury brands] **What is stopping me, however, is the service costs that I hear are 2-3 times higher for in-house movements than stock ETA, which is to say you will be looking at $1-1.2K per service vs 300-400$ for an ETA movement. Add parts problems, shortage of skilled labour and possible longer time required for getting your piece fixed or serviced and this idea is beginning to lose its appeal**. May be i am on a wrong path here - do you care to comment on this?

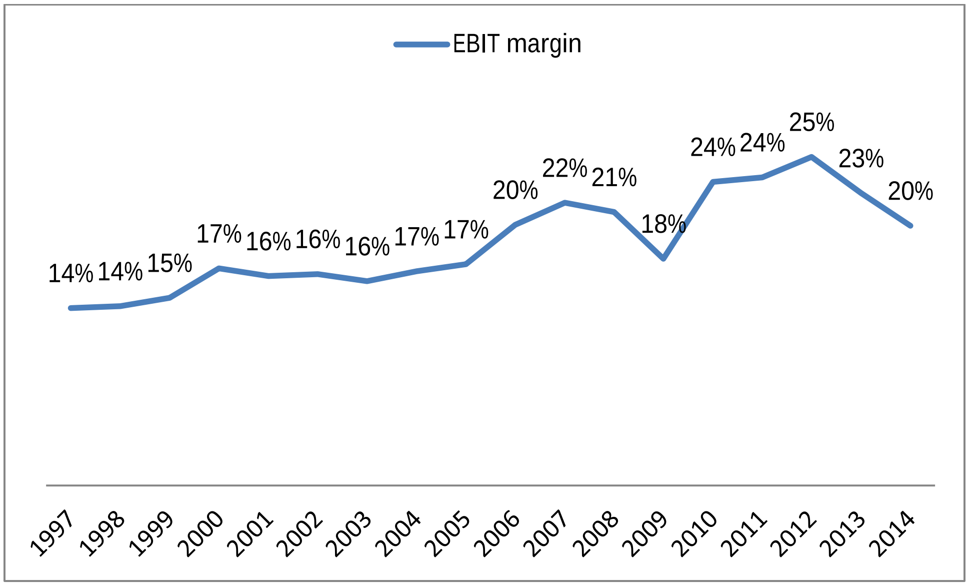
Answer:

You are indeed right, **the disadvantage of manufacture calibres is their high cost of service and parts [Quan: manufacture calibres means in-house movements]. Independent watchmakers are unlikely to be able to source parts for these calibres as most of these companies refuse to supply spares to third party watchmakers. They essentially force you to send the watch directly to their main service centre**. While the quality of the work done by these centres is impeccable, and covered by a manufacturer's warranty, it is substantially more than an ETA service. **A Ferrari is more expensive to service than a Honda, the same thing applies to watches. You can expect to pay between 700-2000 for most standard service jobs, including polishing. More complicated watches will be higher, sometimes more than 10 000$ for a tourbillon or minute repeater!**

JLC is better than most in this regard, they are on the lower end of the scale, but definitely more [expensive] than your typical ETA service." – *Watch in Depth – Movement Calibres*, Jason Cornier, Mattbaily.ca, 30 January 2012

Quality

High Profit Margin Makes Up for the Low Asset Turnover



Swatch can make over 20% EBIT margin

- Revenue breakdown by regions
  - Europe: 34%
    - Switzerland: 12.6%
    - Other Europe: 21.4%
  - Asia: 56%
    - Greater China: 37.9%
    - Other Asia: 18.1%
  - America: 8.4%
  - Oceania: 1%
  - Africa: 0.6%
  - It's possible that Asians account for well over 70% of revenue
    - According to HSBC research
      - 50% of sales of luxury goods in Western Europe are generated by foreigners
        - (perhaps by Asians)
        - Comparable to Hong Kong
        - Higher than North America
          - About 20%
- Revenue breakdown by watch segment

- (for more detail, See the Moat section)
- Luxury: **18%** of revenue
  - (watches over $10,000)
- High range: **28%** of revenue
  - (watches between $3,000 and $10,000)
- Upper mid-range: **22%** of revenue
  - (watches between $1,000 and $4,000)
- Mid-range: **20%** of revenue
  - (watches between $300 and $1,000)
- Low-end: **9%** of total revenue
  - (watches below $300)
- Electronic system: 3% of revenue
  - This segment makes low power integrated circuits
    - (1.5 volt chips)
    - Supply to the quartz movement production
    - But also supply to outside clients
  - 3 companies make 1.5 volt chips in the world
    - The other two are Seiko and Citizen
  - This segment used to make good profits
    - 20% EBIT margin
    - But strong CHF hurt this segment
    - Currently lose a small amount of money

- EBIT breakdown by watch segment
  - Higher price segment has higher margin
    - Omega's EBIT margin is close to **30%**[1]
      - In 25-30% range in 2004
      - Omega's brand positioning increased a lot over the last 10 years
      - Revenue growth also improved margin
    - From the Swatch's 2004 Q4 earnings call transcript[2]
      - Luxury segment: close to **30%** EBIT margin
        - (including Omega)
      - Middle segment: **20-23%** EBIT margin
      - Low-end segment: **5-10%** EBIT margin
    - Nick Hayek said in an interview with Watch-Insider in 2013 that Longines alone made more EBIT than LVMH's watch and jewelry segment

- Longines made CHF 1.2 billion revenue in 2012
- LVMH’s watch and jewelry segment made
  - EUR 334 million EBIT in 2012
    - About CHF 400 million using the 2012 FX rate
  - EUR 265 million EBIT in 2011
    - About CHF 328 million using 2011 FX rate
- => Longines is higher than the **27%-33%** range

- Richemont brands makes over 25% EBIT margin
  - Jewellery Maisons segment makes 35% EBIT margin
    - Mostly from Cartier
    - Cartier watch is of similar size as Omega
  - Specialist Watchmakers makes 26-27% EBIT margin
    - Mostly from luxury brands
- Gross margin is high
  - Richemont’s gross margin is 64%
  - Swatch doesn’t report cost of goods sold
  - If cost of goods sold include only material cost and changes in inventories
    - Gross margin is 79%
  - It suffices to say gross margin is very high
    - Sales growth can results in very high EBIT margin
    - (Reduce SG&A/Sales)

- Tissot can make about 20-23% EBIT margin
  - Mr. Hayek said that mid-range brands make 20-23% EBIT margin
  - Fossil’s wholesale business has over 22% EBIT margin
- **Low-end and electronic system contribute less than 5% of EBIT**
  - Contributes 12% of revenue
  - Electronic system makes some loss
  - Low-end watches makes less than 10% EBIT margin
- **Mid-range brands account for less than 22% of EBIT**
  - Mid-range and higher brands account for over 95% of EBIT
  - Mid-range and higher brands account for 88% of revenue
  - Mid-range brands account for 20% of total revenue
  - Mid-range brands has lower margin than higher brands
  - 22%/0.88 * 0.95 = 22%
- **Brands higher than mid-range account for more than 73% of EBIT**
  - 100% - 5% - 22% = 73%

- Swatch has great currency exposure
    - CHF/Euro isn't very important
        - Other Europe market account for 21.4% of revenue
            - ½ of revenue in Europe is to tourists
            - If tourists are from outside of Europe
                - Swatch has only 11% exposure to Europe
        - If CHF appreciates, Swatch can raise price in Europe
            - Tourists will still buy
                - Euro depreciate against customers' local currency
                - Higher price in Europe is still lower than price in tourist's home country
                    - Example:
                    - China has a lot of import tax, VAT tax, luxury goods tax
                    - Prices in China are 30-50% higher than other market
    - HKD and CNY move closely with USD
    - => CHF/USD is the most important
    - Historically, CHF appreciated about 2.5% annually against USD
        - 1997: 1 CHF = 0.6889 USD
        - 2015: 1 CHF = 1.0779 USD
        - Appreciation can be lumpy
            - 2000: - 11%
            - 2002: + 9%
            - 2003: + 16%
            - 2004: + 8%
            - 2005: - 1%
            - 2006: + 0%
            - 2007: + 5%
            - 2008: +11%
            - 2009: - 1%
            - 2010: + 4%
            - 2011: + 18%
            - 2012: - 5%
            - 2013: + 1%
            - 2014: + 0%

        - Switzerland has low inflation
            - About 2% in 1990s
            - About 1% in 2000s
            - About 0% recently
    - Delta = Local inflation – Switzerland's inflation
    - If Delta = CHF appreciation
        - There's no currency impact on the business
    - If Delta > CHF appreciation
        - Swiss watches become affordable to local population
    - If Delta < CHF appreciation
        - Swiss watches become less affordable to local population
        - Swatch and Tissot are most vulnerable
            - Compete with Japanese competitors
        - The impact is lower on watches over CHF 1,000
            - Don't have to compete with foreign competitors
            - They tend to raise price to offset CHF appreciation
        - Swatch is in a better position
            - Swatch focus on production
                - Vertically integrated production
                - Low cost
            - Competitors focus on marketing
                - Get components from suppliers
                    - Or has low volume
    - Swiss watchmaking industry grew mostly in watches over CHF 3,000
        - Watches below CHF 200
            - In 2000
                - Unit: 22,795 thousands
                - Revenue: CHF 1,231.2 million
                - Price per unit: CHF 54
                    - $32 (2000 FX rate)
            - In 2014
                - Unit: 18,400 thousands
                - Revenue: CHF 1,248.1 million
                - Price per unit: CHF 68
                    - $73
        - Watches from CHF 200 to CHF 500
            - In 2000

            o Unit: 3,144 thousands
            o Revenue: CHF 1,035.8 million
            o Price per unit: CHF 329
                § $194 (2000 FX rate)
        · In 2014
            o Unit: 4,997 thousands
            o Revenue: CHF 1,559 million
            o Price per unit: CHF 312
                § $335
    § Watches from CHF 500 to CHF 3,000
        · In 2000
            o Unit: 3,229 thousands
            o Revenue: CHF 3,856.2 million
            o Price per unit: CHF 1,194
                § $702 (2000 FX rate)
        · In 2014
            o Unit: 3,745 thousands
            o Revenue: CHF 4,342.4 million
            o Price per unit: CHF 1,160
                § $1,247
    § Watches over CHF 3,000
        · In 2000
            o Unit: 488 thousands
            o Revenue: CHF 3,153.2 million
            o Price per unit: CHF 6,461
                § $3,800 (2000 FX rate)
        · In 2014
            o Unit: 1,642 thousands
            o Revenue: CHF 13,828.6 million
            o Price per unit: CHF 8,422
                § $9,056
o Price ($) inflation was normal for watches in CHF 200-3,000 range
o Price ($) inflation was about 6% for watches below CHF 200
    § Volume declined by 19%
o Price ($) inflation was about 6.4%
    § Volume increased by 236%
o Possible explanation

                - Swiss watchmakers raised price to offset CHF appreciation
                - Most brands went upmarket
                    - Example:
                    - TAG Heuer used to be lower than Longines in positioning
                        - TAG Heuer's price is higher than Longines today
                    - Omega has been going upmarket to rebuild its past reputation
                - Swatch maintained pricing discipline at Tissot and Longines
                    - These brand grew a lot
                    - Joined a small group of brands that make over CHF 1 billion revenue
                    - The industry had little volume growth
                    - Swatch gained a lot of market share in this segment
                - Demand from new markets like China was able to absorb 6.4% price inflation in watches over CHF 3,000
        - Conclusion: Swatch handles CHF appreciation better than competitors
- Swatch has low asset turnover
    - A lot of working capital
        - 2014 Revenue/Average Inventories: 1.53
        - 2014 Revenue/Average Receivables: 8.0
        - 2014 Revenue/Average (Inventories + Receivables): 1.3
    - High level of inventories result in inventory risk
        - Swatch has lower inventory risk than Richemont
        - Swatch focuses on production
            - Has a lot of raw materials and work in progress inventories
        - Swatch has higher Finished inventory turnover than Richemont
            - Swatch's Revenue/Average Finished Inventory
                - 2011: 6.3
                - 2012: 5.5
                - 2013: 4.3
            - Richemont's Revenue/Average Finished Inventory
                - 2012: 4.4
                - 2013: 4.1
                - 2014: 3.9
        - Swatch reduces inventory risk by getting closer to customers
            - Has distribution subsidiary in most important markets
            - 28% of revenue from Swatch's own retail stores

· Get “sell-through” information from retailers[3]
    o In 2008, 20-30% of retailers give Swatch sell-through information
        § Swatch gives them 1-2% additional margin

o Inventory turnover declined
    § Revenue/Average Inventories
        · 1998: 3.1
        · 2003: 2.6
        · 2008: 2.3
        · 2013: 1.7
        · 2014: 1.5
    § Swatch’s investor relation explained
        · Swatch increased retail operation
            o 5% of revenue in 1998
            o 28% of revenue today
        · Swatch is a producer of watch and jewelry
            o Not just a trader
                § (like brands that don’t focus on production)
            o Needs a strategic stock of products and components
        · Swatch acquired Harry Winston
            o A solid part of stock is held in gold and diamonds

o Asset turnover declined as a result
    § Sales/Average (Receivables + Inventories) declined
        · Quite stable from 1998 to 2007
            o Around 2x
        · Declined since 2007
            o 2007: 2
            o 2010: 1.7
            o 2014: 1.3
    § Sales/Average NTA declined
        · 1998: 1.53
        · 2003: 1.46
        · 2008: 1.44
        · 2011: 1.41
        · 2012: 1.34
        · 2013: 1.22

- EBIT margin increased
  - Growth of higher price brands improved margin
  - Retail operation also improves margin
    - Example:
    - Assuming Swatch sells a watch to retailer for $1,000
      - Make $200 EBIT
      - If Swatch sell the watch to end-customer
        - Assumes that retail price is $1,500
        - Assumes that retail EBIT margin is 10%
          - $150 EBIT
        - Swatch makes $350 total EBIT
          - 23% EBIT margin
- EBIT/NTA actually improved
  - 1998: 21%
  - 2003: 23%
  - 2008: 31%
  - 2013: 28%

- The decline in working asset turnover isn't necessarily bad
  - Tom Russo said that Wall Street analysts are short-term oriented
    - Always want to see less working capital
  - Tom Russo welcomes more investment in working capital
    - Reinvest in good business
    - Build infrastructure in new market
  - Richemont's Revenue/Average inventories was stable about 2.5x
    - Much higher than Swatch's 1.5
  - But Richemont has lower Revenue/Average Finished inventories
    - Swatch's Revenue/Average Finished Inventory
      - 2011: 6.3
      - 2012: 5.5
      - 2013: 4.3
    - Richemont's Revenue/Average Finished Inventory
      - 2012: 4.4
      - 2013: 4.1
      - 2014: 3.9
    - Swatch my respond to market more quickly than Richemont

- Warren Buffett's comment about luxury watchmakers: "***Luxury watchmakers such as Geneva-based Rolex are great companies. They know my phone number, but they haven't called.***"
- 8 dimensions of quality
    - Relative size
        - Swatch has almost 40% of the Swiss watch industry
        - Most retailers are small
        - Suppliers are small
            - Swatch has vertical integration
    - Focus
        - Swatch is focused on watches
            - To a small extent on jewelry
    - Customer engagement
        - No information
    - Cross-selling
        - Cross sell watch brands to retailers
    - Retention
        - No information
    - Words of mouth
        - No information
    - Reinvestment rate
        - Spends over 10% of revenue a year on marketing
            - Over CHF 800 million a year
        - Invested almost CHF 8 billion in the business since 1997
            - In production
            - In retail operation
    - Stock's popularity
        - Free float: no trustful data because Swatch has two classes of shares
        - According to Stockopedia
            - 3-month average volume: 300,840 shares
            - => 76 million shares are traded in 252 days
        - There are 54.3 million bearer-equivalent shares
        - The Hayek Pool and related entities control 41% of shares
        - => enough to say the annual share turnover is very high

[1] "PIARA CIRLONI: Really last question -- **Omega is in your higher end margin -- (multiple speakers) -- in the 25, 30% operating margin?**

Nicolas Hayek, Jr. [Swatch's CEO]: **Absolutely. Omega is in there. Now, if I would take Omega out there, it would probably even be so high that we cannot block you any more to make up the proposal. We should just concentrate on the three perceived brands and sell all the others!**

PIARA CIRLONI: (LAUGHTER) I did not make such a -- (multiple speakers).

Nicolas Hayek, Jr. [Swatch's CEO]: No, not you but some other people are taking the short-term conclusion. No, but **Omega is -- we will see a further improvement in margins from Omega. Omega is already very high and very good. Our positioning goes up.** New products that are launched in Basel are all in a price segment that are higher and they have additional value. New quartz (ph) (indiscernible) movement, other very nice features, so Omega is -- will do a very good result at margin." – Swatch 2004 Q4 Earnings Call Transcript

[2] "But I want to give you some more information here in the different segments, an indication. Where are our operating income percentages in the segments more or less? This will respond a little bit your second question of swatch. **So, if I look at the prestige and luxury segment of our group, that you can compare with Richmal (ph) [Quan added: Richemont?], that you can compare partially with FMAH (ph) [Quan added: LVMH?], we are between 20 and 30%, rather going to the 30%. If you look at the middle segment, you have around 20, 21, 22, 23%, so very nice margins also. If you go to the lower market segment -- and this is not very new -- the operating income percentages are, of course, less important but they are still close to 10%. They are below 10% but still between 5 and 10%**. So, we still have nice margins down there, of course not the same ones that in the high-end and prestige one, but this is a clear indication that swatch is performing, is bringing profits, but of course not at the same level than the (indiscernible), the Blancpain (ph) or an Omega." – Nick Hayek, Swatch's CEO, 2004 Q4 Earnings Call Transcript

[3] "NICK HAYEK JR [Swatch's CEO]: Yes, okay. In our own retail stores, **I get the sell out information day by day either on a piece of paper, either on an information system**. It depends on the brand because, as you know, Omega is organized differently than Breguet or Blancpain or Swatch, and they have different systems.

For the multibrand stores I get, for example, a daily paper that's filled out by hand because it's only about 14 shops, where I get every single sell out everyday with a potential discount, with the payment, and I get also how many people have been in the store and who was buying the product, what nationality. So this information is on a daily basis for our whole network.

LISA RACHAL: And your wholesale customers, do you have any information?

NICK HAYEK JR: And our wholesale customers, we have a very interesting system. **I don't get it from everybody because some of them are jealous to give us the database, but we have so called sales reductions.**

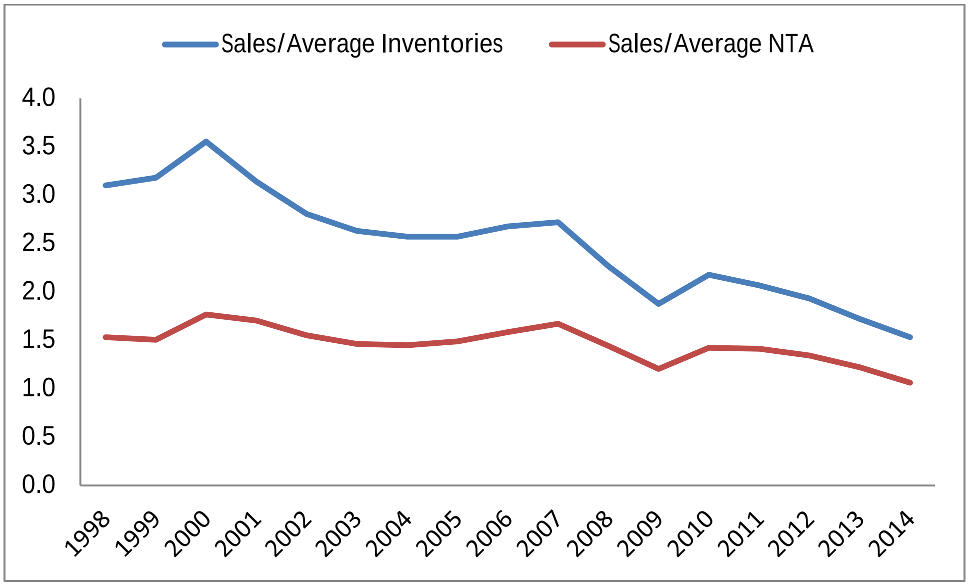
If you give us the sell through information, and you accept to make an automatic replenishment, means that we deliver automatically a product the moment it has been sold out so that you have a good assortment, you get 1% or 2% better conditions from us. And we have a range of countries and retailers that immediately bought into this program.

I can tell you Xinyu in China, he gives us all the sell out information and, by the way, since we are shareholders, [Quan added: Xinyu is the CEO of Hengdeli. Hengdeli is a retailer of luxury goods in China with 35% market share] I get also the sell out information from all our competitors, it's legitimate, we are a shareholder and we have a seat in the Board of Directors, and we get from some countries in Europe, United Kingdom for example, from the major retailers, I get sell out information. Not of all, because some of them are refusing to give us the information. They have not understood that it's good for them that we know what's happening so we could help them to have the right assortment. And that's one of the tendencies and of the push that we are doing to convince the retailer, give us the information, we accomplish work for the assortments, and you will do better businesses and we will do better businesses.

So we encourage this with a certain form of 1% or 2% additional margin if he is doing this with us. **And for the moment, I think about 20% to 30% of the wholesale retailers are doing this with us**. The others are still reluctant. They are old-fashioned. They say, you are not to look into my books." – Swatch 2008 Q2 Earnings Call Transcript

Capital Allocation

Vertical Integration Reduces Asset Turnover



Asset turnover has declined to 1.1 in 2014

- Share dilution from share-based compensation is about 0.5-1% annually
  - 2004: 1.15%
  - 2005: 1.09%
  - 2006: 1.03%
  - 2007: 0.98%
  - 2008: 0.93%
  - 2009: 0.85%
  - 2010: 0.76%
  - 2011: 0.68%
  - 2012: 0.59%
  - 2013: 0.50%
  - Bonus program
    - Bonus potential is defined at the beginning of the year
    - If objectives are surpassed
      - More than 100% of the potential bonus will be paid
    - Criteria include
      - Revenue growth
      - Evolution of EBIT
      - Changes in market shares

            - Evolution of inventories and receivables
            - Accomplishment of development projects
            - Success in negotiations
            - Successful implementation of cost reduction programs
            - Fluctuation of employees
            - Motivation of employees
- Swatch didn't actively acquire new brands
    - Acquired Harry Winston in 2013
        - Before Harry Winston, the last acquisition of a watch brand was made in 2000
            - Jacquet Droz
            - Glashutte
    - Swatch always wanted to acquire a jewelry brand[1]
        - A top jewelry brand can benefit Swatch's distribution strength
            - Both in traditional retailer channel
            - And in own retail stores
    - Swatch was very patient[2]
        - Wants to find the right target
        - Doesn't want to overpay
    - Swatch was very happy to get into the partnership with Tiffany[3]
        - 30 year contract
        - Full autonomy to develop the range of products
            - Especially in the range of the jewelry female products of competitors like Cartier or Bulgari
        - Swatch invests in
            - Collection
            - Distribution
            - Marketing
        - Swatch can open Tiffany watch store
            - With 30-40% jewelry inside delivered by Tiffany[4]
        - Had to pay $0
        - Planned to sell Tiffany watches at $3,500
    - Tiffany later didn't cooperate
        - Swatch said Tiffany neglected and blocked the development
        - Tiffany didn't even show the watches in its flagship store on Fifth Avenue
    - Swatch filed a lawsuit against Tiffany

- Tiffany had to pay CHF 402 million compensation to Swatch
    - In 2013
    - Swatch wrote down Tiffany products in 2012 and 2013
        - CHF 115 million in total
- Swatch acquired Harry Winston in 2013
    - Harry Winston is the number on diamond brand in the world
        - A long with Graff
    - Swatch paid $750 million in cash
        - Assume $250 million debt
    - Harry Winston's 2012 revenue was $412 million
        - 25% of revenue was from watches
    - Harry Winston's 2012 EBIT was $19 million
- Swatch expects Harry Winston to make CHF 1 billion revenue[5]
    - CHF 250 million EBIT
    - In 4-5 years
- Harry Winston is in jewelry what Breguet in watches[6]
- Swatch has a history of successfully reviving watch brands
    - Revived Omega and Longines
        - Both are among top 5 Swiss watch brand today (in sales)
    - Acquired
        - Blancpain in 1991
            - For CHF 30 million
        - Breguet in 1999
            - For CHF 65 million
            - Breguet made 3,000 watches a year in 1999
        - Today these two brands make about CHF 1.1 billion revenue
            - Close to 30% EBIT margin
            - Breguet makes about 30,000 watches a year
- Swatch is under-exposed to the US
    - Harry Winston can help Swatch increase presence in the US

- Swatch spent CHF 715 million in acquisitions and investment in associated companies and joint ventures
    - (Excluding Harry Winston)
    - These acquisitions were in
        - Production
            - Acquired watch component manufacturers

§ Distribution
· Notable investments are in Hengdeli and Rivoli
· Swatch effectively own 20% of Hengdeli
o Hengdeli is a retailer of watches in China
§ With about 35% market share
§ (according to HSBC research)
· Swatch owns 58% of Rivoli
o Rivoli has 360 retail stores in Middle East
o It's difficult to judge financial success of these investments
o These investments make great strategic sense
- Swatch increased its retail operation
o Retail operation account for 28% of revenue today
§ Richemont makes over 50% of sales from its retail operation
o Opening boutique stores is a trend in luxury goods
§ Help build brand image better
§ Get direct information from customers
· Avoid inventory risk
· Avoid discounts
§ Improve margins
- There's a long-term declining trend in inventory turnover
o Revenue/Average Inventories
§ 1998: 3.1
§ 2003: 2.6
§ 2008: 2.3
§ 2013: 1.7
§ 2014: 1.5
o Swatch's investor relation explained
§ Swatch increased retail operation
· 5% of revenue in 1998
· 28% of revenue today
§ Swatch is a producer of watch and jewelry
· Not just a trader
o (like brands that don't focus on production)
· Needs a strategic stock of products and components
§ Swatch acquired Harry Winston
· A solid part of stock is held in gold and diamonds
- Asset turnover declined as a result

- Sales/Average (Receivables + Inventories) declined
  - Quite stable from 1998 to 2007
    - Around 2x
  - Declined since 2007
    - 2007: 2
    - 2010: 1.7
    - 2014: 1.3
- Sales/Average NTA declined
  - 1998: 1.53
  - 2003: 1.46
  - 2008: 1.44
  - 2011: 1.41
  - 2012: 1.34
  - 2013: 1.22

- EBIT margin increased
- It's unclear how much of the increase in margin was due to retail operation
  - Retail operation can improve margin
    - Example:
    - Assuming Swatch sells a watch to retailer for $1,000
      - Make $200 EBIT
      - If Swatch sell the watch to end-customer
        - Assumes that retail price is $1,500
        - Assumes that retail EBIT margin is 10%
          - $150 EBIT
        - Swatch makes $350 total EBIT
          - 23% EBIT margin
  - If retail operation didn't help improve margin
    - Asset turnover declines
    - EBIT/NTA declines
      - Increased retail operation reduces profitability
- Retail operation doesn't seem to increase margin
  - When asked about this issue, Swatch said
    - It depends on the region
    - Retail operations in Asia are more profitable
    - The contribution to P&L is often overestimated
    - But the advertising effect shouldn't be underestimated
      - Create additional sales

- EBIT/NTA actually improved as a result
  - 1998: 21%
  - 2003: 23%
  - 2008: 31%
  - 2013: 28%
  - 2014: 21%
- Swatch is conservative with cash
  - Currently has about CHF 1.4 billion
  - Never had net debt
- Swatch increases dividends almost every year
- Swatch repurchased shares almost every year until 2010
- Swatch created value
  - From 2003 to 2013
    - Revenue compounded 8.2%
    - EBIT compounded 12.2%
    - Over the period
      - Total EBIT: CHF 12,657 million
      - Total cash return: CHF 3,545 million
      - => Swatch returned about 35% of after-tax earnings
    - 65% retained earnings resulted in 8-12% growth
      - Effective 12 – 18% return
  - From 1997 to 2013
    - Revenue compounded 6.8%
    - EBIT compounded 10.1%
    - Over the period
      - Total EBIT: CHF 16,212 million
      - Total cash return: CHF 4,989 million
      - => Swatch returned about 38.5% of after-tax earnings
    - 62.5% retained earnings resulted in 7-10% growth
      - Effective 11 – 16% return

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[1] "Mr. Catanio, because of the jewelry potential acquisition, I think it's not very new. We also said that if you look at our portfolio of high class brands of this company, **we could well imagine to add a very nice jewelry brand. And we can only talk about first class well-known brands or at least the (inaudible) well-known brands.**

It's not that we are going after that with 200 percent of energy. **Ninety-five percent of our energy is on the operational level of this company to grow and to create internal growth. But, of course, we are looking with the reminder of the five percent of our energy, what is out there in the market?** And if there is a nice looking and good possibility and opportunity, we will go after it.

I think, you know, most of the names have been - have been given. It's always the same. Some of them are not available. Other ones are excessive in price. So we need some time. We are not under pressure. We declare very often that our objective is long-term jewelry. We want to achieve at one moment perhaps 10 percent of the watches turnover with jewelry.

But we have given a very large horizon to this. And I cannot announce an imminent acquisition. But we never know. This crazy year 2003 has shown that things go very quickly, either up or own. And now again, we are in a very nice up trend.

Jewelry, of course, if we achieve to integrate a jewelry - an additional jewelry brand into this company, it will benefit from our distribution strengths in the market, as well as in our own retail, as well as in the normal traditional retail where we have a strong position where jewelry perhaps could find its way even if there are no watches included in that." – Nicholas Hayek, Swatch's former CEO, 2003 Q2 Earnings Call Transcript

[2] "As you see-we have really and that's how our dedication. **First, we make grow our brand worldwide and I tell you, we have a good and big growth potential, which is what we are doing**. **We are not desperately looking and running behind an acquisition**. But of course having the cash that we have, we look out if there is something that would fit, but we are not running just to fulfill the desire to add 19th or 20th one. **It must make sense, the price must be right and we evaluated very thoroughly and then lets see**. And if we cannot achieve it this year, OK, we will try to achieve it perhaps next year. **We are not under pressure, of course I would like and all around the table and you also, if there would be a wonderful brand out there.** That would just wait to be both from us but that's not happening, at the moment the situation is not easy, but we have other preoccupation. We are spending our time on our company and then lets see what's happening. We get so many nice inputs from all of you, anyway if there is an opportunity we will be informed from you first, we know that." – Nicholas Hayek, Swatch's former CEO, 2003 Q4 Earnings Call Transcript

[3] "You see, you have forgotten about Tiffany. Tiffany, we gave a very good example. **We spent not one single Swiss franc or dollar to make an acquisition of that brand name for watches. And what we can do is, we have a 30 years contract, we have full autonomy to develop the range of products that we want, especially also products that are in the range of the jewelry female products of some competitors, I always named them as Cartier and Bulgari, without spending one single penny in an acquisition. That's not necessary.**

So we spend the money in investing in the collection, in the distribution and in the marketing. So we have no need. And if I look at our portfolio, I think we have no need to invest the money in buying another brand. **But what we are doing is pushing Tiffany forward, pushing the other brands, pushing the industrial base which, unfortunately, another company like LVMH is not doing. They acquired a brand name, but they didn't acquire any production facilities. And that's where we are very strong.**

And then it's distribution. Why Swatch Group shows these results, despite a more difficult environment? Because **we have a distribution network that goes into the countries, to the shops, to the consumers. And our move with Xinyu in China very early on, and our move with Rivoli, is showing that you can have nice brands, but if you don't have a distribution, if you don't have a control over the distribution, how your product is presented to the final consumer, it's not very helpful.**

And that's why our strategy continues. We push our brands, we add one or the other one in a clever and intelligent way, as we have done with Tiffany. And, on the other hand, we continue to invest in the production capabilities, we invest in the distribution capabilities of this company, and we invest, of course, in the marketing of the company.

So no big merger and acquisition in view." – Nick Hayek, Swatch 2008 Q2 Earnings Call Transcript

[4] "**Now with Tiffany, we have also an agreement that we can open so called Tiffany watch stores with about 30% to 40% jewelry inside that will be delivered by Tiffany**. And this you will see also finally on our turnover in the Swatch Group. So this is an additional possibility to enter the jewelry market with

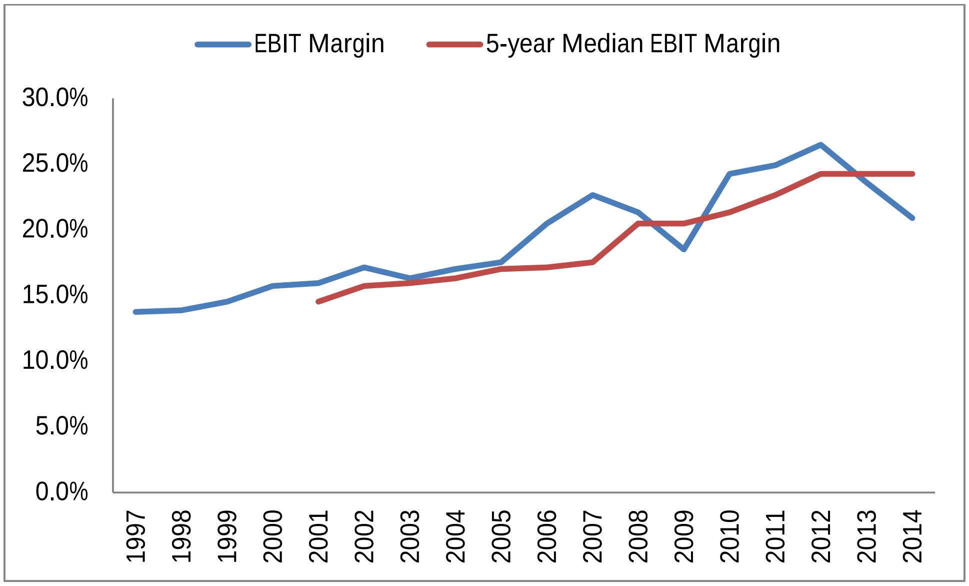
a very, very strong and professional partner." – Nick Hayek, Swatch 2008 Q2 Earnings Call Transcript

[5] "**For Swatch, the Harry Winston brand has the potential to generate more than 1 billion Swiss francs ($1.10 billion) in sales and CHF250 million net profit in about 4-5 years**, Reuters quoted Swatch chief executive Nick Hayek as saying." – *Swatch – Harry Winston Deal: A Win-Win Situation*, Pradip Kumar Saha, Livemint.com, 25 January 2013

[6] "**We bought Harry Winston as a brand. When my father bought Breguet, he did that because he had a vision of how to revive the brand. Harry Winston is in jewelry what Breguet is in watches.**" – *Swatch Sees Double-Digit China Growth for Mid-range*, Silke Koltrowitz, Thompson Reuters, 29 April, 2013

Value

Swatch Can Make 2,041 Million Swiss Francs in EBIT



5-year median EBIT has increased to 24.2% in 2014

- Key inputs
  - Bearer shares: 30.32 million
  - Registered shares: 120 million
  - Bearer-equivalent shares: **54.3 million**
  - 1 bearer share = 5x economic interest of a registered share
  - Register shares has higher voting power than bearer shares
  - Share price: **CHF 450 per share**
    - (it is CHF 428.4 per share on 18 February 2015)
  - Market Cap: 24,435 billion
  - Debt: CHF 111 million
  - Cash: CHF 1,465 million
  - **EV: CHF 23,081 million**
  - Historical effective tax rates was less than 20%
    - Let's assume 20% tax rate
- Earnings power is **CHF 2,041 million**
  - Swatch made **CHF 1,752 million** EBIT in 2014
  - Swatch made deliberate increase in marketing investment in growth market[1 2]
    - USA

        - Japan
        - Mainland China
    - The investment had over 3% impact on 2014's EBIT margin
    - Without the investment Swatch would've made **CHF 2,013 million** EBIT
    - Estimating normal margin is difficult
        - Margin is cyclical but increased overtime
            - 5-year median margin increased every year
        - Possible explanation
            - Marketing investment is lumpy
            - Margin increase as
                - More revenue comes from higher-end brands
                - Revenue of each brand grows
    - It's reasonable to use either
        - Peak EBIT margin
            - (if we believe in margin expansion overtime)
            - 26.5%
        - Last 5-year median EBIT margin
            - (if we believe margin will increase over each cycle)
            - 24.2%
    - Watch and jewelry revenue: CHF 8,435 million
    - Normal EBIT would be
        - Using peak EBIT margin: **CHF 2,235 million**
        - Using 5-year median EBIT margin: **CHF 2,041 million**
    - Using 5-year median EBIT margin is more conservative
        - Based on this approach, Swatch is trading at **11.3x EBIT**
- Swatch is about the middle of peer valuation
    - Cheaper than other luxury-related peers
        - LVMH
            - A direct competitor in the watch and jewelry business
                - Very small
            - LVMH makes more money from
                - Wine and spirit: 20% of profit
                - Fashion and Leather Goods: 56% of profit
                - Perfume and cosmetic: 7% of profit
                - Watch and jewelry: 5% of profit
                - Selective retailing: 15% of profit
                - Other activities and eliminations: -3% of profit

            - LVMH and Swatch can have strong customer overlap
            - **LVMH is trading at 15.1x EBIT**
                - Share price: EUR 158.75
                - Market cap: EUR 81 billion
                - EV: EUR 86 billion
                - EV/EBIT: 15.1
        - Richemont
            - A direct competitor in the watch and jewelry business
            - Richemont is the most comparable peer
                - Most of Richemont’s profit comes from
                    - Jewellery Maison: 72% of profit
                        - Mostly from Cartier
                    - Specialist Watchmakers: 30% of profit
                    - Others include Montblanc and eliminations
            - Richemont makes most profit from Cartier and watch brands that are higher than Cartier
            - Richemont focuses more on marketing
            - Swatch has a more balanced portfolio of brands
                - Has more exposure to growing middleclass around the world
            - **Richemont is trading at 17.4x EBIT**
                - Share price: CHF 83.15
                - Market cap: CHF 47 billion
                - EV: CHF 45 billion
                - EBIT: EUR 2.4 billion
                    - About CHF 2.6 billion
                    - (1 EUR = 1.0747 CHF)
                - EV/EBIT: 17.4
    - More expensive than other watch companies
        - Fossil
            - Focuses on watches between $85 and $600
            - Licensed brands include
                - Adidas
                - Armani Exchange
                - Burberry
                - Diesel
                - DKNY

        - Emporio Armani
        - Michael Kors
        - Etc.
    - License brands account for 50% of revenue
    - About 22% of revenue comes from Michasel Kors
    - Fossil's share price declined 16% on 18 Feb 2015
        - Missed earnings guidance
    - Fossil's current is above historical margin
        - Perhaps thanks to strong growth from Michael Kors
    - Fossil renewed the licensing agreement with Michael Kors
        - In November 2014
        - 1 year before the expiration of the existing agreement
        - Fossil possibly had to pay a higher licensing rate
    - **Fossil is trading at 8.3x EBIT**
        - Share price: $83.69
        - Market cap: $4.3 billion
        - EV: $4.6 billion
        - EBIT: $558 million
        - EV/EBIT: 8.3
- Movado
    - Movado revenue breakdown
        - Luxury brands: 7%
        - Accessible luxury brands: 34%
        - Licensed brands: 45%
        - Retail: 11%
    - Movado own luxury and accessibly luxury brands
        - Luxury
            - ($2,000 - $9,999)
            - Ebel
            - Concord
        - Accessible Luxury
            - ($500 - $2,499)
            - Movado
        - Watches of these brands are made in Swiss
    - Licensed brands include
        - Coach

            - Tommy Hilfiger
            - Hugo Boss
            - Juice Couture
            - Lacoste
            - Scuderia Ferrari
            - Watches of these brands are made in Asia
        - Movado's accessibly luxury brand have the same currency risk like Swatch
        - Movado's licensed business has risk of not owning the brand
        - **Movado is trading at 6.6x EBIT**
            - Share price: $24.08
            - Market cap: $606 million
            - EV: $448 billion
            - EBIT: $68 million
            - EV/EBIT: 6.6
    - Seiko
        - A Japanese competitor
        - 49% of revenue is from watch and clocks
        - 87% of profit is from watch and clocks
        - **Seiko is trading at 14.2x EBIT**
            - Share price: Yen 628
            - Market cap: Yen 130 billion
            - EV: Yen 220 billion
            - Expected 2014 EBIT: Yen 15.5 billion
            - EV/Expected 2014 EBIT: 14.2
    - Citizen
        - A Japanese competitor
        - 52% of revenue is from watch and clocks
        - About 70% of profit is from watch and movements
        - **Citizen is trading at 10.1x EBIT**
            - Share price: Yen 885
            - Market cap: Yen 287 billion
            - EV: Yen 279 billion
            - Expected 2014 EBIT: Yen 27.7 billion
            - EV/Expected 2014 EBIT: 10.1
- Private owner value

- LVMH paid about **3x sales** for Bulgari
  - In 2011
  - Paid by
    - EUR 1.9 billion euros in new LVMH shares
      - Issued 16.5 million LVMH shares
      - To exchange with the family holding in Bulgari
        - 50.4% of Bulgari
    - EUR 2.4 billion cash to buy out minority shareholders
  - About 28.2x EBITDA based on the stock part of the deal
  - About 25.8x EBITDA based on the cash part of the deal
  - About 3x sales[3]
    - In line with recent deals in the sector
  - The high price was due to
    - Cost savings
    - Other suitors
      - Richemont
      - PPR
- LVMH paid **2x sales** for Hublot
  - In 2008
  - The price was about
    - 2x 2007 revenue
    - 12x 2007 EBIT
  - Hublot price range: EUR 8,000 to EUR 300,000
  - Has 300 points of sales worldwide
    - EUR
  - LVMH
- Kering paid **13x EBITDA** for Ulysse Nardin
  - In July 2014
  - Ulysse sold about 27,000 pieces a year
    - CHF 250 million revenue

- Swatch's historical price was volatile
  - Beta: 1.3
  - From 2004 to 2014
    - Share price increased more than 23% from min to max price in any single year
    - EV/forward EBIT moved about 4.4 units in a single year
    - EV/last-year EBIT moved about 5 units in a single year

- Median Min EV/forward EBIT was 9.3x
- Median Max EV/forward EBIT was 14x
- Median Min EV/last-year EBIT was 11.5x
- Median Max EV/last-year EBIT was 15.3x
- Median Min EV/S: 2.1x
- Median Max EV/S: 3.3x

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[1] “In Watches & Jewelry, without Production, growth in gross sales of 5.6% and in net sales of 3.9% was generated, despite an ongoing long-term defensive price adjustment policy. In comparison, exports of wristwatches for the entire Swiss watch industry to the end of December 2014 increased by 1.7%, which in turn indicates a clear gain again in market share by the Swatch Group. **This underscores the long-term strategy followed by the Group, which is characterized by a defensive price adjustment policy and a high level of investment, in contrast to short-term profit thinking**. Therefore, all brands deliberately undertook more marketing investment, not only in the first half 2014 during the Olympic Winter Games in Sochi, but also in the second half of the year, by investing in the growth markets of the USA, Japan and Mainland China. In particular, Omega signed a renewal contract until 2022 for the US PGA Golf tour, and Longines massively increased its presence in equestrianism, mainly in Japan and the USA.” – *Swatch Group: Key Figures 2014*, Press Release, 05 February 2015

[2] “**In the second half of 2014, deliberate increase in marketing investments in growth markets USA, Japan and Mainland China, with an impact of over 3 percentage points on the operating margin.**” – *Swatch Group: Key Figures 2014*, Press Release, 05 February 2015

[3] “**Analysts said the high price was justified by the savings**.

"**The high price is probably explained by the fact that there were rival suitors**," said fund manager Gerard Moulin from Delubas Asset Management in Paris.

Rival bidders included the Richemont group and PPR (PRTP.PA), sources close to the groups told Reuters on Monday. Both groups declined to comment.
Any acquisition of family-controlled assets usually sees a buyer paying a sizeable premium to convince families to sell.

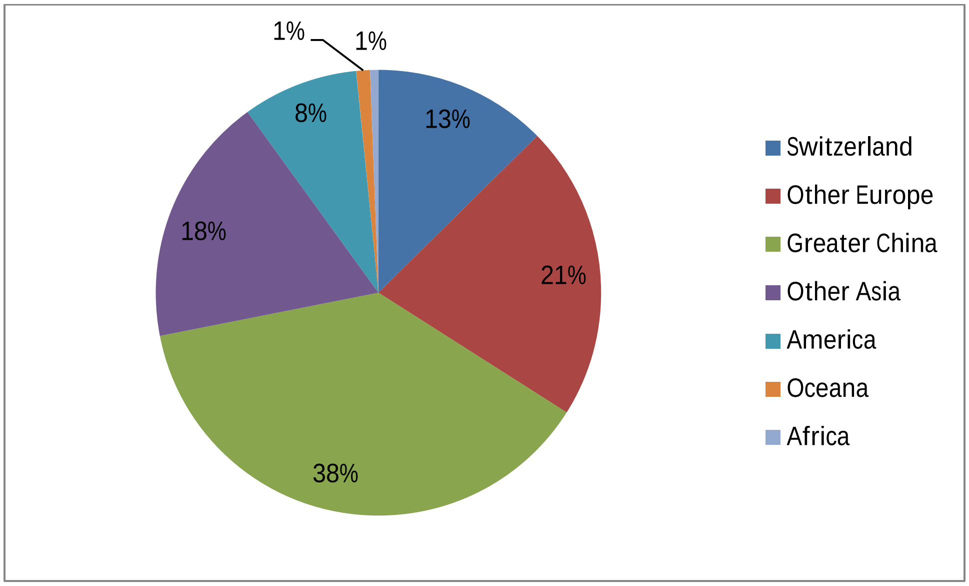
The deal valued Bulgari on a ratio of enterprise value to sales of about 3 times, compared with other potential takeover candidates Burberry

(BRBY.L) on 2.7 times and Tiffany (TIF.N) on 2.3 times, using forward sales estimates.

"This multiple is in line with historic deals in the sector and the recent acquisition of (online luxury fashion retailer) Net-a-porter by Richemont," **which was roughly 3 times enterprise value to sales**, Deutsche Bank said in a note." – *LVMH Bags Jeweller Bulgari in $5.2 Billion Deal*, Astrid Wendlandt, Thompson Reuters, 07 March 2011

Growth

Swatch Will Benefit from Growing Middle Class in Emerging Markets



56% of Swatch's revenue is generated in Asia

- The future is favorable for the Swiss watchmaking industry
  - The CHF 3,000+ watch segment enjoy great growth since 2000
    - Export Unit compounded 9% annually
      - 2000: 488 thousands
      - 2014: 1,642 thousands
    - (CHF) Export Revenue compounded 11%
      - 2000: CHF 3,153.2 million
      - 2014: CHF 13,828.6 million
    - ($) Export Revenue compounded 16%
      - 2000: $1,860 million
      - 2014: $ 14,906 million
  - Asia accounted for 70% of the rises in exports during the 2000-2012 period[1]
  - Industry growth in recent years slowed down due to corruption crackdown in China
    - Watch is one of the most appreciated gifts in China
      - According to Asia specialists at BoA Merrill Lynch:[2]
        - Gifts accounts for 30% of luxury product sales in China

                - 1/3 are destined for officials
        - Reforms was implemented in China around 2012 to reduce corruption
            - High-end watches suffered
        - (CHF) exports growth of the segment declined
            - 2013: 2.8%
            - 2014: 2.7%
            - (USD/CHF was stable in this period)
    - The China market has stabilized[3]
        - Swatch expects 7 – 9 % revenue growth in 2015 in local currency
        - LVHM's watch segment[4]
            - Lost 20% in the upper segment
                - In China
                - In 2014
            - Expect a bit up in 2015
    - Long-term prospect is determined by purchasing power
        - Chinese middle class will keep growing
        - There's huge potential in other emerging market[5]
            - Vietnam
            - India
            - Russia
            - Ukraine
            - Malaysia
            - South Korea
            - Mexico
        - Luxury watches have limited footprint other emerging markets[6]
            - Russia
            - India
            - Latin America
            - And Africa
            - Reasons
                - Affordability
                    - High tariffs
                    - High taxes on luxury goods
                - Culture of consuming luxury goods
                - Poor retail infrastructure

            - The taste for Western status symbols in emerging markets is high[7]
    - The demand for Swiss watches grows faster than per Capita GDP
        - (Credit Suisse found that the average elasticity of Swiss watch exports in relation to per capita GDP growth from 2000 to 2012 is bigger than 1 in most countries observed)
    - Future growth shouldn't be faster than in the past in any specific market
        - (not talking about new market)
    - Emerging market account for more share of the industry today
        - Asia accounts for 53% of exports
            - Source: Federation of the Swiss Watch Industry
        - The actually number is more
            - A lot of purchases in Europe are made by tourists
    - China and emerging market are still growing over 5% in GDP
    - **The CHF 3,000+ segment should be able to grow at 4-6%**
- Swatch can grow more than 5%
    - Omega
        - Omega currently sells about 800,000 watches a year
        - Nicholas Hayek said in interview with Harvard Business Review
            - (In 1993)
            - Rolex sells 600,000 watches a year
            - That's about as many as you can sell before a luxury brand begins to dilute[8]
        - The world population was about 5.5 billion in 1993
            - China and many Asian countries weren't significant for the luxury watch business
        - The world population is about 7 billion
            - China is the main market
            - Emerging markets are becoming important
        - Omega can sell 1.4-1.6 million unit without brand dilution
        - Omega will continue moving upmarket to compete with Rolex
            - Rolex's average price is about 40% lower than Rolex
                - Watch-Insider estimated
                    - Omega average (wholesale) price : CHF 3,000
                    - Rolex average (wholesale) price : CHF 5,000
            - Anecdotes show that Omega is about 40% cheaper than Rolex

        - Omega used to sell watches in the CHF 1,000-2,500 range[9]
        - Omega has gradually increased average price
            - Introduce new products
            - Use more precious materials
            - Stop selling cheaper products
        - This long process also helped raise brand perception
            - In China, Omega is the number 1 brand
    - These two brands have the same potential
        - Omega used to be more prestigious than Rolex
        - Omega and Rolex are always seen as the alternative of each other
    - Omega has been aggressive recently
        - Introduced watches with liquidmetal materials
            - Omega has an exclusive right to use the material
        - Adopt a new certification
        - Omega will abandon COSC chronometer certificate
            - (currently most brands use COSC)
            - Rolex is COSC's biggest customer
        - COSC Chronometer certification is about accuracy and performance
            - Accurate within -4 to +6 seconds a day
        - Omega will start working with METAS
            - The Swiss Federal Institute of Metrology
            - Supply its Master Co-Axial with a very stringent and comprehensive certification
                - Accurate within 0 and +5 seconds per day
                - Power reserve and water resistance of the watches will be tested
                - Test the anti-magnetic properties of the movement
                    - Uses a massive magnet that
                        - weights 1,500 kilos or 3,300 pounds
        - Magnetic fields are a great problem for mechanical watches

                - Cellphones or tablets can disturb the watch's performance
            - Omega's Master Co-Axial watches solve the problem
            - The new certification help differentiate Omega
                - (and raise average price)
        - Omega can raise average price a lot
            - 67% to be equal to Rolex's average price
        - **Omega can easily double revenue**
            - If this happens in 10 years, annual growth will be 7.2%
- Longines
    - Mr. Nick Hayek said Longines has two main competitors
        - TAG Heuer
            - In the same segment
            - TAG Heuer currently sells more expensive watches
                - TAG is more focused on racing
                - TAG's product lines are related to motor sports
                    - Grand Carrera
                    - Carrera
                    - Monaco
                    - Aquaracer
                    - Link
                    - Formula 1
        - Cartier
            - Both have fancy designs
            - Longines's motto: Elegance is an attitude
    - TAG Heuer is at a disadvantage
        - Swatch reduced movement supply
        - Hairsping will be the bottleneck
            - Swatch supplies 90% of hairspring in the market
    - Longines can sell more expensive watches if Omega moves upmarket
        - Longines has great horological pedigree
        - Longines is below Omega because Swatch puts more marketing behind Omega
        - Longines's strategy wasn't moving upmarket[10]

            - But Longines can introduce more expensive lines if Omega moves upmarket
        - Longines had double digit growth in each of the last 5 years
        - Longines's annual growth was 15% between 2007 and 2013
            - 2007: CHF 600 million
            - 2013: CHF 1,400 million
        - Longines didn't benefit from Chinese corruption
            - They don't buy Longines watches as bribe
        - Longines can grow better than local GDP growth
    - **Omega and Longines will grow over 5%**
        - The fat will get fatter in this segment
            - (watches between $1,000 - $10,000)
    - Tissot and middle brands
        - Faces a lot of competition
            - Seiko
            - Citizen
            - Fashion brands
                - Michael Kors
                - Hugo Boss
                - Fossil
                - Etc.
        - The Swiss watch industry performed quite well in this segment
        - Watches from CHF 200 to CHF 500
            - Unit:
                - 2000: 3,144 thousand
                - 2014: 4,997 thousand
                - Annual growth: 3.4%
            - (CHF) Revenue
                - 2000: CHF 1,035.8 million
                - 2014: CHF 1,559 million
                - Annual growth: 3%
            - ($) Revenue
                - 2000: $611 million
                - 2014: $1,680 million
                - Annual growth: 7.5%
        - Watches from CHF 500 to CHF 3,000
            - Unit

    - 2000: 3,229 thousands
    - 2014: 3,745 thousands
    - Annual growth: 1.1%
  - (CHF) Revenue
    - 2000: CHF 3,856.2 million
    - 2014: 4,342.4 million
    - Annual growth: 0.9%
  - ($) Revenue
    - 2000: $2,274 million
    - 2014: $4,281 million
    - Annual growth: 4.6%
- CHF appreciation hurt growth of the CHF 200-500 segment
- It's hard to read data about the CHF 500-CHF 3,000 segment
  - Omega left this segment during this period
  - TAG Heuer's prices went up a bit over this segment
  - A lot of other brands went up market when costs increased
- Tissot has been growing similarly to Longines
  - (Tissot compete in the CHF 300-1,000 range)
  - Tissot had double digit growth in each of the last 5 years
  - Tissot's annual growth was 12% between 2007 and 2013
    - 2007: CHF 600 million
    - 2013: (about) CHF 1,200 million
  - Tissot is the top choice for entry-level Swiss watches
    - Over 62.5% market share in this segment
- Tissot's past growth came from market share gain
  - Tissot volume far exceed Swiss watch volume growth in its price range
- **Big questions**:
  - Will Tissot's growth limited by the low industry growth?
  - Will Tissot drive industry growth?
- Rational expectation: the same rate as local GDP growth
  - The Swiss watch industry can have 3% volume growth in the CHF 300 – CHF 1,000 segment
    - Smaller growth in mature market
    - Bigger growth in emerging market
  - (CHF) revenue growth will match volume growth

        - CHF is about 80% overvalued based on purchasing power parity
        - CHF appreciation shouldn't be bigger than (local inflation – Switzerland's inflation)
      - Tissot (and other Swatch's brands) will gain market
        - Volume growth starts from **high single digit**
          - **Approaches 3%** in the long run
- Breguet, Blancpain, and Jaquet Droz
  - (over $15,000 per watch)
  - All these brands have lower volume than Patek Philippe
    - Patek: about 55,000
    - Breguet: about 30,000
    - Blancpain: about 20,000
    - Jaquet Droz: about 5,000
  - But many other brands have lower volume than Patek Philippe
  - It's unclear how customers choose a brand in this segment
  - No reason to expect grow faster than industry
    - **4-6% growth**
- Harry Winston: huge potential
  - Harry Winston's 2012 revenue was $412 million
    - 25% of revenue was from watches
  - Harry Winston's 2012 EBIT was $19 million
  - Swatch expects Harry Winston to make CHF 1 billion revenue[11]
    - CHF 250 million EBIT
    - In 4-5 years
  - Harry Winston is in jewelry what Breguet in watches [12]
  - Swatch has a history of successfully reviving watch brands
    - Revived Omega and Longines
      - Both are among top 5 Swiss watch brand today
        - (in revenue)
    - Acquired
      - Blancpain in 1991
        - For CHF 30 million
      - Breguet in 1999
        - For CHF 65 million
        - Breguet made 3,000 watches a year in 1999

            - Today these two brands make about CHF 1.1 billion revenue
                - Close to 30% EBIT margin
                - Breguet makes about 30,000 watches a year
        - Harry Winston's reputation is among the top
        - Cartier is much bigger
            - Accounts for most of Richemont's Jewellery Maisons segment (including watches)
                - Revenue: EUR5.4 billion
                - EBIT: EUR 1.9 billion
        - Harry Winston watches average $18,000 per watches
            - Harry Winston watch revenue will never reach Cartier's level
- Swatch can easily achieve 5-7% long-term revenue growth
- **Profit will grow faster than the 5-7% range**
    - There will be more margin expansion
        - More retail
        - More revenue from higher price brands

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[1] "In particular, the Swiss watch industry owes its success to its foresight in actively targeting growth in the emerging markets. By far the biggest contribution to the growth of Swiss watch exports over the past decade has come from Asia. **In overall terms, the Asian countries were responsible for around 70% of the rise in exports during the 2000-2012 period**. Of these, Hong Kong and China provided the biggest fillip to growth. Around 28% of total watch exports went to these two countries in 2012; this compares with a figure of only 14% in 2000." – *Swiss Watch Industry Prospects and Challenges*, Credit Suisse, October 2013

[2] "**Luxury watches soon established themselves as a favored gift for government officials and party functionaries in China. Gifts are estimated to account for around 30% of luxury product sales in China, one third of which are destined for officials.**" – *Swiss Watch Industry Prospects and Challenges*, Credit Suisse, October 2013

[4] "Every market that goes up needs to consolidate," Biver [head of LVMH's watch unit] said at his home near Montreux. "**We probably lost 20 percent in the upper segment, but now that has been absorbed. In 2015, we are not going to lose 20 percent. I believe 2015 could be stable, and eventually a little bit up in the luxury segment.**" – *Chinese Market to Stabilize in 2015, LVMH's Watch Chief Says*, Corinne Gretler, Bloomberg, 20 January 2015

[5] "**According to our model, emerging markets such as Vietnam, India, Russia, the Ukraine, Malaysia, South Korea and Mexico will gain the most in significance for the Swiss watch industry over the next five years. Some Latin American countries, such as Brazil, Columbia and Argentina, as well as South Africa, Turkey and Thailand, should also rise in the export rankings**. Some of the above-mentioned countries are already relatively well established export markets for the Swiss watch industry: South Korea, Russia and Mexico featured among the 15 main export markets in 2012 (Figure 13). **However, most other emerging economies represent minor markets with low penetration, but great potential for the Swiss watch industry. One reason for this is the high import duties and (luxury) taxes which some countries impose on watches**. If trade barriers and other hindrances to market entry were to be eliminated, the Swiss watch industry could tap great potential in these markets too. This explains why the sector is so interested in concluding further free trade agreements. Switzerland has had a free trade agreement with the Ukraine since June 2012, and similar negotiations with Russia, India, Vietnam, Thailand, Malaysia and Indonesia are under way. At the beginning of August 2013, the Swiss-Russian bilateral agreement on the mutual recognition of hallmarks for watches made of precious metals entered into force, which should make it easier to export Swiss luxury watches into Russia. On the other hand, Switzerland has yet to enter into official negotiations for free trade agreements with Brazil and Argentina." – *Swiss Watch Industry Prospects and Challenges*, Credit Suisse, October 2013

[6] "What is interesting though is that for luxury, China is by far the most important driver. **Unlike fast moving consumer goods companies (say beverages for instance), luxury goods have a limited footprint in Russia, India, Latam and Africa for reasons that are either economic (affordability), cultural and/or linked to a poor retail infrastructure**." – *Consumer Brands & Retail Global Luxury Goods – Equity October 2011*, HSBC Global Research

[7] "While the outlook for the Swiss watch industry is largely positive, certain challenges will remain throughout the coming years. One of these is competition not only from foreign watchmakers, but from other forms of luxury goods. Is there a danger that watches – like other status symbols in the past – will fall out of fashion? The risk seems negligible: the watch's function as a timepiece is less relevant in the era of mobile phones and computers. For the owner, it is more of a social signal, communicating the wearer's external values such as status or personality. **The taste for Western status symbols in the emerging markets is likely to remain high, and in contrast to other luxury goods, such as automobiles or artwork, a watch can be worn and displayed at all times. Moreover, a watch is the only universally accepted piece of jewelry for**

men." – *Swiss Watch Industry Prospects and Challenges*, Credit Suisse, October 2013

[8] "Second, and much worse, Omega became greedy. **Rolex sells 600,000 watches per year. That's about as many as you can sell before a luxury brand begins to lose its prestige. That's about how many Omega was selling in the late 1970s**. But Omega wanted to grow more rapidly. So they took the easy route. They figured, "If we can sell 600,000, why not a million? Or 2 million? Or 3 million?"

Which meant, of course, they had to lower the price radically. A jeweler would say, "Omega is wonderful, but it is too expensive for my clients. How about giving me an Omega that is cheaper?" Now, if you are crazy, or I guess if you are greedy, you agree.

That was the kiss of death. Omega was everywhere: high price, medium price, precious metals, cheap gold plating. There were 2,000 different models! No one knew what Omega stood for. By the end of 1980, the company was again in a deep crisis, its deepest ever." – Swatch's former CEO Nicolas Hayek said in *Message and Muscle: An Interview with Swatch Titan Nicolas Hayek*, William Taylor, Harvard Business Review, March 1993 Issue

[9] "Contrary to what is happening at many other brands, this rise in strength is not occurring due to a rise in market position. It is partially being made possible, however, by Omega's move up-market. "**Omega is gradually leaving the range of products priced between CHF 1,000 and 2,500. This offers Longines the opportunity to expand into this space**," explained Nick Hayek Jr. And how better to fill this space than with sports watches?" – After 175 Years, A Rise in Strength Without Moving Up-Market, Pierre Maillard, Europa Star WorldWatchWeb, 18 January 2008

[10] "Longines has not the same strategy. Longines is about two times, two and a half times, the average price lower than Omega. It's -- I would say, at Tagheuer's level. Tagheuer is between Tissot and Longines. And they are going more in direction Tissot than Longines recently. Opening more point of sales, lowering the prices.

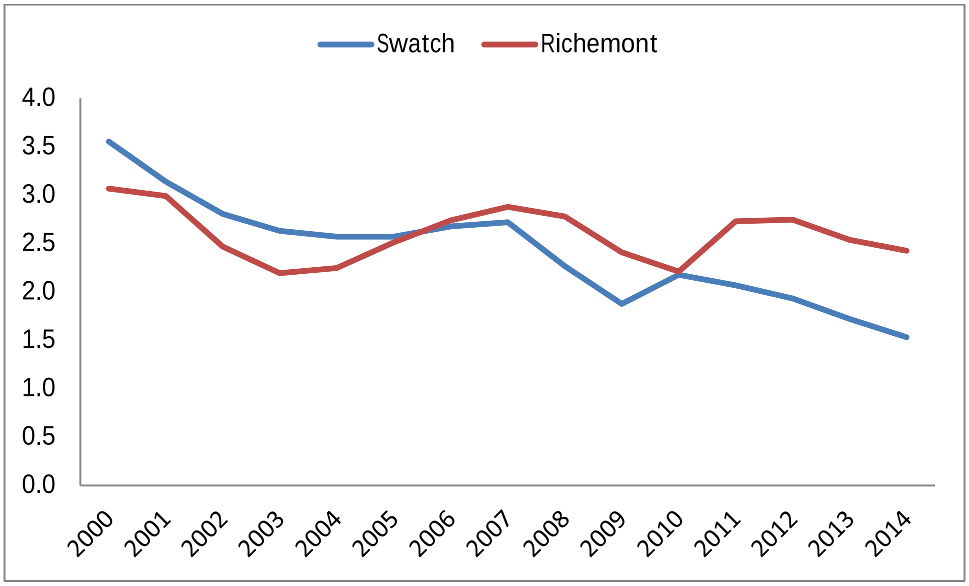
So, Longines is behaving good. But they've made more investment and the Master collection has not been launched massively yet. It's always being launched in the second half of the year. Still -- we still wait to launch the Master collection in big numbers. We have been waiting and we will do the big impact in the second half of the year. **So, with Longines you don't have the same strategy. We're not reducing point of sale by [sale] to increase the average price. The average price will be increased by the Master collection, but it's not the same strategy as Omega. It's a much broader distribution and it's more in the direction of -- we have a bit higher position than Tagheuer.**" – Nicolas Hayek, Swatch's former CEO, Swatch 2005 Q2 Earnings Transcript

[11] "**For Swatch, the Harry Winston brand has the potential to generate more than 1 billion Swiss francs ($1.10 billion) in sales and CHF250 million net profit in about 4-5 years**, Reuters quoted Swatch chief executive Nick Hayek as saying." – *Swatch – Harry Winston Deal: A Win-Win Situation*, Pradip Kumar Saha, Livemint.com, 25 January 2013

[12] "**We bought Harry Winston as a brand. When my father bought Breguet, he did that because he had a vision of how to revive the brand. Harry Winston is in jewelry what Breguet is in watches.**" – *Swatch Sees Double-Digit China Growth for Mid-range*, Silke Koltrowitz, Thompson Reuters, 29 April, 2013

Misjudgment

What Does Declining Inventory Turnover Imply?



Swatch's inventory turnover declined more than Richemont

- What's China's GDP growth?
    - China is growing at 7-8%
    - It can be bad for Swatch if China runs into a recession like Japan
- We don't know how customers choose a brand
    - Luxury evolution has 5 stages
        - Subjugation
        - Start of money
        - Show off
        - Fit in
        - Way of life
    - China is in the show-off stage
    - Customers may not choose a brand because of its marketing message
        - Example:
            - Rolex or Omega are for people who succeed in their field
    - It's unclear how customers choose a brand
    - It can be difficult to know whether a brand will grow
    - It's easier to know which group will gain market share
- Foreign exchange rates add some uncertainty
    - Short-term

- Swiss National Bank recently removed the cap on EUR/CHF
  - On January 15, 2015
  - Allows EUR/CHF to fall below 1.2
- EUR/CHF fell quickly to 0.85
- Current exchange rate (on 18 February 2015)
  - 1 CNY = 0.1505 CHF
  - 1 EUR = 1.0749 CHF
  - 1 HKD = 0.1214 CHF
  - 100 JPY = 0.7938 CHF
  - 1 USD = 0.9414 CHF
- Compared to the average FX rate in 2013, CHF appreciated
  - -1% against CNY, HKD, and USD
  - 15% against EUR
  - 20% against JPY
- Swatch and other brands plan to raise price by 5-7% in Europe
- Swatch has small exposure to Europe
  - 21.4% of revenue from to other European countries
  - About 50% of sales in Europe is from tourists
  - If tourists come from the US or China, there's no impact
    - CHF didn't appreciate against their currency
  - The actual exposure is about 11.2%
- Swatch also has some exposure to Japan
- Deutsche bank analysts estimate that
  - 15% of revenue is in CHF
  - 50% of personnel expenses is in CHF
  - 40% of material purchases is in CHF
  - 20% of other operating expenses is in CHF
- That means about 1/3 of revenue is in CHF
- A more conservative estimate is assuming 50% of cost is in CHF
  - Swatch has over 20% EBIT margin
  - So less than 40% of revenue is in CHF
- 15% appreciation against EUR results less than 6% rise in EUR-translated costs
  - 5-7% price increase can be enough to protect profit
    - (assuming no decline in volume)

            - But translating into CHF, profit and sales will decline by about 10%
                - 1.1% negative impact on the whole group
                - (The exposure to Europe is about 11.2%)
    - Long-term
        - CHF is about 80% overvalued based on purchasing power parity
        - Delta = Local inflation – Switzerland's inflation
        - If Delta = CHF appreciation
            - There's no currency impact on the business
            - CHF remains overvalued based on PPP
        - If Delta > CHF appreciation
            - Swiss watches become affordable to local population
            - CHF becomes less overvalued based on PPP
        - If Delta < CHF appreciation
            - Swiss watches become less affordable to local population
            - CHF becomes more overvalued based on PPP
        - The chance is higher that Delta will be >= CHF appreciation
- Earnings power is uncertain
    - Different brands have different margin profile
    - Swatch may be investing for future
        - Swatch made deliberate increase in marketing investment in growth market[1] [2]
            - USA
            - Japan
            - Mainland China
        - The investment had over 3% impact on 2014's EBIT margin
    - Margin increased overtime
        - 1997: 14%
        - 2002: 16%
        - 2007: 22%
        - 2012: 25%
        - 2013: 23%
        - 2014: 20%
    - It's hard to know what the normal margin is
- Inventory turnover declined
    - Revenue/Average Inventories
        - 1998: 3.1

        - 2003: 2.6
        - 2008: 2.3
        - 2013: 1.7
        - 2014: 1.5
    - Swatch's investor relation explained
        - Swatch increased retail operation
            - 5% of revenue in 1998
            - 28% of revenue today
        - Swatch is a producer of watch and jewelry
            - Not just a trader
                - (like brands that don't focus on production)
            - Needs a strategic stock of products and components
        - Swatch acquired Harry Winston
            - A solid part of stock is held in gold and diamonds
    - They believe investment in inventories was better than other options
    - When asked about lower inventory turnover than Richemont, they pointed to the difference in
        - The risk and independency factor
        - Group structure
        - Brand portfolio
    - They see inventories as the driver for future revenue
- The management seems to focus on long-term results
    - This is a family business
        - The Hayek Pool and its related companies, institutions and individuals hold about 41% of Swatch
    - Mr. Hayek spends little time for financial market
        - Abandoned his one and only investor road show after only 2 day
            - Over a decade ago
            - Met with a California pension fund manager
                - Didn't know what brands Swatch owned
    - They believe in vertical integration
        - Keep talking about auto industry
            - The British wants to make high-end cars
                - End up with
                    - Jaguar
                    - Aston Martin
                - Hard to make money

                · The German focuses on volume
                    - Succeed in both mass market and luxury market
    - They created great shareholder value overtime
- It's impossible to know whether Swatch has problem with nepotism
    - Nicolas Hayek founded Swatch
    - His son is the current CEO
        - Nick Hayek
        - Since 2003
    - His daughter is the current Chairwoman
        - Nayla Hayek
        - Became Chairwoman in 2010
            - After her father's death
    - His grandson is the CEO of Blancpain, Breguet, and Jaquet Droz
        - Marc Hayek
            - (son of Nayla Hayek)
        - He took over Blancpain since 2001
    - They all managed the company very well

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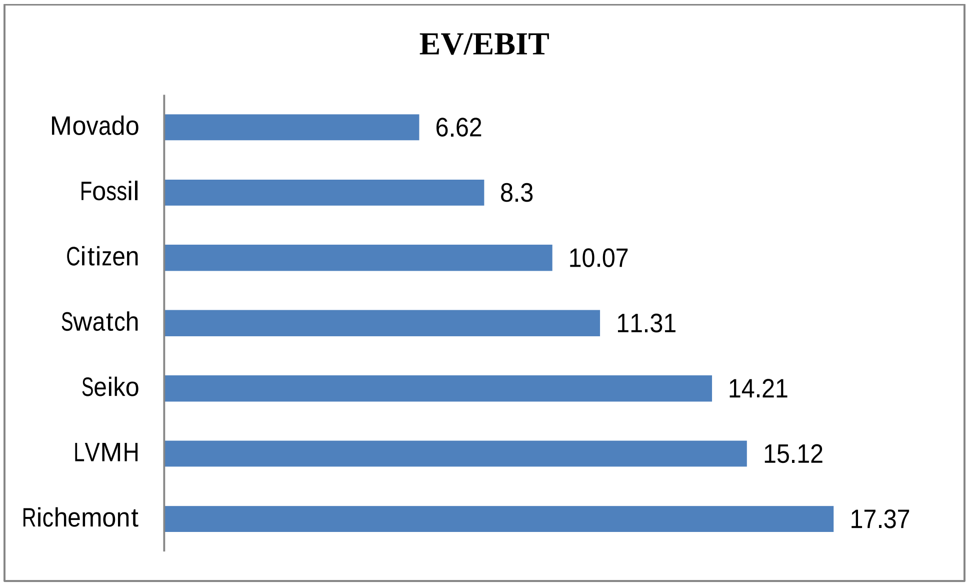
[1] "In Watches & Jewelry, without Production, growth in gross sales of 5.6% and in net sales of 3.9% was generated, despite an ongoing long-term defensive price adjustment policy. In comparison, exports of wristwatches for the entire Swiss watch industry to the end of December 2014 increased by 1.7%, which in turn indicates a clear gain again in market share by the Swatch Group. **This underscores the long-term strategy followed by the Group, which is characterized by a defensive price adjustment policy and a high level of investment, in contrast to short-term profit thinking**. Therefore, all brands deliberately undertook more marketing investment, not only in the first half 2014 during the Olympic Winter Games in Sochi, but also in the second half of the year, by investing in the growth markets of the USA, Japan and Mainland China. In particular, Omega signed a renewal contract until 2022 for the US PGA Golf tour, and Longines massively increased its presence in equestrianism, mainly in Japan and the USA." – *Swatch Group: Key Figures 2014*, Press Release, 05 February 2015

[2] "**In the second half of 2014, deliberate increase in marketing investments in growth markets USA, Japan and Mainland China, with an impact of over 3 percentage points on the operating margin.**" – *Swatch Group: Key Figures 2014*, Press Release, 05 February 2015

Conclusions

Swatch Offers More Margin of Safety than Richemont



Swatch is about 35% cheaper than Richemont

- Swatch has some similarity to Ekornes
    - Both Swiss Franc and Norwegian Krone are overvalued
        - Based on purchasing power parity
    - Both sell luxury products
    - Both businesses have little change
- Swatch has wider moat than Ekornes
    - Swatch has stronger relative power than Ekornes in
        - Production
        - Distribution
    - Ekornes relies on a single brand
        - Focuses on a niche in a big market
        - Depends on production capability
    - Swatch has a portfolio of brands
        - Swatch's brands are more popular than Stressless
- Swatch is the best stock to buy based on
    - Moat
    - Durability
- It's easier to predict Ekornes' future growth than Swatch
    - Stressless penetration is low in most market

    - Stressless can attract people everywhere
    - Swatch has great exposure to China
        - A recession in China will impair a lot of Swatch's intrinsic value
- Swatch's intrinsic value depends on macroeconomic factor
    - China growth
        - And other emerging markets
    - Swiss franc
- The chance is higher than 50% that
    - China will have over 5% GDP growth
    - Swiss franc's won't appreciate more than the gap between local inflation and Switzerland's inflation
    - In this case, Swatch can grow profit over 5-7%
    - In that case, Swatch deserve over 20x after-tax earnings
        - Or over 16x pre-tax normal EBIT
- The chance is lower than 50% that China will run into a recession
    - In this case, Swatch will have a huge problem
        - The business may decline
        - Chinese Yuan can decline
            - Like what happened recently with Japanese Yen or Euro
    - What's the margin of safety in this case?
        - Swatch can still grow in other emerging markets
        - 10-year average EBIT is 1,375 million Swiss Francs
        - At 450 Swiss Francs per share, the price is 16.8x 10-year average EBIT
            - Equivalent to 21x after-tax earnings
                - Almost 5% yield
                - Not terribly bad in such environment
                    - Low-yield in most countries
        - Richemont's investors will lose a lot more money than Swatch's shareholders
            - Swatch is cheaper than Richemont based on current prices
            - Swatch has many affordable brands
- Swatch is a far above average business
    - Deserves at least 12x pre-tax normal EBIT

Financial Positions

- Absolute debt level from year to year
    - No debt
    - Almost CHF 1.4 billion net cash
- Relative leverage to peers?
    - Richemont uses some debt
- Is management aggressive or conservative?
    - Conservative
- Has the company ever paid down debt?
    - No debt
- Does it constantly grow debt?
    - No debt
- Are they willing to stay the same size ever?
    - Possibly
    - They weren't active in acquiring new brands
    - They focused on vertical integration
        - Production
        - Distribution

Management

- CEO tenure
  - Nick Hayek is the son of Nicolas Hayek
  - He became the CEO of Swatch in 2003
  - He achieved great success
    - Omega, Longines, Tissot became billionaire brands
  - Omega successfully raise its brand perception
    - And continue moving upmarket
  - Longines and Tissot dominate its segment
  - Breguet became a top luxury brand
    - Along with Patek Philippe
  - Swatch increased retail operation
    - Effectively owns 20% of Hengdeli
      - A retailer with about 35% market share in China
    - Owns 58% of Rivoli
      - Rivoli has 360 retail stores in Middle East
  - Retail revenue as % of total revenue increased
    - 1998: 5%
    - 2014: 28%
  - From 2003 to 2014
    - Revenue grew 7.7% annually
    - EBIT grew 10% annually
    - While returning about 35% of earnings to shareholders
- Share ownership
  - The Hayek Pool and its related companies, institutions and individuals hold about 41% of Swatch
- Incentive compensation?
  - Bonus potential is defined at the beginning of the year
  - If objectives are surpassed
    - More than 100% of the potential bonus will be paid
  - Criteria include
    - Revenue growth
    - Evolution of EBIT
    - Changes in market shares
    - Evolution of inventories and receivables
    - Accomplishment of development projects
    - Success in negotiations

            - Successful implementation of cost reduction programs
            - Fluctuation of employees
            - Motivation of employees
- Candor?
    - Candid about mistake?
        - Not sure
    - Vague or clear about problems?
        - Not sure
    - But he isn't promotional
    - He spends little time for financial market
        - Abandoned his one and only investor road show after only 2 day
            - Over a decade ago
            - Met with a California pension fund manager
                - Didn't know what brands Swatch owned
    - He isn't afraid to say some advices are short-sighted
- Overoptimistic?
    - Realistic about goals?
    - No sign of being overoptimistic
    - He would say "Omega can double revenue"
        - But he never gives a timeline