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IDEA

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Swatch and Richemont | Europe

DTC and the Bullwhip Effect

A bumpy transition ahead for Swiss watch industry.

Supply chain inefficiencies have led to a significant inventory build up across the industry, and this is particularly true for key player Swatch. This is mostly a function of a distribution channel phenomenon - known as the bullwhip effect - where demand levels are distorted along the supply chain. A structural change in the industry distribution channel (move to direct to consumer, or DTC) is magnifying this cyclical phenomenon (which is a function of recovery in industry sales, up until recently). This has led to disappointing cashflow generation and return on capital employed (particularly for Swatch), while the market expects most other luxury goods groups to post record levels of profitability this year. Of note, the Swatch group barely depreciates its inventory: applying Richemont's inventory write down policy to Swatch would lead a c.20% lower EPS for 2017 (all else being equal).

Going forward, the listed players are facing a difficult strategic dilemma... The transition to DTC will be disruptive and game changing. While we expect it to be highly beneficial to the watch brands in the long term, in the short to medium term (3 to 5 years), it could be highly disruptive. It will also present the watch brands with a dilemma: to either buy out the inventory of the third party retailers (thus leading to further pressure on cashflow and ROIC) or allow this inventory be sold at a discount on third party online platforms (thus potentially damaging brand equity long term, and sales short term). We estimate that there is about €16bn of watch inventory among third party retailers worldwide today.

...at a time when industry sales are under pressure due to both cyclical and structural factors. From a cyclical standpoint, watch sales are being impacted by a significant slowdown in sell out in Greater China since the summer (with HK sales declining) and, to a lesser extent, by weakness with European consumers. From a structural standpoint, we have become incrementally more bearish throughout the year on the impact of smartwatches (e.g. Apple) will have on the Swiss watch industry (evidenced by volume contraction in the below CHF 3,000 category, a significant challenge for vertically integrated Swatch).

Downgrading Swatch to Underweight and Richemont to Equal-weight. The share prices of both Swatch and Richemont have been under significant pressure in the latter half of 2018, reflecting some of the concerns highlighted above, we think. However, we believe that the market is still underestimating the short to medium-term pressure on sales and margins (our Swatch 2019e EPS is 18% below consensus) as well as the impact of adverse WC on valuation (our DCF derived PT moves from CHF 375 to 250). Regarding Richemont, we think a number of initiatives are moving right direction (e.g. repositioning of Cartier) and are convinced its jewellery sales should grow materially in the long term. However, the combination of adverse macro and DTC transition related turbulence lead us to move to the sidelines for now.

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Brands

Europe
IndustryView **In-Line**

What's Changed	FROM	TO
Richemont SA (CFR.S)		
Rating	Overweight	**Equal-weight**
Price Target	83.00	**73.00**
Richemont (CFRJ.J)		
Rating	Overweight	**Equal-weight**
Price Target	13707.00	**10620**
Swatch (UHR.S)		
Rating	Equal-weight	**Underweight**
Price Target	375.00	**250**

We would like to thank Oliver Müller, founder of Swiss watch industry consultancy firm LuxeConsult, for his contribution to our understanding of the bullwhip effect on the Swiss watch supply chain. Having worked for 21 years in the watch industry, he started applying the bullwhip effect model to explain issues in supply chain management (SCM). Mr Müller is not a member of Morgan Stanley's Research Department

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Executive Summary

We are downgrading Swatch to Underweight and Richemont to Equal-weight due to a combination of factors: 1) inventory management challenges at Swatch in the past few semesters, likely a symptom of inefficiencies in the supply chain; 2) more difficult than anticipated transition from wholesale to direct to consumer (DTC); 3) increased evidence that smartwatches are impacting the below CHF 3,000 segment (wholesale value), which is 80% of Swatch Group sales; 4) weaker end demand YTD and a more cautious outlook, particularly when it comes to Chinese nationals.

Our previous thesis was built on the margin benefits of the Swiss watch industry undergoing a transformational channel shift from wholesale to retail. While our view of the long-term benefits of this shift remains unchanged, we now think that it will be a highly disruptive process in the short to mid term (3-5 years). We expect the shift to present the watch brands with a dilemma: to either buy out inventory of third party retailers (thus leading to pressure on cash flows and ROIC) or allow the inventory to be sold at discount on third party online platforms (thus potentially damaging brand equity long term and sales short term).

Supply chain inefficiencies have led to a significant inventory build up across the industry, and this is particularly true for key player, Swatch. This is mostly a function of a distribution channel phenomenon - known as the bullwhip effect - where forecasts produce supply chain inefficiencies. It refers to increasing swings in inventory in response to shifts in customer demand as one moves further up the supply chain. This phenomenon is cyclical in nature and partially explains the relatively wide swings in profitability of a number of players of the Swiss watch industry (other factors include the discretionary nature of spending on Swiss watches and/or the relatively high price points of the product). While the EBIT margin for one of the industry leaders in leather goods - Vuitton - has never been below 40% in over twenty years, one of the Swiss watch industry leaders - Swatch Group - has seen its EBIT margin range between 10% and 27% over the past twenty years, a much higher margin swing. Even though Swiss watch sales have recovered in 2017 and 2018 YTD (exports up +2.7% and +7.5% respectively in value terms) post the anti-corruption measures by the Chinese government, there has still been an inventory build up at Swatch (to CHF 6.7bn as of June 2018), rather than an inventory decline despite increasing sales (up +12.6% YoY at constant FX in 1H18).

What is different this time is that structural trends such as DTC are amplifying the phenomenon... The first of these trends is the change in the distribution channel, away from wholesale to direct to consumer (DTC). We expect this shift to be disruptive and game changing. We believe that 2018 marked a pivotal year in this respect: a number of watch brands (Audemars Piguet, Bulgari, etc.) have announced significant online investments, third party retailers are increasingly under pressure and grey market platforms are flourishing, potentially damaging the brand equity of a number of brands such as Omega, Breguet, Cartier or Jaeger-LeCoultre (as new watches are sold at a

discount).

…and the acceleration of the smartwatch impact. The first Apple smartwatch was launched in September 2014. In 2018, based on MS estimates, Apple will be selling 22.5m Apple Watch units worldwide and is expected to sell 30m units in 2019, as per MS analyst Katy Huberty. And Apple is not the only smart watch brand (Samsung, Fossil etc… have also launched smartwatches). To put things in perspective, total number of Swiss watches sold in 2018 should amount to around 24m (mechanical and quartz movements combined). Swiss watch exports for the price segment below the CHF 500 level has, over the past two decades, performed broadly in line with total Swiss watch exports when measured by value according to FHS. However, what we find worrisome is that a slight divergence has kicked in since last year, with the spread having widened further so far in 2018 (See Exhibit 22).

So inventories are at record high at a time when industry sales are now under pressure due to both the structural factors mentioned above, as well as cyclical ones. From a cyclical standpoint, watch sales are being impacted by a significant slowdown in sell out in Greater China since the summer (with HK sales actually declining) and, to a lesser extent, by weakness with European consumers.

Going forward, the listed players are facing a very difficult strategic dilemma when it comes to DTC. The transition to DTC will be disruptive and game changing. While we expect it to be highly beneficial to the watch brands in the long term, in the short to medium term (3 to 5 years), it will be highly disruptive. It will present the watch brands with a dilemma: to either buy out of the inventory of third party retailers (thus leading to further pressure on cashflow and ROIC) or let this inventory be sold at discount on third party online platforms (thus damaging their brand equity long term, and their sales short term). We estimate that there is about €16bn of watch inventory among third party retailers worldwide today.

Downgrading Swatch to Underweight and Richemont to Equal-weight. The share prices of both Swatch and Richemont have been under significant pressure YTD, reflecting some of the concerns highlighted above, we think. However, we believe that the market is still underestimating the pressure on sales and margins in the short to medium term (our 2019e EPS is 18% below consensus) as well as the impact of adverse WC on valuation (our DCF derived PT moves from CHF 375 to 250, implying 12% downside potential). Regarding Richemont, we think a number of initiatives are moving in the right direction (e.g. repositioning of Cartier) and are convinced its jewellery sales should grow materially in the long term. However, the combination of adverse macro and DTC transition related turbulence lead us to move to the sidelines for now. We lower our PT from CHF 83 to 73. The table below recaps our changes and how we compare to consensus for both Swatch Group and Richemont.

Risks. There could be significant upside risk to our price target on Swatch Group. These include: a) the group dramatically improving the efficiency of its supply chain; b) industry sales re accelerating, led by a pick up in demand from Chinese nationals (over 50% of Swatch sales and profit in 2018e) as government measures are expected to positively affect sales; c) Swatch Group announcing a significant buy back program: assuming that the Group would use 50% of its c.CHF 1.4bn net cash pile to buy back its outstanding shares, this would lead to a c.4% EPS accretion on 2019 estimates); d) the Swatch Group

could look to capture part of the third party retailers' existing mark up; e) FX swing could have a material impact on Swatch Group's profitability given the fact that the group is vertically integrated and manufactures the vast majority of its products in Switzerland, while the majority of sales are made to Chinese nationals (evolution of the Swiss Franc vs. the Chinese Renminbi is therefore a key driver of profitability).

Exhibit 1: Swatch: Current estimates vs. previous, consensus and implied multiples

MS est. (CHFm)	Dec-18e	Dec-19e	Dec-20e
Net Sales	**8,693**	**8,751**	**9,071**
% change	+9.2%	+0.7%	+3.7%
EBIT	**1,259**	**1,204**	**1,283**
margin	14.5%	13.8%	14.1%
% change	+25.6%	-4.3%	+6.6%
EPS (CHF)	**18.07**	**17.28**	**18.54**
% change	+30.6%	-4.4%	+7.3%
vs. Consensus	**Dec-18e**	**Dec-19e**	**Dec-20e**
Net Sales	-0.0%	-3.5%	-5.0%
EBIT	-4.9%	-17.2%	-20.9%
EPS	-3.3%	-17.8%	-22.2%
vs. last estimates	**Dec-18e**	**Dec-19e**	**Dec-20e**
Net Sales	-1.3%	-2.9%	-2.7%
EBIT	-6.5%	-20.1%	-20.2%
EPS	-6.7%	-20.4%	-20.4%
Implied multiples at spot	**Dec-18e**	**Dec-19e**	**Dec-20e**
PE	16.6x	17.4x	16.2x
EV/EBITDA	8.5x	8.7x	8.3x
EV/Sales	1.7x	1.7x	1.7x
Implied multiples at PT	**Dec-18e**	**Dec-19e**	**Dec-20e**
PE	13.8x	14.5x	13.5x
EV/EBITDA	6.9x	7.1x	6.7x
EV/Sales	1.4x	1.4x	1.4x

Source: Morgan Stanley Research estimates, Consensus from Thomson.

Exhibit 2: Richemont: Current estimates vs. previous, consensus and implied multiples

MS est. (EURm)	Mar-19e	Mar-20e	Mar-21e
Net Sales	13,967	14,796	15,456
% change	+27.2%	+5.9%	+4.5%
Adj. EBIT	2,369	2,468	2,592
Margin	17.0%	16.7%	16.8%
% change	+15.4%	+4.2%	+5.1%
EPS (EUR)	3.23	3.37	3.44
% change	+33.2%	+4.1%	+2.0%
vs. Consensus	**Mar-19e**	**Mar-20e**	**Mar-21e**
Net Sales	-0.2%	-1.8%	-4.0%
Adj. EBIT	+7.2%	-3.2%	-7.3%
EPS	+5.2%	-1.5%	-10.5%
vs. last estimates	**Mar-19e**	**Mar-20e**	**Mar-21e**
Net Sales	-1.6%	-3.2%	-3.4%
Adj. EBIT	-2.9%	-7.8%	-8.5%
EPS	-2.5%	-8.8%	-9.7%
Implied multiples at spot	**Mar-19e**	**Mar-20e**	**Mar-21e**
PE	17.8x	17.1x	16.8x
EV/EBITDA	9.1x	8.8x	8.4x
EV/Sales	2.0x	1.9x	1.8x
Implied multiples at PT	**Mar-19e**	**Mar-20e**	**Mar-21e**
PE	20.0x	19.2x	18.8x
EV/EBITDA	10.4x	10.0x	9.5x
EV/Sales	2.3x	2.1x	2.1x

Source: Morgan Stanley Research estimates, Consensus from Thomson. ~~Note: MS estimates for EBIT are underlying hence higher than consensus for FY19e at EBIT and EPS levels.~~

Exhibit 3: Luxury & Brands: Valuation multiples based on MS estimates and spot share price

Company	Y/E	Currency	Rating	Price Target	Price	YTD perf	EV/EBITDA (x)			P/E (x)		
							2018e	2019e	2020e	2018e	2019e	2020e
Luxury/Brands												
Brunello Cucinelli*	Dec	EUR	NA	NA	28.75	6.4%	20.6	18.6	16.6	38.9	34.8	32.5
Burberry	Mar	GBp	E	1,850.00	1,766.50	(1.4%)	10.5	10.1	9.2	21.3	20.2	18.4
Hermes	Dec	EUR	E	490.00	481.30	8.8%	21.0	19.1	17.6	37.1	34.3	30.9
Hugo Boss	Dec	EUR	U	51.50	57.30	(19.2%)	8.2	7.7	7.4	16.2	15.0	14.6
Kering	Dec	EUR	E	440.00	409.70	12.2%	12.3	10.6	10.0	18.6	15.9	15.0
LVMH	Dec	EUR	O	315.00	254.35	3.6%	11.3	10.2	9.6	19.6	18.1	16.8
Michael Kors	Mar	USD	E	69.00	38.83	(38.3%)	5.7	5.6	NA	7.6	7.4	NA
Moncler	Dec	EUR	O	32.50	28.46	9.1%	13.7	12.0	10.8	23.7	20.5	18.7
Pandora	Dec	DKK	E	370.00	296.00	(56.2%)	5.0	5.0	5.1	6.4	6.2	6.1
Prada	Dec	HKD	E	27.00	26.20	(7.4%)	12.1	10.4	9.4	27.7	22.3	19.6
Ralph Lauren*	Mar	USD	NA	NA	108.14	4.3%	7.9	7.6	7.1	16.4	14.9	13.6
Richemont	Mar	CHF	E	73.00	65.08	(26.3%)	9.3	8.7	8.3	19.0	17.3	16.9
Salvatore Ferragamo	Dec	EUR	U	16.50	18.24	(17.7%)	13.6	13.3	11.6	30.2	29.4	24.5
Swatch	Dec	CHF	U	250.00	300.10	(24.5%)	6.9	7.1	6.7	16.6	17.4	16.2
Tapestry	Jun	USD	E	44.00	32.47	(18.5%)	8.4	7.8	7.3	13.4	12.6	11.9
Tiffany	Jan	USD	E	96.00	85.94	(17.3%)	10.1	9.9	9.3	18.2	18.0	16.9
Tod's	Dec	EUR	U	37.00	39.72	(34.8%)	10.2	9.9	9.5	26.2	26.3	23.0
Luxury average						**(0.2%)**	**12.7**	**11.5**	**10.7**	**22.4**	**20.5**	**19.0**
Global average						**(0.0%)**	**11.4**	**10.4**	**8.8**	**21.5**	**19.7**	**15.6**

Source: Morgan Stanley Research estimates. Consensus & Pricing data (as on date indicated) from Thomson Reuters.
Note Financials calendarised to December YE hence Richemont metrics do not match with Exhibit 2 above as its fiscal year ends in March. European and Global averages weighted for market cap. * Indicates data based on consensus estimates (Source: Thomson Reuters). Rating legend: O=Overweight, E=Equal-weight, U=Underweight

The bullwhip effect

The bullwhip effect is constitutive of the Swiss watch industry, given the specific nature of its value chain. As such, poor inventory management in an up cycle is not particularly new. However, the magnitude of the inventory build up at Swatch Group has been greater than expected, despite the tools the group now has at its disposal (e.g. real time sell out data at third party retailers) to better manage its supply chain. As a result, Swatch should post a return on capital employed for 2018e that is in line with its WACC, on our estimates. This may disappoint the market given that Swatch is a market leader (30% market share) in an oligopolistic industry with high barriers to entry, in a year where the market expects the Luxury Goods industry worldwide to post record profit. Going forward, the Group inventory position is now at an all time high, at a time when industry sales are softening (particulary Swatch's core range) and when the shift to direct to consumer might force the Swatch Group to buy back part of the third party retailers' excess inventory.

How has the bullwhip effect led to a build up of inventory at the brands level?

What is the bullwhip effect? As laid out by an article from MIT Sloan Management review, the bullwhip effect is a phenomenon, in which distorted information from one end of a supply chain to the other can lead to inefficiencies. Affected areas include excessive inventory investment, misguided capacity plans and ineffective transportation, amongst others. Specifically, the article refers to a case in which the end demand from consumers is at a steady rate, but that the demand order variabilities in the supply chain are amplified as they moved up the supply chain. Effectively, this impact depicts the movement of a bullwhip, with the amplitude of a whip increasing down its length, and hence the name.

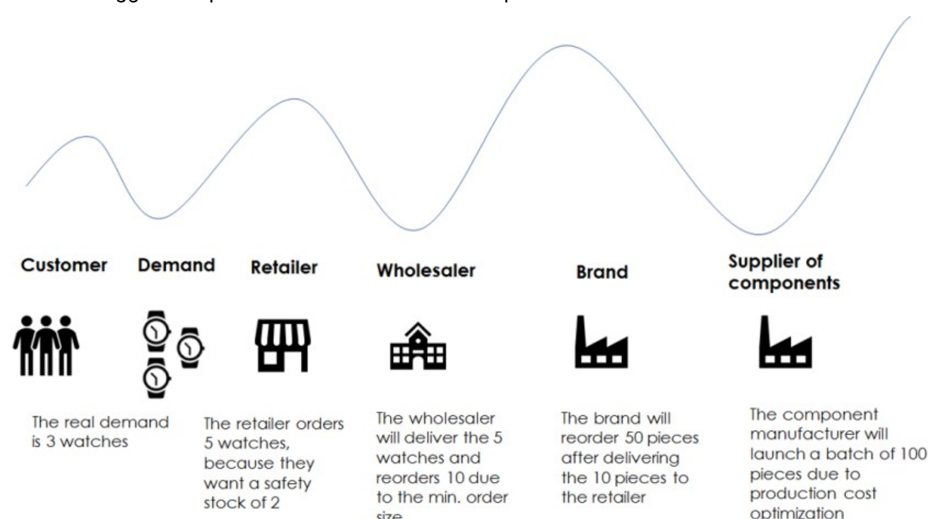
Why does it matter in the watchmaking industry? Given the high fragmentation of the industry in the value chain upstream (hundreds of independent suppliers of cases, dials, etc.) and downstream (close to 90% Swiss watches are sold at wholesale, via several hundred retailers with store networks ranging from one point of sale to several dozens), this often leads to an insufficient transmission of information in the supply chain and therefore, inefficiencies. While other industries are also impacted by the bullwhip effects - such as car making - these effects are generally better managed (e.g. the car industry working with a 'just in time' delivery system with their OEMs.

An illustrative example of the multiplier effect. In the theoretical example below, a client orders three watches at a retail store. The retailer then orders five watches from the wholesaler, because they want a safety stock of two watches. The wholesaler will deliver the five watches and reorders ten due to the minimum order size. The watch brand will reorder 50 pieces after delivering the 10 pieces to the retailer. At the end of

the supply chain, the component manufacturer will launch a batch of 100 pieces to optimise production costs. All in all, because of lack of visibility regarding real end demand, the need to have buffer inventory and because of production cost optimisation, the end market demand of only three watches potentially triggers a production batch of 100 pieces.

As mentioned, this is a theoretical example and we are aware that the large watch companies (such as Swatch and Richemont) now own the vast majority of the local country wholesalers they transact with, as well as some of the retail stores. However, this does not always mean that inefficiencies in the supply chain are completely resolved, as we discuss below.

Exhibit 4: The bullwhip effect in the Swiss watch industry: the end customer demand of three watches triggers the production batch of a hundred pieces



Source: LuxeConsult

What are the main reasons for the bullwhip effect in the watchmaking industry? We believe there are three main reasons: 1) the data is not transparent; 2) the data is not precise enough; 3) the data is not synchronised along the value and supply chain, i.e. there is no connection between real demand (from individual customers around the world) and the production.

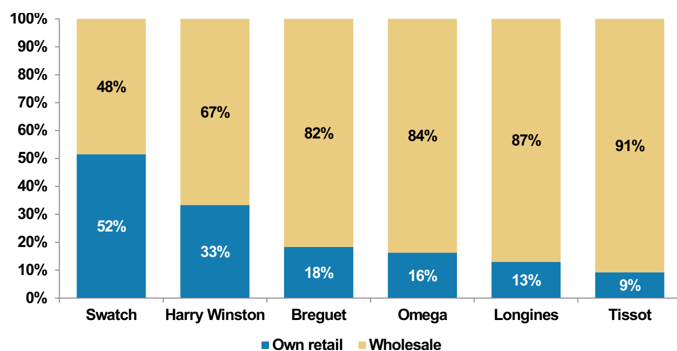
There is little information available to Swiss watch industry participants regarding the global market: a) export figures published by the FHS (Federation Horlogere Suisse). FHS data itself is based on the Swiss customer export statistics; b) in Hong Kong - the world's largest Swiss watch market - some of the market participants are publicly listed (Emperor, Oriental and Hengdeli) and therefore publish their sales figures; c) in Japan, department stores sales are published.

The figures published by the FHS are based on sell-in and this can lead to distortions in the interpretation of the 'real' sales, depending on the percentage of retail integration. Below, we show the estimated percentage of sales generated by brand at retail and at wholesale. For example, we estimate that 30% of the Omega division's sales are generated at retail. Applying a multiplier of 2.0x (an average level of mark-up from wholesale to retail in the watch industry, as per our estimates), this implies that only 15% of all the Omega watches sold (in value terms) are sold in Omega's directly

operated stores and 85% by third party stores.

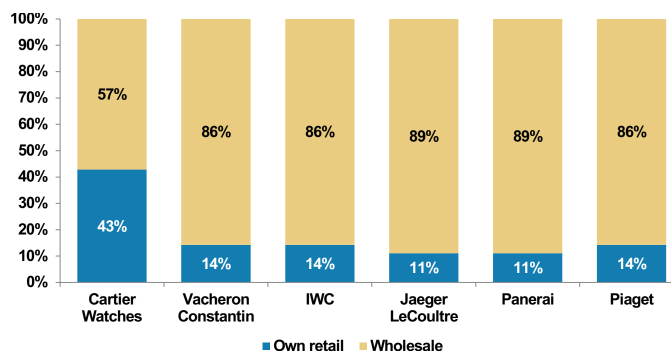
Over the years, Swatch Group and Richemont have increasingly been in a position to access real-time sell out data from third party retailers. However, we believe that the data is not fully synchronised along the supply chain (see below), particularly in the case of Swatch.

Exhibit 5: Swatch Group: Estimated sales by channel by brands



Source: Morgan Stanley Research estimates

Exhibit 6: Richemont Group: Estimated sales by channel by brands



Source: Morgan Stanley Research estimates

Inaccurate assumptions by watch brands leads to inaccurate supply levels. A common and misleading belief in the luxury industry is that an overstock is cheaper than a stock-out due to the high margins. The thought is that, with markups of 5-8x the cost of goods sold, you can easily 'stock up'. In a worst case scenario, the brand discounts the product or depreciates its inventory. This belief leads not only to overstocking (increase in capital employed) but also to the wrong inventory being in the wrong place in the value chain at the wrong time. This is because the watch brand will sometimes try to push excess inventory down the supply chain, for example by bundling its best-selling watch models with models that have a lower turnover for its wholesale partners.

In practice, the supply chain is not connected in terms of information transmission: there is limited visibility for each link in the chain. The information given by one link in the chain to its next partner is often delayed and sometimes skewed by the expectations that the partners have of each other. For example, if the retailer expects a brand to miss its deliveries, the retailer would order a higher quantity than needed to ensure that there is a buffer. If the information given to the next partner in the value chain doesn't reflect real demand in time and quantity, the aggregated distortion will worsen going up the value chain. The aggravation factors are the following: a) the information systems are not connected: very often the sales reporting softwares does not interact directly with the ERP/MRP (enterprise and material resource planning); b) the batch sizes can substantially differ from the sales quantities. This is especially a problem at phase-in and phase-out of a specific SKU; c) the manufacturing processes are not yet industrialized.

Phase-in / launch of new products. Should a product prove successful and the brand has underestimated the quantities needed and would like to readjust the quantities ordered quickly, manufacturing processes are unfortunately not adapted for quick replenishment. Should a product *not* be successful by the time the brand has started delivering to the third party retailers, its production pipeline is full. By the time the sales department notify the production department what the sell-out quantities are,

inventory is sometimes already at one year of sales. The brand has to decide to either scrap the components or depreciate the work in progress.

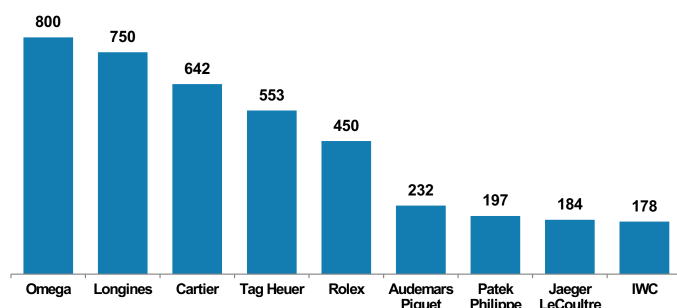
Phase-out: the planned phase-out has to be accelerated, because your competitor has launched a new product in its own product segment.

Focus of the range is key. The more focussed the brand's core range (i.e. the ongoing product collection on which the band communicates) is, the lower the risk of obsolescence due to fashion changes or new technologies. A mono product brand such as Rolex or Audemars Piguet has an easier task than Omega or Cartier with their multiple product families.

For example, based on data available on the various websites in Europe, we estimate that Omega carries a product range of 800 SKUs and Longines 750. As a comparison, Rolex carries 450 SKUs and Patek 197 (the total number for Omega and Longines is actually 1,600 and 1,540, however these two brands sell a number of models online which are already in phase out as these models are still sold by third party retailers. Most of Omega and Longines' competitors immediately stop advertising models that are no longer being produced).

Looking at it relative to the estimated total number of units sold by brand and/or the sales per brand, the number of unit sold per SKU was two times higher at Rolex than at Omega (and over three times higher when looking at sales per SKU). Longines also has a broad product range.

Exhibit 7: Estimated number of SKU by brand



Source: Morgan Stanley Research estimates

Exhibit 8: Sales and units per SKU

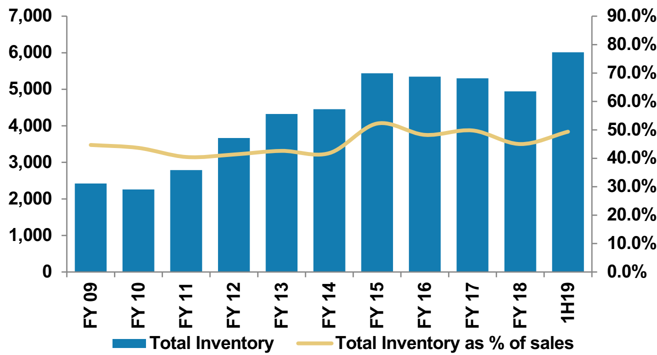
Brands	SKUs	Units sold (2017)	Units sold per SKU	Sales per brand (CHF m)	Sales per SKU (CHF 000s)
Omega	800	730,000	913	2,270	2,838
Longines	750	1,900,000	2,533	1,470	1,960
Cartier Watches	642	472,500	736	1,670	2,601
Tag Heuer	553	680,000	1,230	830	1,501
Rolex	450	770,000	1,711	3,900	8,667
Audemars Piguet	232	42,000	181	930	4,009
Patek Philippe	197	56,000	284	1,265	6,421
Jaeger LeCoultre	184	110,000	598	600	3,261
IWC	178	190,000	1,067	845	4,747

Source: Morgan Stanley Research estimates

Swatch and Richemont's inventory in an historical context

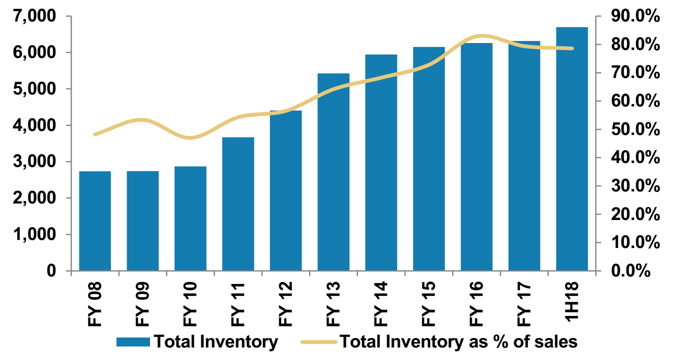
Over the past decade, the inventory levels at both Swatch and Richemont have seen a material increase in absolute terms. On a relative basis, we note though that the pace of increase at Richemont has been broadly in line with its sales growth, as the inventory as % of sales ratio has remained largely stable around 50% over the past decade. On the other hand, Swatch has also seen a material increase on a relative basis, as its inventory as % of sales has increased from around 50% in 2008-09 to 80% as of June 2018 (see exhibit below).

Exhibit 9: Richemont inventory evolution as % of sales



Source: Company disclosures
Note: Fiscal year ending as of March

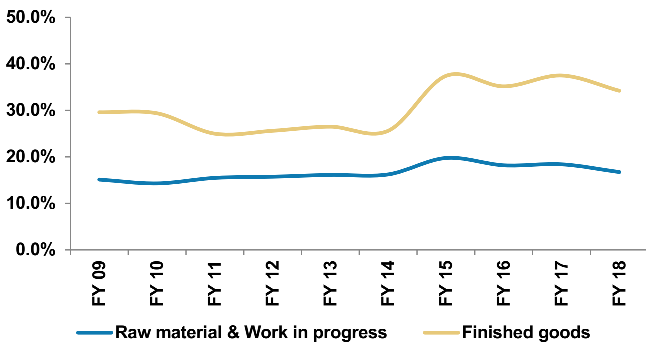
Exhibit 10: Swatch inventory evolution as % of sales



Source: Company disclosures
Note: Fiscal year ending as of December

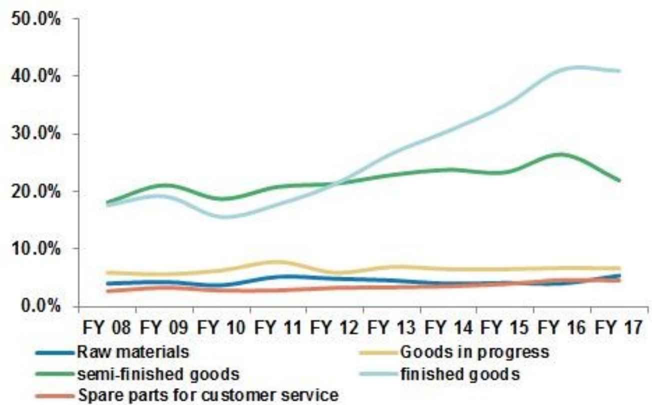
When breaking down the inventory as % of sales by segment, we note that finished goods has been the most important driver of inventory growth at both Swatch and Richemont over the past decade. At Richemont, raw materials and work in progress has remained broadly stable at around 15% of sales, while finished goods have increased from 25-30% to 35% of sales as of FY18. At Swatch, the change has been even more noteworthy, as finished goods as % of sales have increased from 15-20% to 40% as of FY17, while all other segments have remained broadly stable over the past decade.

Exhibit 11: Richemont inventory as % of sales by segment



Source: Company disclosures
Note: Fiscal year ending as of March

Exhibit 12: Swatch inventory as % of sales by segment

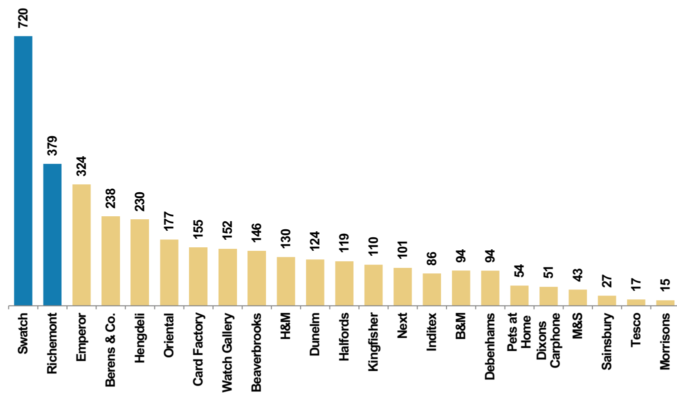


Source: Company disclosures
Note: Fiscal year ending as of December

As can be seen below, Swatch Group currently carries much more inventory than other watch or generalist retailers. As of December 2017, its inventory days of finished goods stood at 720 days. vs 379 for Richemont, 324 for Emperor Watches, 230 for Hengdeli or 177 for Oriental.

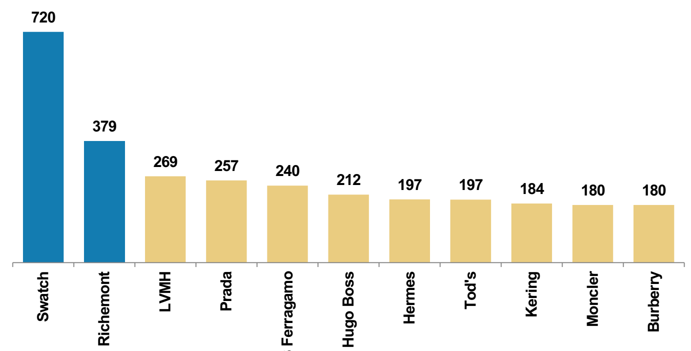
When contrasting Swatch vs. other luxury groups, its inventory position is also much higher: LVMH stood at 269 days (due to the significant impact of Cognac on total inventory), Kering at 184 and Burberry at 180 days.

Exhibit 13: Swatch and Richemont inventory days vs. other retailers in 2017



Source: Company data
Note: Swatch and Richemont inventory days based on finished goods only. Total inventory days are 1,396 and 471 days respectively for latest fiscal reported

Exhibit 14: Swatch and Richemont inventory days vs. other luxury goods groups in 2017

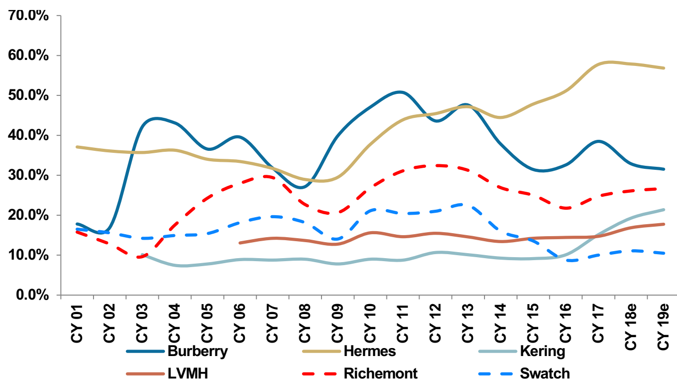


Source: Company data
Note: Swatch and Richemont inventory days based on finished goods only. Total inventory days are 1,396 and 471 days respectively for latest fiscal reported

As can be seen in the chart below, Swatch's pre-tax ROIC has been declining over the past 18 years and should be near an all time low in 2018. In 2018e, we expect EBITDA / Gross capital employed to reach 11.1%. This compares to 22.5% at the peak (in 2013). When looking at EBITDAR / (Gross capital employed + capitalized leases - intangible assets - goodwill), we estimate the pre-tax ROIC in 2018e at 11.7%. This compares to a peak of 20.8% in 2010.

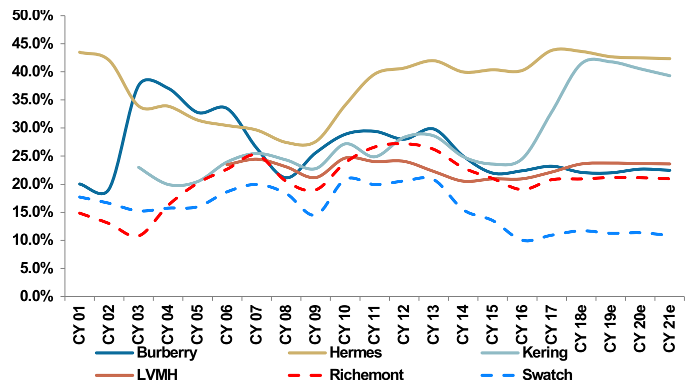
The performance is as unflattering when looking at the relative performance. As can be seen in the exhibits below, Swatch's pre-tax ROIC ten years ago was either in the middle of the pack or very close to the bottom end. In 2018e, we expect Swatch's pre-tax ROIC to be below its main peers in the European Luxury Goods industry. For example, when looking at EBITDAR / (Gross capital employed + capitalized leases - intangible assets - goodwill), we estimate Swatch's pre-tax ROIC in 2018e at 11.7% vs. 20.5% for Richemont, 23.6% for LVMH or 41.1% for Kering.

Exhibit 15: ROIC evolution since 2001, excluding leases



Source: Company data, Morgan Stanley Research estimates
Note: ROIC: EBITDA/Gross Capital Employed

Exhibit 16: ROIC evolution since 2001, including leases



Source: Company data, Morgan Stanley Research estimates
Note: ROIC: EBITDAR / GCE + capitalized leases, ex. Goodwill ex. Intangibles

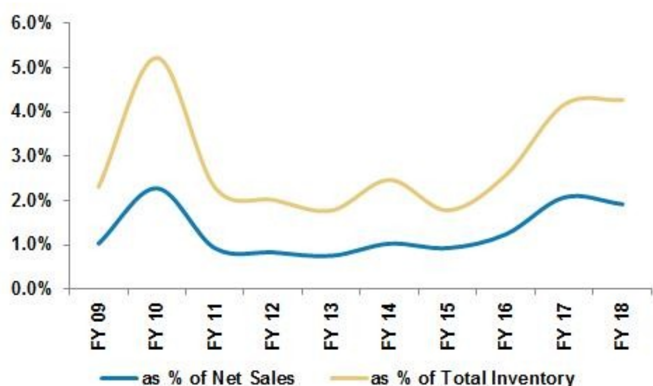
Swatch inventory provision policy does not appear conservative enough

Regardless of what Swatch might do with regards to third party retailer inventory, the overall inventory level appears excessive in absolute terms (penalizing ROIC) and will likely depreciate in value as, according to our estimates, it is made up of thousands of slow turn watch models. It is interesting to compare Swatch and Richemont's depreciation and provision policy with regards to inventory.

As can be seen in the table below, net inventory write downs have been substantially higher at Richemont than at Swatch in recent years, despite the fact that inventory days of finished goods at Richemont have been consistently lower than at Swatch (despite Richemont's much more significant vertical integration downstream, partially a function of the product mix: c.60% of Richemont sales are done at retail vs. only c.30% at Swatch).

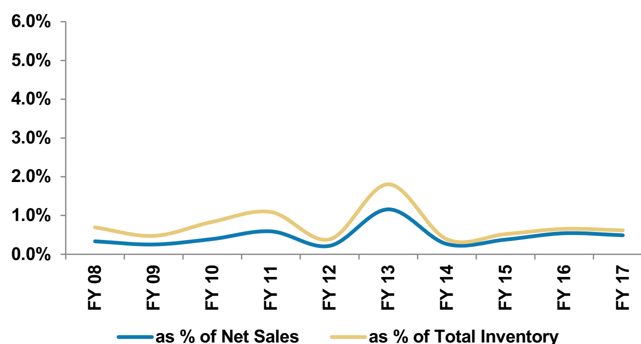
Over the past decade, Richemont's net inventory write downs have averaged 1.3% of sales and 2.9% of total inventory. This compares to 0.5% and 0.7% respectively at Swatch. Applying Richemont's ratios to Swatch in 2017 would lead to a ~20% decline in underlying EPS (all else being equal).

Exhibit 17: Richemont's net inventory writedown as % of sales and inventory



Source: Company disclosures
Note: Fiscal year ending as of March

Exhibit 18: Swatch net inventory writedown as % of sales and inventory



Source: Company disclosures
Note: Fiscal year ending as of December. Rise in FY13 related to Tiffany products

Exhibit 19: Gross and net inventory write-down for Swatch and Richemont

Richemont (March end) EURm	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17	FY 18
Total Inventory	2,422	2,260	2,789	3,666	4,326	4,455	5,438	5,345	5,302	4,943
Inventory written down	124	158	122	115	127	163	159	232	329	294
Inventory written down reversed during the year	-68	-40	-58	-41	-50	-53	-62	-94	-108	-83
Net Inventory write down in the year	**56**	**118**	**64**	**74**	**77**	**110**	**97**	**138**	**221**	**211**
as % of Net Sales	**1.0%**	**2.3%**	**0.9%**	**0.8%**	**0.8%**	**1.0%**	**0.9%**	**1.2%**	**2.1%**	**1.9%**
as % of Total Inventory	**2.3%**	**5.2%**	**2.3%**	**2.0%**	**1.8%**	**2.5%**	**1.8%**	**2.6%**	**4.2%**	**4.3%**

Swatch (December end) CHFm	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17
Total Inventory	2,738	2,743	2,869	3,671	4,407	5,426	5,943	6,151	6,259	6,318
Inventory written down	22	17	26	42	42	105	33	47	49	48
Inventory written down reversed during the year	-3	-4	-2	-2	-25	-7	-10	-15	-8	-9
Net Inventory write down in the year	**19**	**13**	**24**	**40**	**17**	**98**	**23**	**32**	**41**	**39**
as % of Net Sales	**0.3%**	**0.3%**	**0.4%**	**0.6%**	**0.2%**	**1.2%**	**0.3%**	**0.4%**	**0.5%**	**0.5%**
as % of Total Inventory	**0.7%**	**0.5%**	**0.8%**	**1.1%**	**0.4%**	**1.8%**	**0.4%**	**0.5%**	**0.7%**	**0.6%**

Source: Company data

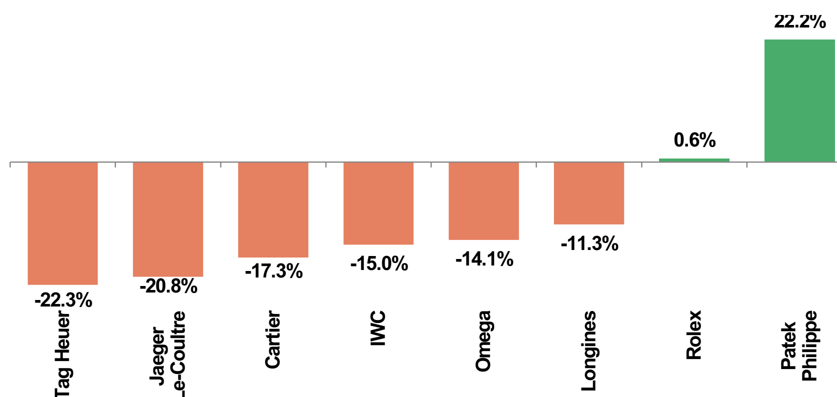
Why is the bullwhip effect magnified by the move to DTC?

We expect the move to direct to consumer (DTC) to be a game changer and to be highly beneficial to the main watch brands in the long term. However, in the short to medium term (3 to 5 years), it will likely be significantly disruptive for the listed groups (Swatch, Richemont and LVMH), a function of the fact that they currently rely on a very large network of third party retailers (Omega is distributed in over 4,000 points of sale vs. 450 for Patek Philippe, as a comparison). More importantly, the listed companies' brands are sometimes not as strong as those of the leading private players (such as Rolex, Patek Philippe or Audemars Piguet), as evidenced by flat to declining resale value over time and/or new watches not selling above the listed retail price. This could leave them in a position where they are forced to buy some of the third party retailers' excess inventory, clogging the supply chain further and negatively impacting cashflow and return on capital employed.

The distribution dynamics of the Swiss watch industry are rapidly changing. As discussed in previous research reports, the share of eCommerce in the Swiss watch sector has remained small so far (approx. 4%, we estimate), below other sub segments of the luxury goods industry. This is mostly a supply rather than a demand issue as a large number of brands do not offer the option to buy online (e.g. Rolex which does not sell online directly and does not allow third party retailers to sell on their own websites). Under-penetration of online is also a function of Watch brands having so far taken very timid steps to shift away from wholesale (third party retailers) towards their own online provision. Regarding the latter, this means rationalising their distribution network more aggressively and/or not making the online offer more attractive, for example by limiting new product launches to the online websites (as Nike or Adidas are increasingly doing) or by offering discounts (or more precisely, offering a free maintenance service for certain period of time, which would be equivalent to offering a discount but without damaging the brand equity).

2018 was a pivotal year. Over two-thirds of luxury goods bought today are first researched online. In the case of high end watches, this has meant that customers naturally end up exposed to third party platforms. Most of these platforms sell grey-market watches and have recently flourished as they can give reassurance regarding authenticity and offer heavy discounts. As can be seen in Exhibit 8 below, new Cartier watches (such as the Ronde Solo de Cartier or the Tank Solo) are discounted by 15% to 25% on Chrono24. For some Tag Heuer watches the discount can go as high as 30%. For Swiss watch brands, lack of online retailing has made this channel the exclusive domain of grey-market players, which has serious implications for brand equity. As a result, recently, a number of watch brands have announced that they will be moving more aggressively towards direct to consumer in general and online in particular. For example, Audemars Piguet announced on April 2018 that it had collaborated with JD.com in opening an online pop-up boutique, and Panerai announced in June 2017 that it had launched a 100 pieces limited edition in Panerai's e-boutique, its first e-commerce launch.

Exhibit 20: Swatch and Richemont main brands: Price comparison vs. Chrono24 for new watches



Source: Company websites, Chrono24, Morgan Stanley Research estimates
Note: Chrono24 prices are for new/unused/not worn watches only.

Long term, a number of powerful benefits for Swatch Group and Richemont. We believe the move towards a more DTC-driven distribution model, with a much greater emphasis on direct eCommerce sales, would not just be defensive. It could also be highly beneficial for the watch brands in other ways:

1) capturing third party retailers' high mark up – we calculate that, for a watch sold for CHF 10,000 at retail, the move from wholesale to direct online sales could lead to a doubling of profit. In column A of the table below, we assume that a watch brand makes an operating profit per watch of ~17%, or CHF 1,000 for a watch sold for CHF 6,000 by the brand to the retailer (we have assumed in this case that the watch brand entirely owns and operates its national wholesale divisions downstream – mostly the case for large groups such as Swatch Groups or Richemont). We then assume that the watch retailer sells this watch CHF 10,000. This translates to a 40% gross margin (CHF 4,000). In our scenario, the watch retailer generates a 10% operating profit (more or less the industry average), or CHF 1,000 per watch on a fully allocated cost basis.

In order to assess the profitability per watch for watch brands selling directly online, we make the following (conservative) assumptions in column C: (1) the cost of shipping a watch (1kg box) internationally long distance (e.g. Geneva to New York or Beijing) varies between CHF 250 and CHF 350. Assuming that ~50% of products are returned (and the costs are incurred by the watch brand), this would raise the cost to CHF 350 to 550; (2) We assume an average interaction with a sales representative of two hours plus increased labour costs at headquarters related to the DTC move. This adds ~CHF 300 to the process; 3) Finally, we assume ~CHF 500 of increased advertising costs on a per watch basis. This is based on watch makers spending the ~CHF 200 third-party retailers are already spending on a per watch basis. It also includes increased spending to compensate for the fact that there will be less impulse buying amongst consumers (as there will be fewer stores). Finally, it also includes incremental acquisition costs from search engines (e.g. Google).

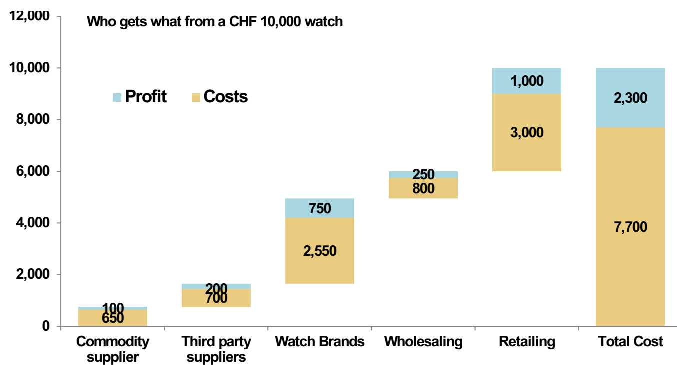
In column D, we assume that the watch brand offers 10-year free service for the watch, limited to two maintenance repairs over the period (watches, on average, need to be serviced every five years). We assume a cost of ~CHF 800 per repair per watch (i.e. a total of ~CHF 1,600 over ten years). We then assume that 75% of customers take

advantage of the offer. This translates into a cost of ~CHF 1,200 per watch for the watch brand.

2) *better supply chain management*: immediate access to POS data means lower inventory (a major issue for the industry as we have previously discussed) and lower obsolescence risk (e.g. no longer need to buy back inventory from third party retailers, cf. Cartier >€200m spent over the past two years);

3) *much better access to end customer data*. This is a critical issue in an industry where c.90% of watches are sold by third party retailers.

Exhibit 21: Who gets what from a CHF 10,000 Swiss watch? A theoretical breakdown of the Swiss watch industry value chain



Source: Morgan Stanley Research estimates

Exhibit 22: Watch brands: a move away from wholesale to self distribution online would be significantly accretive to margins, even taking into account generous commercial policies, such as providing 10 years of free service

	A	B	C	A + C	D	A + C + D
	Watch brand	Watch retailer	Additional cost from selling online directly	Watch brand selling online	Additional cost from selling online directly with 10 year free service	Watch brand selling online
Sales	6,000	10,000		10,000		10,000
cost of goods sold	-1,650	-6,000		-1,650		-1,650
Gross margin	4,350	4,000		8,350		8,350
GM as % of sales	**73%**	**40%**		**84%**		**84%**
Personnal costs	-1,380	-1,000	-300	-1,680		-1,680
as % of sales	**23%**	**10%**		**17%**		**17%**
Rental costs	-300	-1,200		-300		-300
as % of sales	**5%**	**12%**		**3%**		**3%**
Adveritising costs	-550	-200	-500	-1,050		-1,050
as % of sales	**9%**	**2%**		**13%**		**13%**
Other SG&A	-1,120	-600	-300	-1,420	-1,200	-2,620
as % of sales	**19%**	**6%**		**14%**		**26%**
Operating profit	1,000	1,000		3,900		2,700
OP as % of sales	**17%**	**10%**		**39%**		**27%**

x 3.9 x 2.7

Source: LuxeConsult, Morgan Stanley Research

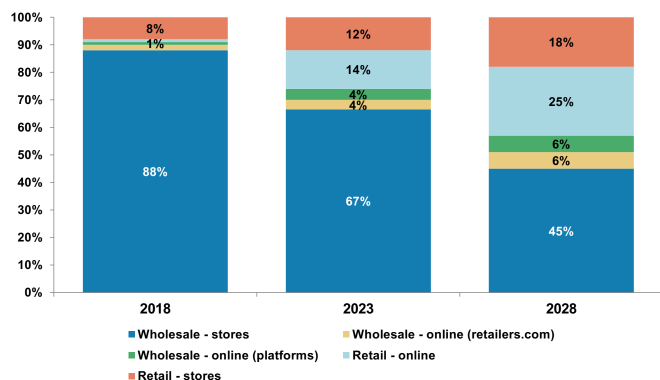
However, in the short to medium term, the transition could be highly disruptive. There are currently thousands of independent watch retailers worldwide: most of them operate one store, but a few of them operate a several dozen. For example, Swiss based retailer Bucherer recently acquired market leader Tourneau in the US and currently operates a total of approximately 80 stores across Europe and the United States. It is difficult to assess the financial health of watch retailers as only three of them around the world are listed (and all three are located in Hong Kong): Emperor Watch, Oriental Watch and Hengdeli. While these three retailers appear to be performing well, a number of others are struggling financially and may have to close stores, according to press reports as well as conversation with industry contacts.

Today, we estimate the distribution of Swiss watches to be as follows (in value terms): third party retailers (or wholesale channel) account for approx. 88% of sales, wholesale online (e.g. watchesofswitzerland.co.uk) about 2%, third party platforms (e.g. Mr Porter or Chrono24) for about 1%, Retail online (e.g. omega.com) for about 1% and retailers offline (e.g. the Omega directly operated stores) for about 8%. Our estimates are based on a combination of the FHS Swiss watch exports data and company disclosures. By 2023, we think the third party retailers' share could have contracted to about 67%, the wholesalers online should have expended to about 3.5% (their inability to offer discounts online, unlike in stores, will cap this channel growth we think), online platforms to about 4%, retailers online to about 14% and retailers offline to about 12%. Of note, this growth in the share of retailers' offline should be achieved at constant (if

not slightly shrinking) store networks.

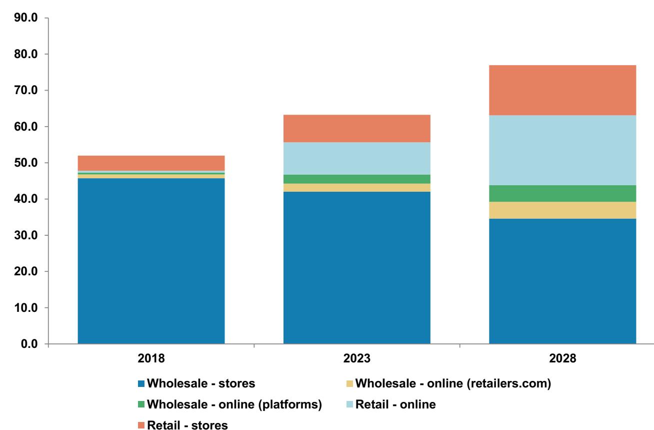
In a scenario in which total Swiss watch sales go from an estimated CHF 52bn value at retail in 2018 to CHF 60bn (ie. +4% CAGR, in line with the past 10 year average), this means that the actual sale sales of third party retailers (online and offline) will decline from CHF 46.8bn to CHF 44.3bn (down -5% on a cumulated basis), if we apply our assumptions above.

Exhibit 23: Swiss watch market: Expected change in the distribution channel mix over the next five and ten years (percentage)



Source: Morgan Stanley Research estimates

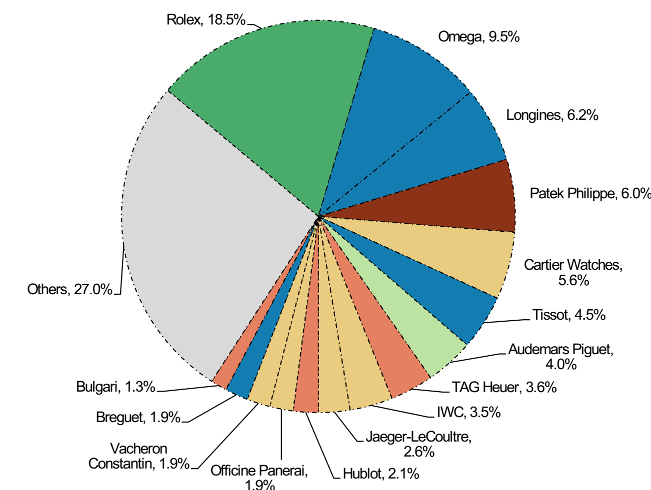
Exhibit 24: Swiss watch market: Expected change in the distribution channel mix over the next five and ten years (CHF bn, Retail value)



Source: Morgan Stanley Research estimates

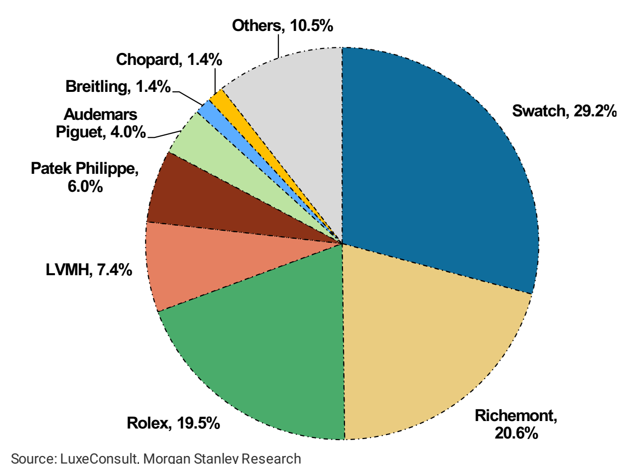
The transition should be relatively smooth for the strongest brands. Today, there are only a very limited number of strong brands (defined as having waiting lists for some of their best sellers and/or with second hand prices constantly appreciated): essentially Rolex, Patek Philippe and Audemars Piguet. Combined, they have a market share of approximately 30% in value - see below. These brands are currently posting much higher profitability levels (EBIT margin in excess of 30%, we estimate) and have a much better grip on their distribution than their competitors. For example, they have zero tolerance for grey market practices (Rolex has 'one strike and you're out policy' towards third party retailers). Neither does it directly supply the grey market (as some competitors do. As a result it has been more reluctant to change its distribution model. Today, we estimate that the share of wholesale is c.90% at Audemars Piguet, c.95% at Patek Philippe and c.99% at Rolex.

Exhibit 25: Swiss watches: Retail market share by brand in 2017



Source: LuxeConsult, Morgan Stanley Research

Exhibit 26: Swiss watches: Retail market share by group in 2017



Source: LuxeConsult, Morgan Stanley Research

However, this could change rapidly and a move to a DTC model, which could negatively affect traffic levels for many third party retailers (as these brands are generally the big traffic driver to the stores). In January 2018, Francois-Henry Bennahmias (Audemars Piguet's CEO) indicated that Audemars Piguet will be moving online and stated that "2018 will be the test (for e-commerce). 2019 will be the explosion". In April 2018, Audemars Piguet started selling online (in China) for the first time. While we belive that the company is already profitable, it is currently leaving a lot of money on the table by mostly relying on third party retailers for its distribution, as retail margins are materially higher than wholesale, as we have highlighted in a previous report. The move to DTC will allow Audemars Piguet to capture third party retailers' profit margins, improve ROIC and develop a direction connection with the end customers.

For a brand like Audemars Piguet, the transition to DTC should be relatively smooth: with a waiting list of 12 to 18 months on some of its best sellers and a sales volumes limited (voluntarily) to approximately 40,000 watches, it is relatively easy to enforce the changes when it comes to the distribution model. At worst, the watch brand will have to clean the market (i.e buy back the inventory of the slow moving SKU - such as the Millenary, the Jules Audemars, etc. - from third party retailers). On the best selling product families such as the Royal Oak and the Royal Oak Offshore (which, combined, account for c.80% of sales), we think the transition to DTC will be a non issue: third party retailers will not sell at a discount on a platform a watch that is sellable at retail at a premium.

But the DTC move is likely to be an issue for weaker brands. However, the transition to a DTC model should be clearly more difficult for relatively weaker brands, defined as brands where second hand value is flat to down over time, partially as a result of over distribution (either via legitimate third party retailers and/or the grey market).

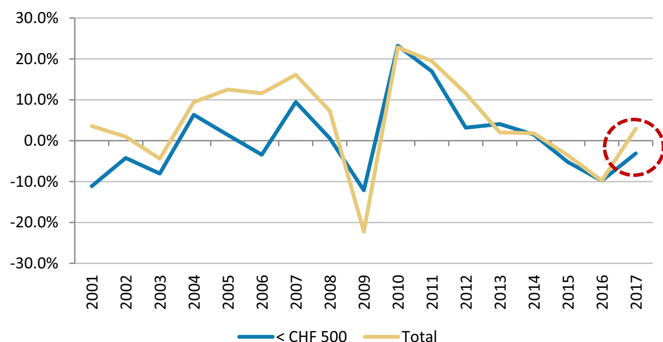
Update on the smartwatches threat

Diverging trends for Smartwatches vs. Swiss Watches

The recent underperformance of the low to mid-end segment of Swiss watches is likely partly caused by the disruption from smartwatches, and we see no signs of a reversal in this trend. As of 3Q18, the gap between the growth of global smartwatch shipments vs. Swiss watch exports (in units) was at its widest point since 1Q17. With smartwatches mostly priced at below CHF 500, we see the Swatch Group in particular being exposed, with 35% of its sales to this 'below CHF 500' segment (vs. the industry at 11% and Richemont at 7%).

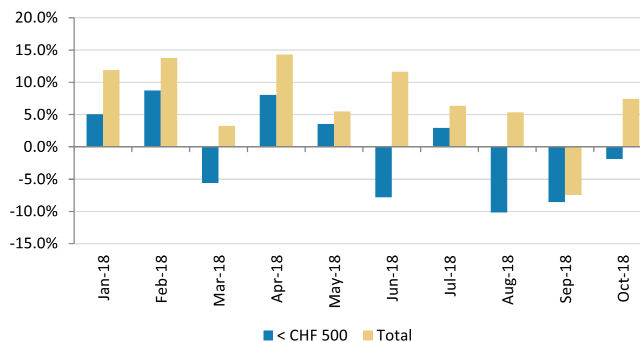
Swiss watch exports for the price segment below the CHF 500 level has, over the past two decades, performed broadly in line with total Swiss watch exports when measured by value as per FHS. However, we note that a slight divergence has kicked in since last year, with the spread having widened further so far in 2018 (See Exhibit 23).

Exhibit 27: Swiss Watch Exports: Below CHF 500 vs. total exports by value (2001-17)



Source: FHS

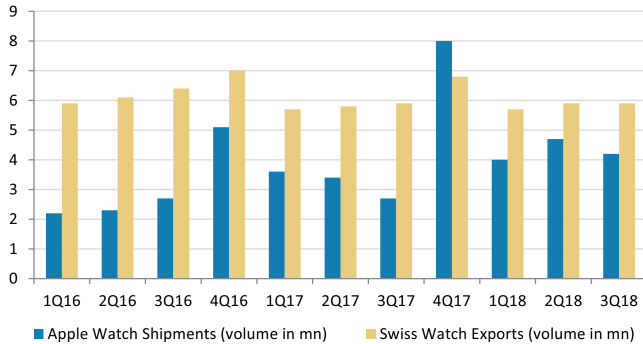
Exhibit 28: Swiss Watch Exports: Below CHF 500 vs. total exports by value (2018 YTD)



Source: FHS

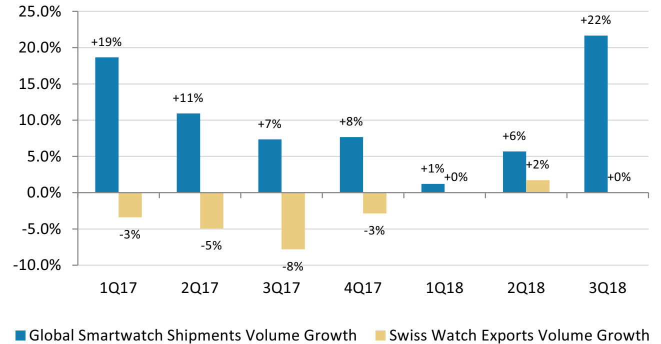
We think a key driver of the divergence between the total Swiss watch exports and the price segment below CHF 500 has been the rise of smartwatches, led by Apple Watch. Since the introduction of the first Apple Watch in 2015, we note that the Apple has increasingly closed the gap vs. Swiss Watch exports since then. As of the first 9 months in 2018, the Apple Watch has seen a growth of +33% yoy to 12.9m shipments. This compares to a flattish growth in volume terms for Swiss watch exports, with the volume standing at 17.5m as of 9M18. At an industry-wide level, we note that global smartwatch shipments have in the past 2 years consistently exceeded Swiss Watch exports in terms of volume growth, with the spread currently being at its highest point since 1Q17 (See Exhibit 25).

Exhibit 29: Apple Watch shipments vs. Swiss Watch exports globally (in million of units)



Source: FHS, IDC, Morgan Stanley Research
Note: Exports refer to global exports excl. Switzerland, and shipments are global

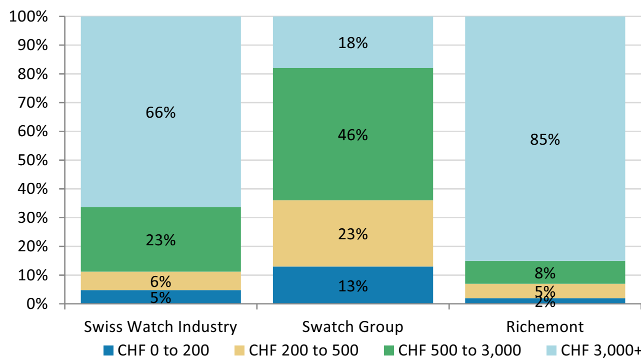
Exhibit 30: Global Smartwatch shipments vs. Swiss Watch exports (in million of units)



Source: FHS, IDC, Morgan Stanley Research
Note: Exports refer to global exports excl. Switzerland, and shipments are global

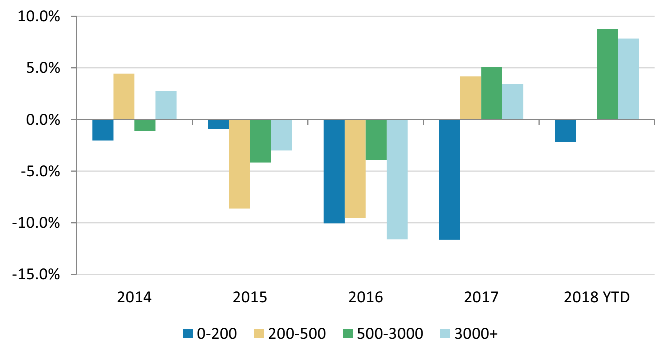
Given that the Apple Watch is priced at around CHF 450, we think that Swiss watches around or below the CHF 500 price segment are most exposed to this risk (although this is at a wholesale price subject to a c. 2x mark-up). As of 3Q18, Apple watch shipments rose by +56% yoy vs. Swiss watch exports at -1% yoy in volume terms. Going forward, we expect this divergence to continue, on the back of the recent launch of Apple Watch Series 4 on September 21 this year, which has received upbeat reviews from many reputable sources in the watch industry, including Hodinkee. While Swatch Group holds high-end watch brands such as Omega, Breguet and Blancpain, we estimate that more than 35% of it sales in value terms are exposed to the price segments below CHF 500. This compares to an exposure for the overall Swiss Watch Industry at just 11% of sales in value terms as per FHS, while Richemont is even lower at just 7% of sales (See Exhibit 26). Based on the trends in the recent years, it is evident that the CHF 500-3000 and CHF+3000 segments have outperformed the low to mid-end segments (See Exhibit 27), and we expect this trend to continue going forward amidst the rising threat from smartwatches.

Exhibit 31: Breakdown of value by pricing segment for the Swiss watch industry, Swatch Group and Richemont



Source: FHS, Morgan Stanley Research estimates

Exhibit 32: FHS Swiss Watch Exports growth in value terms by price segment



Source: FHS

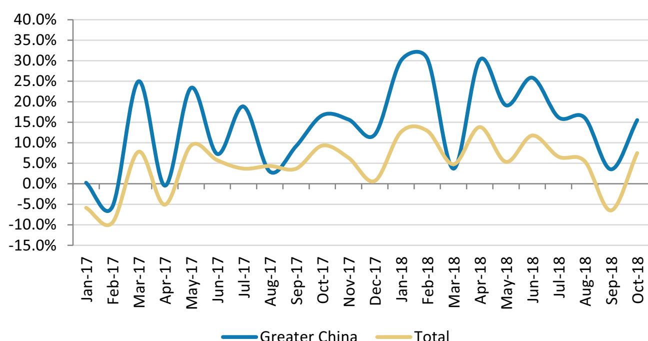
Update on demand from Chinese nationals

Decline in sentiment in 2H18

Based on the current trading and latest commentary from the Hong Kong based watches and jewellery retailers, we expect to see a moderation in demand in 2H18 in Greater China for both Swatch and Richemont. Some of the Hong Kong retailers have cited the recent unfavorable FX movements, the US-China trade dispute and a tough comp base in 2H18 as the main reasons for the slowdown in demand. In the European Luxury space, Swatch Group and Richemont remain amongst the ones that are most exposed to Chinese nationals, with an exposure of above 40% of sales.

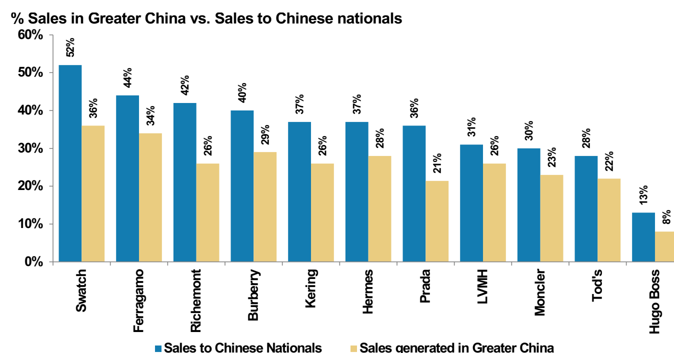
Growth in demand from Greater China has in the past two years consistently exceeded the overall market growth, as measured by Swiss watch exports in value terms (See Exhibit 33), and we note that Greater China accounts for more than 50% of the growth for Swiss watch exports. More importantly, Richemont and Swatch Group are amongst the companies in our coverage that are most exposed to Chinese nationals at above 40% of sales.

Exhibit 33: Swiss watch exports yoy growth: Greater China vs. Total



Source: FHS

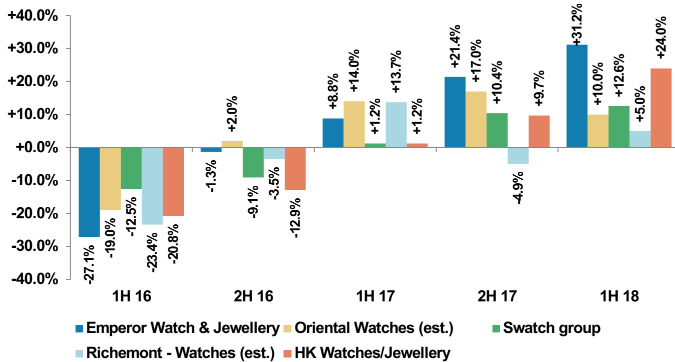
Exhibit 34: Exposure to Greater China and Chinese nationals by company



Source: Company disclosures, Morgan Stanley Research

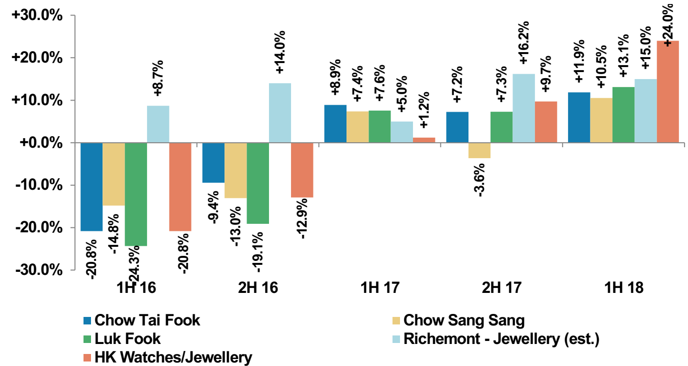
For the main Hong Kong based watch retailers (namely Oriental Watches and Emperor Watches & Jewellery), sales momentum has picked since early 2017, in line with the rest of the Swiss watch market. As per the Swiss Watch Exports data from FHS, the Hong Kong market accounts for 15% of the overall Swiss Watch market by value and nearly 40% of the growth in 2018 YTD. However, it is worth noting that the Hong Kong based watch retailers are mainly exposed to the high-end of the market, with Rolex, Patek Philippe and Cartier accounting for around 50% of sales for Emperor, and Rolex itself accounts for nearly 70% of sales for Oriental Watches. In the jewellery space, the Hong Kong based retailers have also seen an uptick since last year, broadly in line with the performance of the overall Hong Kong Watches & Jewellery sales growth and Richemont.

Exhibit 35: Same store sales growth for watches retailers in HK vs. Swatch and Richemont



Source: Company disclosures, Morgan Stanley Research

Exhibit 36: Same store sales growth for jewellery retailers in HK vs. Richemont



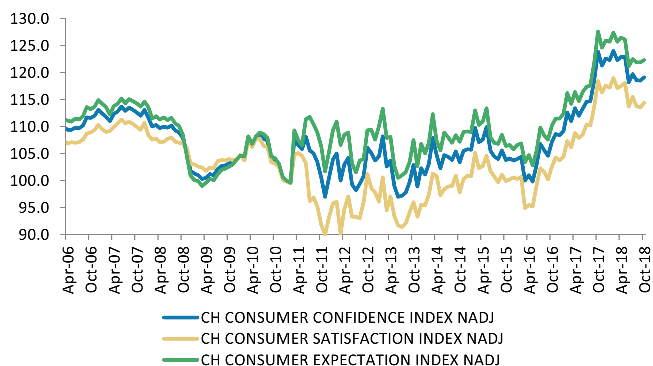
Source: Company disclosures, Morgan Stanley Research

However, the trend for the Hong Kong based watches and jewellery retailers has changed over the course of the second half of 2018, with September being particularly soft (in line with the trend observed in the Swiss Watch Exports data). The softness in 2H18 is likely caused by a variety of factors, including 1) unfavourable FX movements (strengthening HKD and weakening CNY), 2) tough comp base in 2H18, 3) decline in sentiment in Hong Kong due to the heightened volatility of the local equity market and concerns of the property market overheating.

Likewise, the decline in sentiment in 2H18 has recently been echoed by both Chow Tai Fook and Luk Fook Holdings on November 29. Specifically, Chow Tai Fook and Luk Fook Holdings both cited the US-China trade dispute and the recent unfavorable FX movements as the most important reasons for the slowdown in demand observed in 2H18. Luk Fook Holdings stated that it has seen a single-digit sales growth decline in Hong Kong and Macau in October, whereas China saw a double-digit decline over the same period.

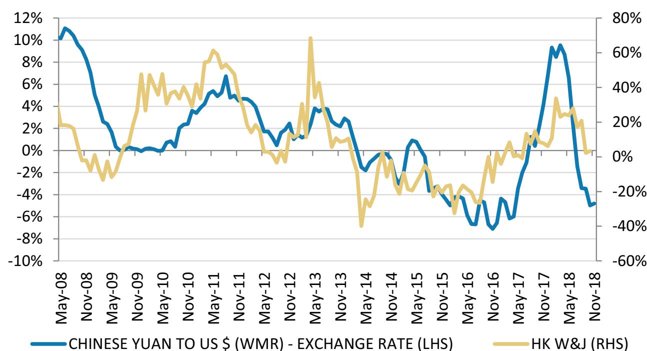
Based on the latest FX rate between CNY-USD and the most recent consumer confidence index in China as of October, we see no signs of a reversal in the moderating trends that has been observed by the Hong Kong based watches and jewellery retailers so far in 2H18. As a result, we have also lowered our expectations for organic growth in Greater China for both Swatch and Richemont. For the Swatch Group, we have reduced our group sales growth by -2.5% for 2H18e (-1.3% for FY18e) and by -2.8% on average across 2019-21. For Richemont; we have reduced our net sales in FY19e by -1.6% and by -3.3% on an average for FY20-21e.

Exhibit 37: Consumer confidence levels in China have declined from its recent highs



Source: CEIC, DataStream, Morgan Stanley Research

Exhibit 38: CNY-USD FX rate vs. HK Watches & Jewellery sales growth



Source: DataStream, Hong Kong Census and Statistics Department (HKCSD), CEIC, Morgan Stanley Research

Yoox Net-A-Porter

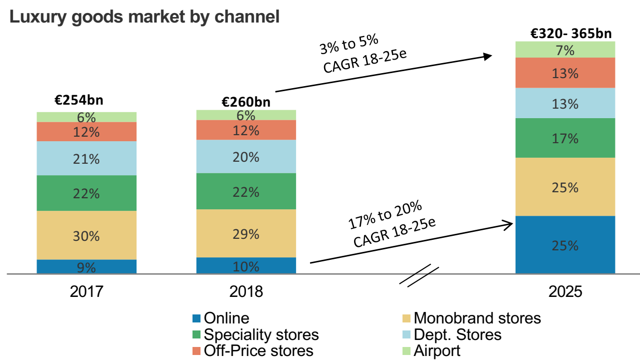
Top line growth on path of normalisation

The online channel in luxury goods is set to grow at a 17-20% 2025e CAGR as per Bain & Altagamma, faster than any other channels. However, we expect YNAP to underperform its overall peers in the online channel given its format of a multi-brand platform (1P). As this format implies that YNAP effectively operates as a wholesale partner, we anticipate the progressive shift to direct-to-consumer in luxury goods to play against its 1P model. On the other hand, we expect the luxury brands' own e-commerce efforts (brand.com) and the marketplace format (3P) to drive growth in the online channel. Both of these formats allow the luxury brands' to retain control over their distribution, and the 3P format has another advantage vs. the 1P format in relation to the range of brands/SKUs on offer. As such, we see YNAP's top line growth on a path of normalisation; we forecast a progressive slowdown towards mid to high single digits by 2021 for Richemont's online distributors division.

As at the latest fiscal year ending in December 2017, YNAP accounted for 15% of pro forma sales and 5% of pro forma EBIT for Richemont.

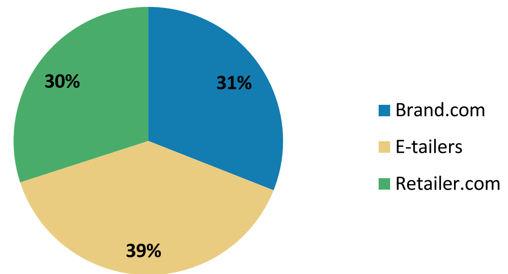
The online channel is now the fastest growing one in the luxury industry. Bain & Altagamma estimates that e-commerce currently accounts for only 10% of overall luxury goods sales (equivalent of €26bn of global sales, significantly below other consumer categories), but this channel is now growing very rapidly and is set to account for around 25% of the sector sales by 2025e. With the overall luxury goods market set to grow at a 3-5% CAGR by 2025, this implies a CAGR of c.17-20% for the online channel until 2025 as per the latest Bain & Altagamma estimates. Within the online channel for luxury goods, we note that the sales split by segment is roughly equal between brand.com (i.e. gucci.com), etailers (i.e. Farfetch, Net-A-Porter etc.), and retailer.com (i.e. harrods.com), with the first two growing at the fastest pace according to Bain & Altagamma.

Exhibit 39: Online set to be the fastest growing luxury channel worldwide



Source: Bain & Altagamma

Exhibit 40: Online Luxury market by segment

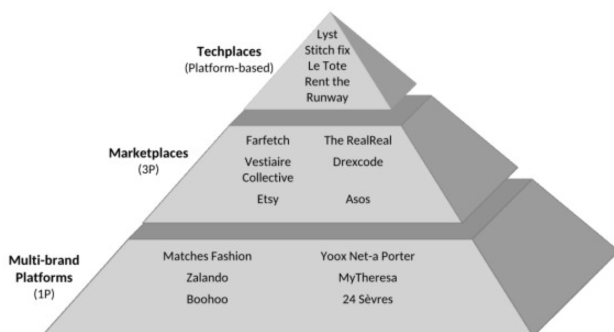


Source: Bain & Altagamma

However, we note that the e-tailers sub-channel is a relatively crowded field, where there is a lot of differentiation between the individual players. Broadly speaking, we think that the e-tailers can be placed into three categories: techplaces, marketplaces (3P), and multi-brand platforms (1P) (See Exhibit 41). When breaking down the sales growth by categories within the e-tailers sub-channel, we note that marketplaces (3P) such as Farfetch and techplaces such as Lyst have recorded the strongest growth in the past couple of years at +40% CAGR in 2014-16 (See Exhibit 42). Over the same period, the brand.com channel has seen robust growth of +20% CAGR, while retailer.com (Department Stores) and the multi-brand platforms (1P) such as YNAP have seen the slowest growth at +15% CAGR.

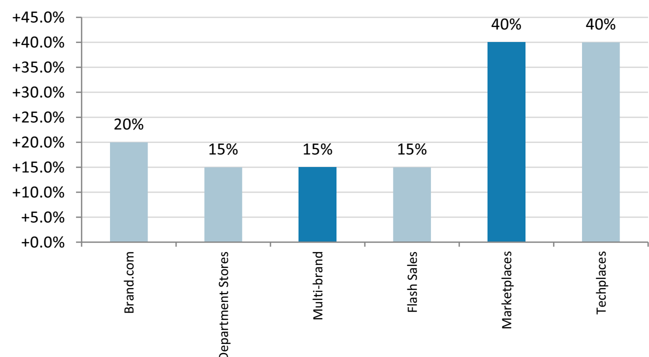
When it comes to the e-tailers sub-channel, the main players in the luxury industry operate within the marketplace and the multi-brand platform formats. The business models for these two formats vary in particular in relation to inventory risk. Marketplaces operate with an asset light model in the sense that they don't take on inventory risk, as they purely offer an online marketplace that connects the buyers to the sellers. For the multi-brand platforms, they take on the inventory risk themselves, as they effectively operate as wholesale partners to the luxury brands. Going forward, we expect the marketplace format (3P) to continue to outperform the multi-brand platforms (1P) for two distinct reasons.

Exhibit 41: Pyramid: Breakdown of e-tailers



Source: McKinsey (The age of digital Darwinism, 2018), Morgan Stanley Research

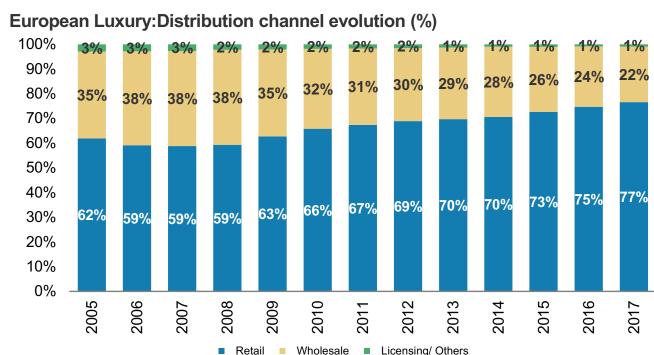
Exhibit 42: Luxury e-commerce sales growth (2014-16 CAGR) by channel



Source: McKinsey, Morgan Stanley Research

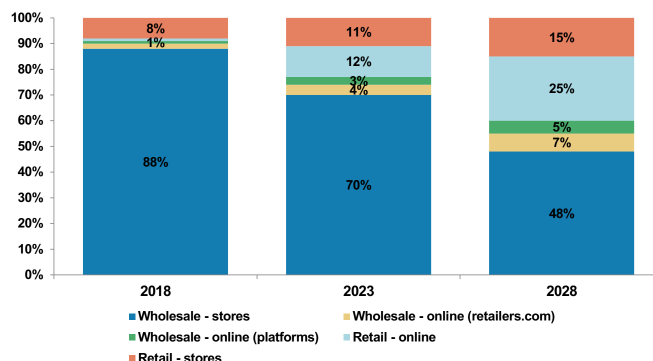
1) Structural shift to direct-to-consumer (DTC). The luxury goods sector has over the past decade seen a progressive shift away from wholesale to retail, with retail now accounting for nearly 80% of sales vs. 60% a decade ago (See Exhibit 43). As we highlighted in our European Insight report from earlier this year, 'Transformational Channel shift ahead (March 19, 2018)', we expect luxury brands to continue their structural shift from wholesale to retail in order to improve their control over distribution and for brand-building purposes. For example, Louis Vuitton (the biggest luxury brand in the world with sales of more than €10bn p.a.) operates with a 100% retail model. Between the online marketplace and the multi-brand platform formats, we expect the majority of luxury brands to continue to favour the former given that it effectively operates as an extension to their retail operations, while the latter operates as a wholesale partner.

Exhibit 43: Luxury distribution channel mix evolution



Source: Company data, Morgan Stanley Research. Note: We use weighted average of the distribution mix of European Luxury brands

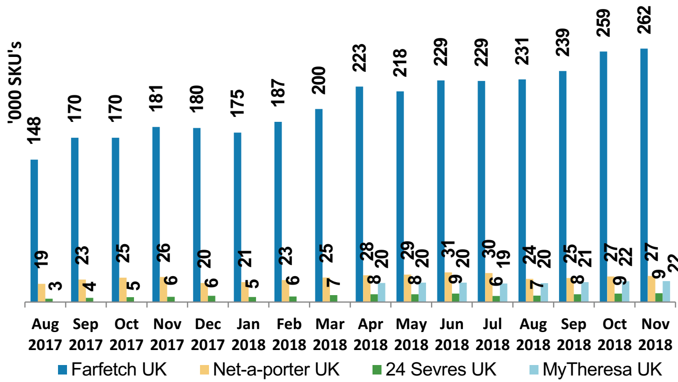
Exhibit 44: We expect distribution channel mix to evolve towards a DTC model over next 5 to 10 years



Source: Morgan Stanley Research estimates

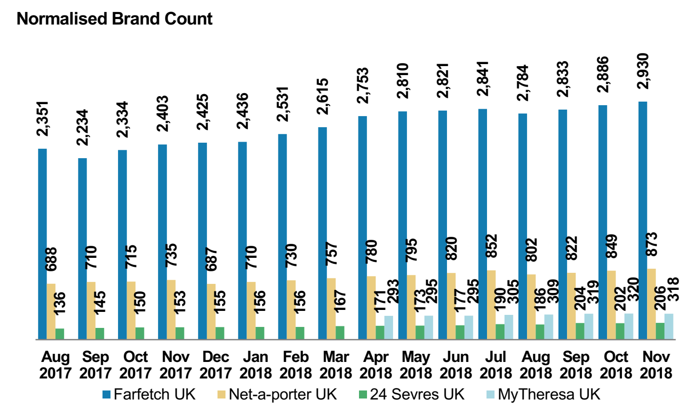
2) Range of brands and SKUs. Given that the online marketplace format does not take on inventory risk, it is able to offer a much broader range of brands and SKUs compared to the players operating with a multi-brand platform format. As shown in our latest proprietary AlphaWise data, tracking the number of brands and available SKUs on offer at the four leading UK luxury e-tailers, the marketplace format comes out on top on every metric. Specifically, we find that Farfetch (3P) is well ahead of its 1P peers, offering nearly 2,900 brands vs. 873 at Net-A-Porter as of Nov-18. In terms of available SKUs, the picture is very similar, with Farfetch offering more than 260,000 products on its website compared to 27,000 for Net-A-Porter as of Nov-18.

Exhibit 45: Normalised Brand Count by luxury e-tailer



Source: AlphaWise, Morgan Stanley Research

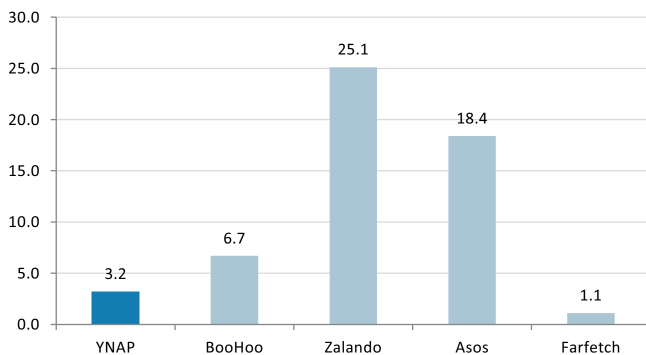
Exhibit 46: SKU Count regardless of colour/category by luxury e-tailer



Source: AlphaWise, Morgan Stanley Research

Given the structural advantages of the online marketplace format (3P) that Farfetch has over the multi-brand platforms (1P), it comes out on top versus most of its peers in terms of growth in active customers at around +40%. This compares to most of its peers currently growing at around 10-20% YoY, with YNAP being the laggard in that group at sub 10% growth. However, we also note that Farfetch is still much smaller than its peers, with just 1.1m active customers versus YNAP at 3.2mn and the general online fashion retailers ranging from 6-25mn. (See Exhibit 47).

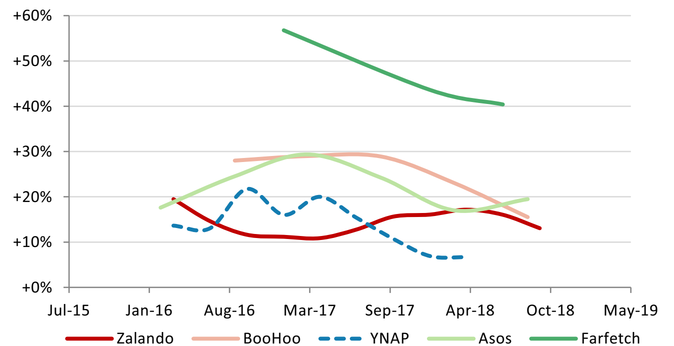
Exhibit 47: Active Customers (in mn) by company



Source: Company disclosures

Note: YNAP as of Mar-18, BooHoo as of Aug-18, Zalando as of Sep-18, Asos as of Aug-18, Farfetch as of Jun-18

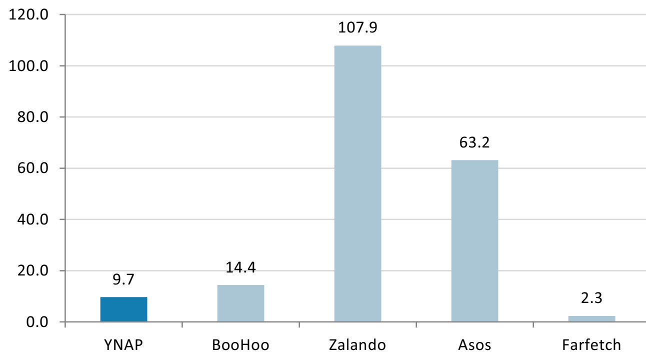
Exhibit 48: Active Customers Growth by Company



Source: Company disclosures

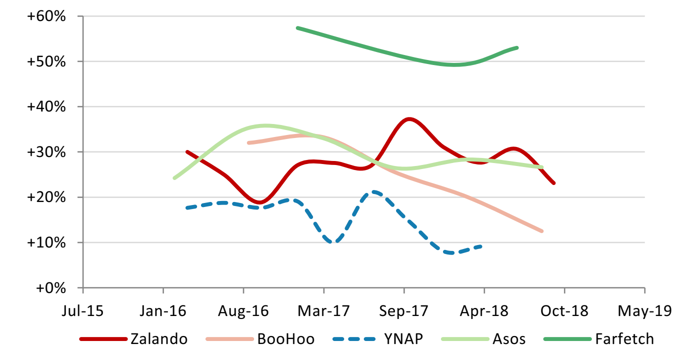
In terms of growth in number of orders, we see a similar trend, with Farfetch continuing to see growth of +50% (over the last 12 months), although we also note that the size of Farfetch remains significantly below its peers on this metric (See Exhibit 49). Unlike the growth in active customers, the number of orders growth has remained at a broadly stable level over the last couple of years for Farfetch. This compares to its 1P peers such as BooHoo and YNAP, which have both experienced a deceleration since 2016, as both are now growing at around +10% vs. 20-30% in 2016-17 (See Exhibit 50).

Exhibit 49: Number of Orders (in mn) - TTM on a reported basis by company



Source: Company disclosures
Note: TTM for YNAP until Mar-18, BooHoo until Aug-18, Zalando until Sep-18, Asos until Aug-18, Farfetch until Jun-18

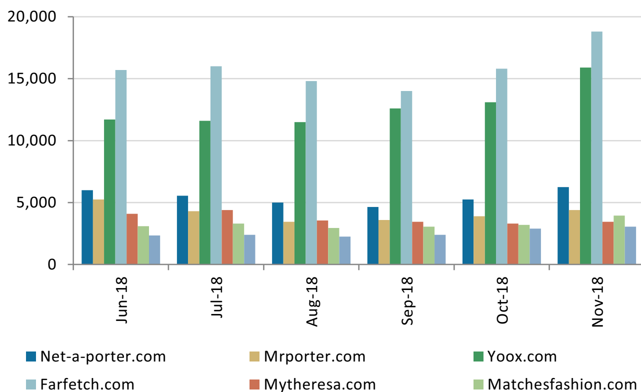
Exhibit 50: Number of Orders Growth by Company



Source: Company disclosures

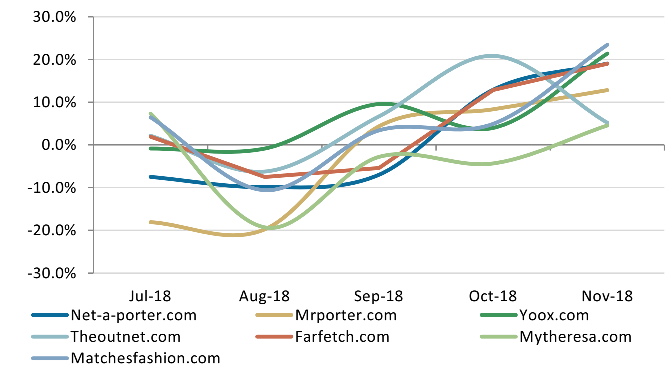
The structural outperformance of Farfetch is also reflected in the latest website traffic data, as it has over the past 6 months consistently recorded the highest number of site visitors amongst its direct peers, including Net-A-Porter, Mrporter, Yoox, Mytheresa, Matchesfashion and The Outnet (See Exhibit 51). Likewise, Farfetch has continued to see a solid momentum in terms of total visits growth on a month-on-month basis (See Exhibit 52). However, we also note that Yoox and The Outnet have also picked up momentum in the most recent months. We think that this improvement is likely a reflection of the recent integration in 2H18 of the omni-stock program, covering the off-season multi-brand platforms (namely Yoox and The Outnet). Benefits of the roll-out of this program include allowing customers to have a global view of inventory levels and local payment methods (such as AliPay).

Exhibit 51: Total Visits (in 000's) by website



Source: SimilarWeb, Morgan Stanley Research

Exhibit 52: Total Visits Growth MoM by Website

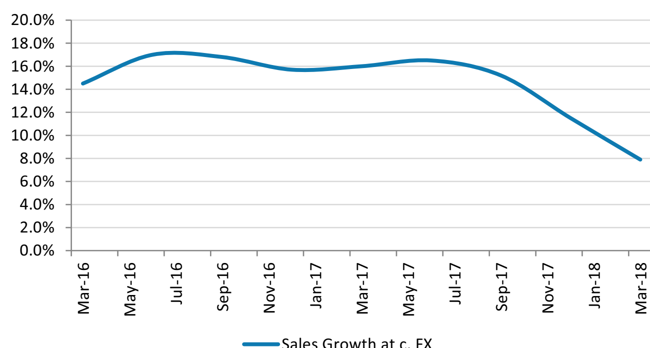


Source: SimilarWeb, Morgan Stanley Research

On a more positive note for YNAP, the structural decline of department stores is set to benefit the multi-brand platforms such as YNAP, as smaller to medium-sized luxury brands remain heavily reliant on wholesale partners. Given the lack of scale of these brands, they don't have sufficient resources or the required brand equity to go direct-to-consumer, whether online or via opening physical retail stores. As such, the main option for these luxury brands to gain exposure to e-commerce is through wholesale partnerships with the likes of YNAP. Therefore, we expect the brand composition in the future to progressively move towards smaller and medium-sized brands for YNAP.

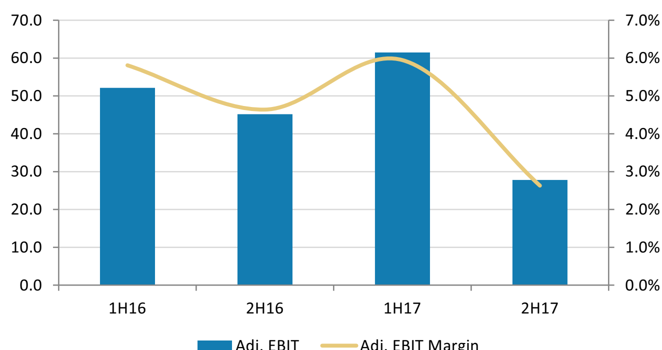
Over the most recent couple of years, YNAP has experienced a progressive deceleration in its sales growth at constant FX from +16% in 2016 to below 10% as of 1Q18. We think this slowdown is a reflection of the structural disadvantage of the multi-brand platform and the rapidly rising competition within the luxury e-commerce field. From a profitability point of view, operating margins came under pressure last year as a result of company-specific initiatives such as the integration of the omni-stock program for both its in-season and off-season offerings.

Exhibit 53: Historical sales growth at constant FX evolution for YNAP (prior to Richemont takeover)



Source: Company disclosures

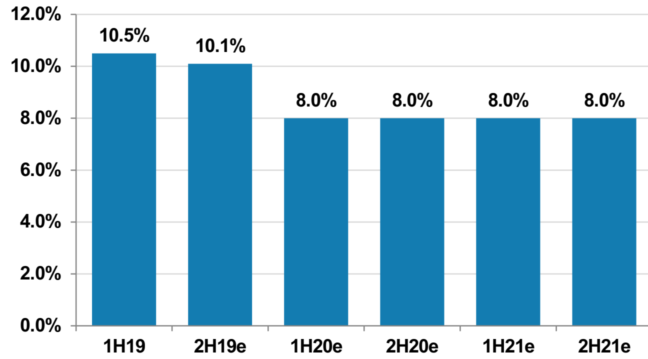
Exhibit 54: Historical operating margin progression for YNAP (prior to Richemont takeover)



Source: Company disclosures

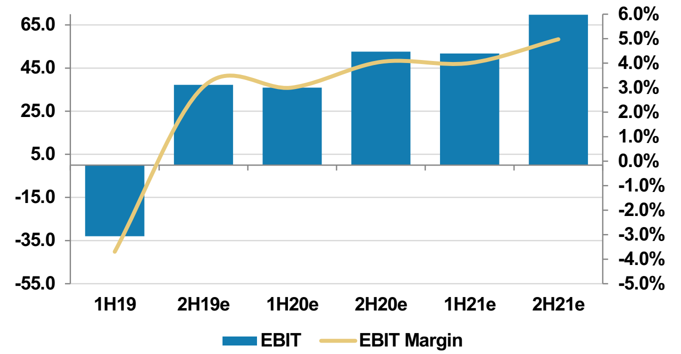
Looking ahead, we expect the deceleration of the top line growth for the online distributors division to continue in the forthcoming years, as we anticipate it progressively slowing down to a mid-to-high single digit growth rate by 2021 (See Exhibit 22). We expect the structural disadvantage of the 1P platform to continue to be a drag to YNAP's growth aspirations going forward, as most recently demonstrated by the termination of the JV with Kering, as we see the 3P marketplace format and the luxury brands' own e-commerce efforts to be the structural winners in the medium term. With that said, we expect a progressive improvement in the operating margin, as headwinds from the on-going integration of the omni-stock program should fade in the near term. As a result, we see the adj. EBIT margin moving towards a mid-single-digit level by 2021, although this remains well below the initial guidance of a high-single-digit adj. EBIT margin by 2020 provided by the previous management team in 2016.

Exhibit 55: Sales growth at constant FX forecasts for the online distributors division at Richemont



Source: Company disclosures, e = Morgan Stanley Research estimates

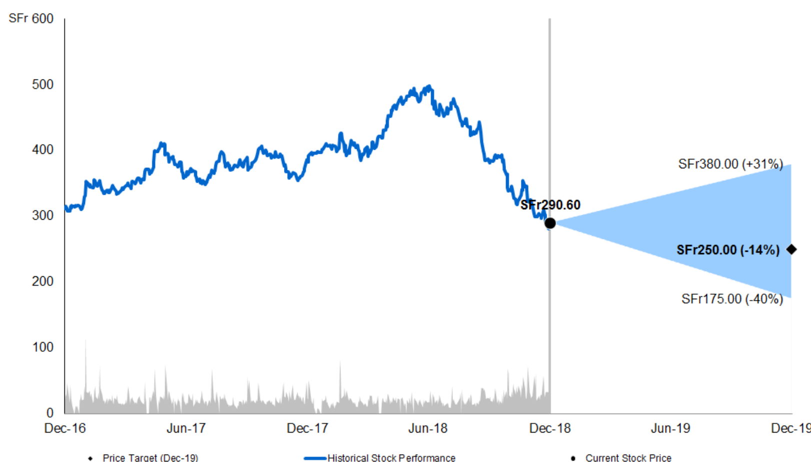
Exhibit 56: Adj. operating profit forecasts for the online distributors division at Richemont



Source: Company disclosures, e = Morgan Stanley Research estimates

Swatch (Underweight, PT SFr 250) - Risk Reward

Risk/reward profile skewed to the downside



Source: Thomson Reuters consensus (historical share price data), Morgan Stanley Research estimates

Price Target **SFr 250 (was SFr 375)**

We use a DCF derived valuation methodology to better reflect margin potential and cash flow generation. We assume a WACC of 8.3% and long-term growth rate of 2.5%.

Bull **SFr 380 (was SFr 500)**

22.1x base case 2019e EPS

Growth returns in the watch segment with higher than expected pricing power, recovery in the third-party movements business. At Swatch, we assume an 8% sales CAGR over 2018-21 and an operating margin of 20% in 2022.

Base **SFr 250 (was SFr 375)**

14.5x base case 2019e EPS

We assume progressive normalisation in the top line and no margin progression. With slowing demand from Chinese consumers and increasing competition from wearables, we see organic growth progressively slowing down to 3% by FY20. Due to a subdued top line growth, we see EBIT margins remaining stable around 14% in the medium term.

Bear **SFr 175 (was SFr 200)**

10.2x base case 2019e EPS

Watch volumes further contract and no pricing power; little cost action taken to support profit. We assume a material slowdown in demand from Chinese consumers, and that raw material costs such as gold/gem stones rise sharply on the backdrop of a downturn in the global economy. In this scenario, sell-out disappoints, as we see a negative sales CAGR in 2018-22e and EBIT margin falling back to 10% by 2022e (comparable to FY16).

Investment Thesis

- **We downgrade Swatch to Underweight.** Despite the recent sell-off, our confidence levels remain low as a result of 1) lack of conservatism in its inventory write-down policy, with a lack of visibility ahead, 2) intensifying competition from wearables, and 3) signs of a potential slowdown in China.
- **Chinese nationals account for c.50% of sales.** Swatch Group is the company in European Luxury that is most exposed to Chinese nationals. With China retail sales growth having moderated in recent months. Given the subdued top line trajectory, we have lowered our expectations for margin progression. We now see the EBIT margin staying flat at around 14% over the medium term (Comparable to FY17 level).
- **Risk reward profile skewed to the downside.** The current share price is implying a 1-year forward P/E of 17x, broadly in line with its historical average. We see further downside ahead given the amount of uncertainty in the current market environment in relation to the trade tensions, FX rates, inventory levels, and consumer sentiment in Greater China.

Risks to Achieving Price Target

- We believe that the three greatest sources of upside risks are a) smartwatches impacting Swiss watch sales less than anticipated, particularly the low end segment (Swatch has a market share of ~70% in the 'below CHF 200' category; b) Swatch Group proactively addresses grey market trading leading to improved brand equity and a higher pricing power, c) FX/macro (e.g. the Chinese Yuan appreciating vs. the USD and/or consumer spending visibly improves.

Swatch: Earnings model and valuation methodology

We cut our EPS in FY18e to FY21e cycle by -17% on average, bringing us on average -16% below consensus. We downgrade to an Underweight rating, and we lower our PT from CHF 375 to CHF 250, which implies over 10% downside.

The table below summarizes our sales and earnings estimates up to FY 2023. Swatch has a market share of close to 29% in value terms and close to 70% in volume terms of Swiss watch export. For the FY18 (ending Dec-2018), we model a group organic growth of +7.3%, which we expect to normalise to low single-digit range from 2019 onwards. We model a mid single digit decline in EBIT in FY19 after two successive years of 25%, growth which we expect to recover from FY20 to mid single digit increase. The deceleration is largely a function of operating deleverage at Watches & Jewellery segment (ex- Harry Winston) leading to ~80bps margin contraction in overall division in FY19.

For FY19-23, we expect the top line to grow +2.3% CAGR (supported by an estimated similar growth in total Swiss industry watch export over the period; this compares with a +5.2% CAGR over the 15 years to 2017). We model Group operating margin growing from 13.8% in FY19 to 14.5% by FY23, i.e. more or less in line with the FY18 level.

Exhibit 57: Swatch: Key estimates table since 1H 16

	1H 16	2H 16	FY 16	1H 17	2H 17	FY 17	1H 18e	2H 18e	FY 18e	FY 19e	FY 20e	FY 21e	FY 22e	FY 23e
Net Sales	**3,716**	**3,837**	**7,553**	**3,705**	**4,255**	**7,960**	**4,266**	**4,427**	**8,693**	**8,751**	**9,071**	**9,353**	**9,556**	**9,755**
% change	**-11.4%**	**-9.9%**	**-10.6%**	**-0.3%**	**+10.9%**	**+5.4%**	**+14.7%**	**+4.0%**	**+9.2%**	**+0.7%**	**+3.7%**	**+3.1%**	**+2.2%**	**+2.1%**
o/w Watches & Jewelry	3,586	3,719	7,305	3,576	4,126	7,702	4,136	4,288	8,424	8,474	8,786	9,059	9,253	9,443
% change	-11.3%	-10.0%	-10.7%	-0.3%	+10.9%	+5.4%	+15.7%	+3.9%	+9.4%	+0.6%	+3.7%	+3.1%	+2.1%	+2.1%
% comparable change	-	-	-11.6%	+2.9%	+11.7%	+7.3%	+12.5%	+3.1%	+7.4%	+2.5%	+3.1%	+3.0%	+2.0%	+1.9%
EBITDA	565	677	1,242	601	877	1,478	867	913	1,780	1,731	1,831	1,912	1,958	2,005
margin %	15.2%	17.6%	16.4%	16.2%	20.6%	18.6%	20.3%	20.6%	20.5%	19.8%	20.2%	20.4%	20.5%	20.6%
% change	-40.7%	-24.9%	-33.0%	+6.4%	+29.5%	+19.0%	+44.3%	+4.1%	+20.4%	-2.8%	+5.8%	+4.4%	+2.4%	+2.4%
EBIT	**353**	**452**	**805**	**371**	**631**	**1,002**	**629**	**630**	**1,259**	**1,204**	**1,283**	**1,345**	**1,379**	**1,414**
margin %	**9.5%**	**11.8%**	**10.7%**	**10.0%**	**14.8%**	**12.6%**	**14.7%**	**14.2%**	**14.5%**	**13.8%**	**14.1%**	**14.4%**	**14.4%**	**14.5%**
% change	-53.6%	-34.5%	-44.5%	+5.1%	+39.6%	+24.5%	+69.5%	-0.2%	+25.6%	-4.3%	+6.6%	+4.8%	+2.6%	+2.5%
o/w Watches & Jewelry	402	492	894	422	682	1,104	685	675	1,360	1,297	1,371	1,429	1,458	1,487
margin %	11.2%	13.2%	12.2%	11.8%	16.5%	14.3%	16.6%	15.7%	16.1%	15.3%	15.6%	15.8%	15.8%	15.7%
% change	-50.2%	-32.8%	-41.9%	+5.0%	+38.6%	+23.5%	+62.3%	-1.1%	+23.1%	-4.6%	+5.7%	+4.2%	+2.0%	+2.0%
Net Financial expense & others	-5	-23	-28	2	3	5	-12	18	6	8	16	18	21	23
PBT	348	429	777	373	634	1,007	617	648	1,265	1,212	1,300	1,364	1,400	1,436
margin %	9.4%	11.2%	10.3%	10.1%	14.9%	12.7%	14.5%	14.6%	14.6%	13.9%	14.3%	14.6%	14.7%	14.7%
Tax	-85	-99	-184	-92	-160	-252	-149	-148	-297	-285	-305	-320	-329	-338
Net Income	263	330	593	281	474	755	468	500	968	927	994	1,043	1,071	1,099
margin %	7.1%	8.6%	7.9%	7.6%	11.1%	9.5%	11.0%	11.3%	11.1%	10.6%	11.0%	11.2%	11.2%	11.3%
% change	-52.0%	-42.2%	-47.0%	+6.8%	+43.6%	+27.3%	+66.5%	+5.4%	+28.2%	-4.2%	+7.2%	+4.9%	+2.7%	+2.6%
Diluted EPS, Bearer	**4.67**	**6.00**	**10.68**	**5.07**	**8.76**	**13.84**	**8.69**	**9.30**	**18.07**	**17.28**	**18.54**	**19.45**	**19.96**	**20.46**
% change	**-51.8%**	**-42.1%**	**-46.7%**	**+8.6%**	**+45.9%**	**+29.6%**	**+71.6%**	**+6.2%**	**+30.6%**	**-4.4%**	**+7.3%**	**+4.9%**	**+2.6%**	**+2.5%**
DPS, Bearer	-	-	6.75	-	-	7.50	-	-	7.73	7.78	8.34	8.75	8.98	9.21

Source: Company data, Morgan Stanley Research estimates (e)

In the two tables below, we contrast our current vs. previous estimates and consensus expectations (Thomson Reuters). Compared to our previous estimates, we have lowered our sales estimates by -1% in FY18 and -3% on average across FY19-21e. At the EBIT level, we cut our estimates by -7% in FY18 and -20% on average across FY19-21e. Compared to consensus, we are broadly in line on sales, but -5% lower on EBIT in FY18e, as we expect a +7% increase in opex, partly driven by unfavourable FX movements. In FY19-21e, we are on average ~6% below on sales and on average -21% lower on EBIT,

which is mainly a reflection operational deleverage and continued pressure on labour costs. Overall, we expect opex to increase by around 3% p.a. from FY19-21e.

Exhibit 58: Swatch: Current vs. Previous estimates

MS est. Current	2018e	2019e	2020e	2021e
Net Sales	8,693	8,751	9,071	9,353
EBIT	1,259	1,204	1,283	1,345
margin %	14.5%	13.8%	14.1%	14.4%
PBT	1,265	1,212	1,300	1,364
EPS	18.1	17.3	18.5	19.4
DPS	7.7	7.8	8.3	8.8
Capex	555	559	579	597

Current vs. Previous	2018e	2019e	2020e	2021e
Net Sales	-1.3%	-2.9%	-2.7%	-2.7%
EBIT	-6.5%	-20.1%	-20.2%	-20.0%
margin %	-	-	-	-
PBT	-6.5%	-20.0%	-20.0%	-19.8%
EPS	-6.7%	-20.4%	-20.4%	-20.2%
DPS	0.0%	-20.4%	-20.4%	-20.2%
Capex	-1.3%	-2.9%	-2.7%	-2.7%

MS est. Previous	2018e	2019e	2020e	2020e
Net Sales	8,804	9,014	9,319	9,612
EBIT	1,347	1,507	1,609	1,681
margin %	15.3%	16.7%	17.3%	17.5%
PBT	1,353	1,515	1,625	1,699
EPS	19.4	21.7	23.3	24.4
DPS	7.7	9.8	10.5	11.0
Capex	562	576	595	614

Source: Morgan Stanley research estimates
Note: Previous estimates as on Oct 19 2018
Source

Exhibit 59: Swatch: Morgan Stanley vs. Consensus

MS est.	2018e	2019e	2020e	2021e
Net Sales	8,693	8,751	9,071	9,353
EBIT	1,259	1,204	1,283	1,345
margin %	14.5%	13.8%	14.1%	14.4%
PBT	1,265	1,212	1,300	1,364
EPS	18.1	17.3	18.5	19.4
DPS	7.7	7.8	8.3	8.8
Net Debt (Cash)	-798	-1,075	-1,247	-305
Capex	555	559	579	597

MS vs. Cons.	2018e	2019e	2020e
Net Sales	0.0%	-3.5%	-5.0%
EBIT	-4.9%	-17.2%	-20.9%
margin %	-	-	-
PBT	-3.7%	-16.4%	-20.2%
EPS	-3.3%	-17.8%	-22.2%
DPS	-7.6%	-14.2%	-17.6%
Net Debt (Cash)	-46.9%	-41.9%	-46.7%
Capex	8.3%	3.4%	3.9%

Consensus	2018e	2019e	2020e	2021e
Net Sales	8,696	9,068	9,551	10,215
EBIT	1,323	1,454	1,622	1,777
margin %	15.2%	16.0%	17.0%	17.4%
PBT	1,313	1,450	1,629	1,774
EPS	18.7	21.0	23.8	24.6
DPS	8.4	9.1	10.1	11.0
Net Debt (Cash)	-1,501	-1,850	-2,338	-2,711
Capex	513	540	557	578

Source: Morgan Stanley Research estimates. Consensus from Thomson as on Dec 11 2018

Our DCF-implied PT is €250 (vs. €375 before). Below, we set out our assumptions for our DCF.

1. Six years of explicit forecast (2018e to 2023e).

2. The long-term sales growth gradually decelerating to +2% in year 10 while EBIT margins reach 16.5%.

3. Capex-to-sales ratio of 7.1% by year 10 and Capex/Depreciation ratio reaching 1.17x.

4. Terminal growth rate of 2.5% and a 8.3% WACC (based on a 8.3% cost of equity using a beta of 1.1 and on a 3.0% pre-tax cost of debt), unchanged vs. our last DCF.

5. We have further increased the average inventory days across FY18-23e from 1,331 to 1,671 on expected inventory build-up as the reduced sales outlook will make it more difficult to keep sell-in lower than sell-out.

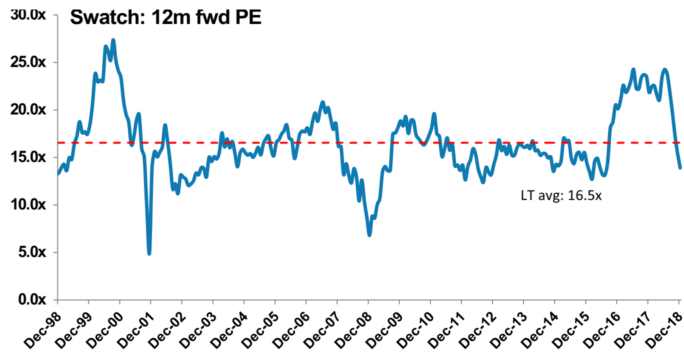
The main changes to driving a decrease from CHF 375 to 250 in our DCF model relate to: 1) more conservative forecast of inventory build-up which explains about two-thirds of the change in the PT and 2) lowered near-term sales growth and EBIT margin progression on the back of the declining sentiment in Greater China, as reflected by the latest commentary by the HK based watch retailers which together contributes the remaining one-third of the change in the DCF.

Exhibit 60: Swatch: DCF valuation

Key Assumptions											
WACC	8.3%										
Terminal Growth Rate	2.5%										
DCF											
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Year 9**	**Year 10**	**TV**
Year ending June 30th	**2018e**	**2019e**	**2020e**	**2021e**	**2022e**	**2023e**	**2024e**	**2025e**	**2026e**	**2027e**	
Sales	8,693	8,751	9,071	9,353	9,556	9,755	9,957	10,162	10,369	10,578	
Sales growth (%)	*+9.2%*	*+0.7%*	*+3.7%*	*+3.1%*	*+2.2%*	*+2.1%*	*+2.1%*	*+2.1%*	*+2.0%*	*+2.0%*	**+2.0%**
EBIT	1,259	1,204	1,283	1,345	1,379	1,414	1,493	1,574	1,659	1,745	
EBIT as % of sales	*14.5%*	*13.8%*	*14.1%*	*14.4%*	*14.4%*	*14.5%*	*15.0%*	*15.5%*	*16.0%*	*16.5%*	**17.0%**
Tax Rate	*23.5%*	*23.5%*	*23.5%*	*23.5%*	*23.5%*	*23.5%*	*23.5%*	*23.5%*	*23.5%*	*23.5%*	**23.5%**
Tax	296	283	302	316	324	332	351	370	390	410	
Profit after tax	963	921	982	1,029	1,055	1,081	1,142	1,204	1,269	1,335	
Depreciation and amortisation	522	527	548	567	579	591	603	616	628	641	
Change in Working Capital	-962	-76	-335	-1,476	-284	-241	-246	-251	-256	-261	
Capital Expenditure	-555	-559	-579	-597	-610	-623	-649	-678	-713	-749	
Asset Disposals/Other	0	0	0	0	0	0	0	0	0	0	
Free Cash Flow	**-33**	**813**	**616**	**-478**	**740**	**809**	**851**	**891**	**928**	**966**	**17,111**
Discount factor	0.996	0.920	0.849	0.785	0.725	0.669	0.618	0.571	0.528	0.487	0.487
Present Value of Cash Flows	-32	748	523	-375	536	541	526	509	490	471	8,338
Enterprise Value	12,274										
EV Adjustments	796										
Market Value	13,071										
Implied Value per Share (CHF)	**250**										

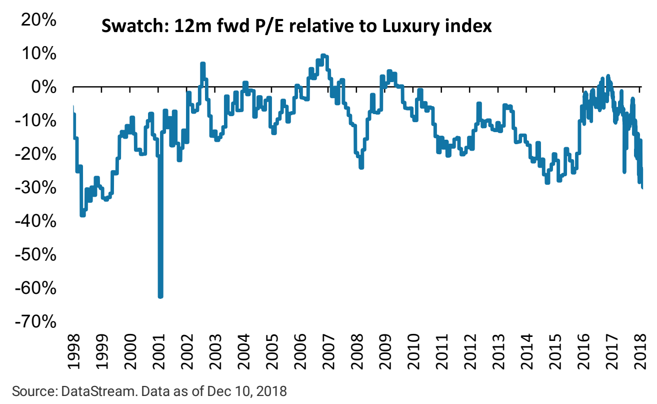
Source: Morgan Stanley Research estimates (e)

Exhibit 61: Swatch: 12m fwd PE



Source: DataStream. Data as of Dec 10, 2018

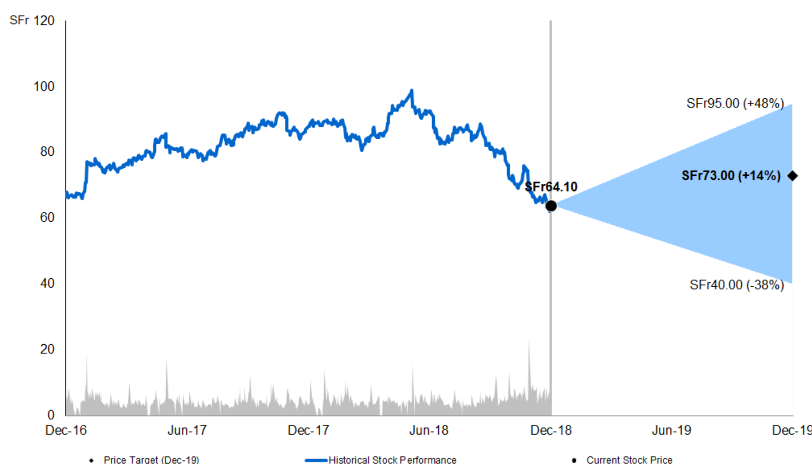
Exhibit 62: Swatch: 12m fwd PE relative



Source: DataStream. Data as of Dec 10, 2018

Richemont (Equal-weight, PT SFr 73) - Risk Reward

Balanced risk/reward profile



Source: Thomson Reuters (historical share price data), Morgan Stanley Research estimates

Price Target **SFr 73 (from 83)/ ZAc 10,620**

We use a DCF derived valuation methodology to better reflect margin potential and cashflow generation. We assume a WACC of 8.0% and a LT growth rate to 2.5% in line with hard luxury peer Swatch.

Bull **SFr 95 (from 110)/ ZAc 13,790**

25.4x March 2020e Base Case EPS

Jewellery Maison outperforms, margins nearly at FY12/13 peak. Jewellery Maison sales grow at a 9.0% CAGR for the next five years, to €10.8bn of sales by FY23e. Margins expand by +60bps on an average per year over the period to reach 33% in FY23e, a level that is near the FY12/13 level at 34-35%.

Base **SFr 73 (from 83)/ ZAc 10,620**

19.2x March 2020e Base Case EPS

Jewellery Maison delivering operating profit growth at a 6.5% CAGR in FY2019-23. We forecast Jewellery Maison sales to grow at a +6% CAGR over this period to €8.6bn in FY23e. Despite the top line growth, we expect margins to remain broadly stable at around 30% in FY19-23 due to the on-going investments in store remodelings and communication at Cartier.

Bear **SFr 40 (from 45)/ ZAc 5,780**

10.7x March 2020e Base Case EPS

Jewellery Maison sales decline leading to further margin contraction. We model flattish Jewellery Maison sales across FY19-23e. Jewellery Maison margins contracts by -100 bps on average per year across FY19-23e to reach a low of 24%, a level last seen in FY07.

Investment Thesis

- **Downgrade Richemont to Equal-weight.** This is mainly a reflection of 1) the recent signs of a potential slowdown in demand from Chinese consumers, on the back of the latest commentary on current trading by the HK based jewellery retailers, 2) intensifying competition from wearables, which is set affect the growth outlook of the specialist watchmakers division and 3) DTC transition related disruption. Moving to the sidelines.
- **We lower our forecasts and PT...** Given Richemont has a material exposure to Chinese nationals (we est 40% exposure to Chinese nationals for the Group) we reduce our PT by -12% to SFr 73 (from SFr 83). This implies +14% upside vs. the current share price, and our price target implies FY20e P/E of 19.2x.
- **...But we still see upside for Cartier.** Cartier's recent performance has been lacklustre relative to Bulgari (LVMH). But under CEO Vigneron (appointed Jan-16), Cartier has refocused its watch offering on the brand's natural territory – away from high-end complications into elegant, more feminine watches. It has rationalised the assortment of some lines, improved price coherence and relaunched some iconic models. Fundamentally, we believe the brand is in a better shape today than three years ago, and we are encouraged to see sell-in is now in line with sell-out.

Risks to Achieving Price Target

- A material slowdown in China presents the biggest risk to Richemont (c. 40% exposure to Chinese nationals) as well as to the entire luxury sector.
- Continued deterioration in watch segment beyond FY18 (with no bottom in the cycle); structural weakness in historically more resilient jewellery category might put further pressure on earnings.
- If our assumption of an efficiency focus fails to materialise this would likely result in EPS pressure.
- Rapid move to grey-market platform disrupting the industry significantly.

Richemont: Earnings model and valuation methodology

We cut our EPS in FY19e to FY21e cycle by -7% on average, bringing us a touch below consensus on average in FY19-21e. We are downgrading to Equal-weight, as we lower our PT from CHF 83 to CHF 73, which implies an +14% upside.

The table below summarises our sales and earnings estimates up to FY23. For the FY19e (ending Mar-2019), we model organic growth of +9% for Jewellery Maison and +3% for the specialist watchmakers. We model a +15% YoY increase in adj. EBIT in FY19e on the back of +10% growth last year. Despite this, we see a -170bps EBIT margin contraction to 17.0% for the group, due to the continued investments into store remodellings and communication, in particular in Jewellery Maisons.

In FY20-23e, we expect the top line to grow at a +5% CAGR (supported by an estimated +3% CAGR growth of total Swiss industry watch export over the period. We model Group operating margin stabilizing around 16.5-17.5% in FY20-23e, which is broadly in line with the 17% margin that we model for FY19e at the group level.

The table below summarises our adjusted EBIT margin estimates for the Group, Jewellery Maisons and Specialist Watchmakers up until 2023e.

Exhibit 63: Richemont: Key estimates table since 1H 16

	1H 17	2H 17	FY 17	1H 18	2H 18	FY 18	1H 19	2H 19e	FY 19e	FY 20e	FY 21e	FY 22e	FY 23e
Net Sales	**5,086**	**5,561**	**10,647**	**5,605**	**5,374**	**10,979**	**6,808**	**7,159**	**13,967**	**14,796**	**15,456**	**16,222**	**17,184**
% change	**-12.6%**	**+5.8%**	**-3.9%**	**+10.2%**	**-3.4%**	**+3.1%**	**+21.5%**	**+33.2%**	**+27.2%**	**+5.9%**	**+4.5%**	**+5.0%**	**+5.9%**
o/w Jewellery Maisons	2,755	3,172	5,927	3,163	3,284	6,447	3,454	3,595	7,049	7,330	7,623	8,005	8,565
% change, constant FX	-12.0%	+8.0%	-2.0%	+17.0%	+11.0%	+14.0%	+12.0%	+6.0%	+9.0%	+3.0%	+4.0%	+5.0%	+7.0%
o/w Specialist Watchmakers	1,445	1,434	2,879	1,527	1,187	2,714	1,550	1,422	2,972	3,060	3,152	3,263	3,393
% change, constant FX	-17.0%	-5.0%	-11.0%	+7.0%	-11.0%	-2.0%	+4.0%	+2.0%	+3.0%	+2.0%	+3.0%	+3.5%	+4.0%
o/w Online Distributors	-	-	-	-	-	-	893	1,225	2,118	2,495	2,694	2,910	3,143
% change, constant FX	-	-	-	-	-	-	*+10.5%*	+10.1%	+10.3%	+8.0%	+8.0%	+8.0%	+8.0%
Gross profit	3,230	3,569	6,799	3,665	3,485	7,150	4,256	4,986	9,242	9,890	10,332	10,844	11,487
margin %	63.5%	64.2%	63.9%	65.4%	64.8%	65.1%	62.5%	69.6%	66.2%	66.8%	66.8%	66.8%	66.8%
% change	-14.7%	+7.1%	-4.5%	+13.5%	-2.4%	+5.2%	+19.2%	+43.1%	+29.3%	+7.0%	+4.5%	+5.0%	+5.9%
EBITDA	1,317	1,117	2,434	1,431	1,160	2,591	1,698	1,349	3,047	3,179	3,328	3,526	3,824
margin %	25.9%	20.1%	22.9%	25.5%	21.6%	23.6%	24.9%	18.8%	21.8%	21.5%	21.5%	21.7%	22.3%
% change	-20.3%	+6.7%	-9.8%	+8.7%	+3.8%	+6.5%	+18.7%	+16.3%	+17.6%	+4.3%	+4.7%	+5.9%	+8.5%
Reported EBIT	798	966	1,764	1,166	678	1,844	1,130	957	2,087	2,292	2,420	2,610	2,883
margin %	15.7%	17.4%	16.6%	20.8%	12.6%	16.8%	16.6%	13.4%	14.9%	15.5%	15.7%	16.1%	16.8%
% change	-42.6%	+44.0%	-14.4%	+46.1%	-29.8%	+4.5%	-3.1%	+41.1%	+13.2%	+9.8%	+5.6%	+7.8%	+10.5%
Adj. EBIT	**1,047**	**826**	**1,873**	**1,166**	**886**	**2,052**	**1,314**	**1,055**	**2,369**	**2,468**	**2,592**	**2,762**	**3,015**
margin %	**20.6%**	**14.9%**	**17.6%**	**20.8%**	**16.5%**	**18.7%**	**19.3%**	**14.7%**	**17.0%**	**16.7%**	**16.8%**	**17.0%**	**17.5%**
% change	-24.7%	+7.6%	-13.2%	+11.4%	+7.3%	+9.6%	+12.7%	+19.0%	+15.4%	+4.2%	+5.1%	+6.5%	+9.2%
o/w Jewellery Maisons	856	977	1,833	981	945	1,926	1,167	1,037	2,204	2,234	2,308	2,439	2,636
margin %	31.1%	30.8%	30.9%	31.0%	28.8%	29.9%	33.8%	28.9%	31.3%	30.5%	30.3%	30.5%	30.8%
% change	-22.3%	+19.9%	-4.3%	+14.6%	-3.3%	+5.1%	+19.0%	+9.8%	+14.5%	+1.3%	+3.3%	+5.7%	+8.1%
o/w Specialist Watchmakers	269	29	298	294	139	433	311	156	467	456	457	463	485
margin %	18.6%	2.0%	10.4%	19.3%	11.7%	16.0%	20.1%	10.9%	15.7%	14.9%	14.5%	14.2%	14.3%
% change	-33.1%	-79.6%	-45.2%	+9.3%	+379.3%	+45.3%	+5.8%	+12.0%	+7.8%	-2.3%	+0.2%	+1.4%	+4.7%
o/w Online Distributors	-	-	-	-	-	-	-33	37	4	89	122	136	153
margin %	-	-	-	-	-	-	-3.7%	3.0%	0.2%	3.6%	4.5%	4.7%	4.9%
% change	-	-	-	-	-	-	-	-	-	+1991.1%	+37.2%	+11.6%	+12.6%
Net Financial expense & others	-119	-75	-194	56	-247	-191	1,361	-66	1,295	-75	-135	-177	-175
PBT	679	891	1,570	1,222	431	1,653	2,491	891	3,382	2,217	2,285	2,432	2,708
margin %	13.4%	16.0%	14.7%	21.8%	8.0%	15.1%	36.6%	12.4%	24.2%	15.0%	14.8%	15.0%	15.8%
Tax	-190	-195	-385	-248	-238	-486	-256	-200	-455	-491	-516	-543	-596
Underlying Net Income	738	556	1,294	974	401	1,375	1,038	789	1,828	1,903	1,941	2,042	2,244
margin %	14.5%	10.0%	12.2%	17.4%	7.5%	12.5%	15.3%	11.0%	13.1%	12.9%	12.6%	12.6%	13.1%
% change	-37.9%	-3.9%	-26.8%	+32.0%	-27.9%	+6.2%	+6.6%	+97.0%	+33.0%	+4.1%	+2.0%	+5.2%	+9.9%
Diluted EPS, underlying	**1.31**	**0.98**	**2.29**	**1.72**	**0.71**	**2.43**	**1.84**	**1.40**	**3.23**	**3.37**	**3.44**	**3.61**	**3.97**
% change	**-38.0%**	**-3.6%**	**-26.7%**	**+31.9%**	**-28.1%**	**+6.1%**	**+6.8%**	**+97.3%**	**+33.2%**	**+4.1%**	**+2.0%**	**+5.2%**	**+9.9%**
DPS, Bearer	-	-	1.66	-	-	1.67	-	-	1.91	1.92	1.96	2.06	2.26

Source: Company data, Morgan Stanley Research estimates (e)

In the two tables below, we contrast our current estimates vs. our previous estimates and vs. consensus expectations (Thomson Reuters). We cut our earnings estimates for FY19e to FY21e (EPS down by 7% on average). Compared to consensus, we are ~7%

above in FY19, but on average -5% lower in FY20-21e, although we note that our figures are adjusted whereas consensus is reported.

Exhibit 64: Richemont: Current vs. Previous estimates

MS est. Current	2019e	2020e	2021e
Net Sales	13,967	14,796	15,456
EBIT	2,369	2,468	2,592
margin %	17.0%	16.7%	16.8%
PBT	2,283	2,393	2,457
Net Profit	1,828	1,903	1,941
EPS	3.2	3.4	3.4
DPS	1.9	1.9	2.0
Net Debt (Cash)	-4,725	-4,935	-5,193
Capex	838	888	927

MS est. Previous	2019e	2020e	2021e
Net Sales	14,199	15,282	16,002
EBIT	2,439	2,676	2,832
margin %	17.2%	17.5%	17.7%
PBT	2,377	2,628	2,724
Net Profit	1,878	2,090	2,152
EPS	3.32	3.69	3.80
DPS	2.0	2.1	2.2
Net Debt (Cash)	-5,120	-5,833	-6,627
Capex	852	917	960

Current vs. Previous	2019e	2020e	2021e
Net Sales	-1.6%	-3.2%	-3.4%
EBIT	-2.9%	-7.8%	-8.5%
margin %	-	-	-
PBT	-4.0%	-9.0%	-9.8%
Net Profit	-2.7%	-9.0%	-9.8%
EPS	-2.5%	-8.8%	-9.7%
DPS	-2.5%	-8.8%	-9.7%
Net Debt (Cash)	-7.7%	-15.4%	-21.6%
Capex	-1.6%	-3.2%	-3.4%

Source: Morgan Stanley research estimates
Note: Previous estimates as on Oct 18 2018

Exhibit 65: Richemont: Morgan Stanley vs. Consensus

MS est.	2019e	2020e	2021e
Net Sales	13,967	14,796	15,456
Adj. EBIT	2,369	2,468	2,592
margin %	17.0%	16.7%	16.8%
Net Profit	1,828	1,903	1,941
EPS	3.2	3.4	3.4
DPS	1.9	1.9	2.0

Consensus	2019e	2020e	2021e
Net Sales	13,998	15,070	16,105
EBIT	2,210	2,548	2,798
margin %	15.8%	16.9%	17.4%
Net Profit	1,736	1,911	2,174
EPS	3.1	3.4	3.8
DPS	1.8	2.0	2.2

MS vs. Cons.	2019e	2020e	2021e
Net Sales	-0.2%	-1.8%	-4.0%
EBIT	7.2%	-3.2%	-7.3%
margin %	-	-	-
Net Profit	5.3%	-0.4%	-10.7%
EPS	5.2%	-1.5%	-10.5%
DPS	4.3%	-4.0%	-9.3%

Source: Morgan Stanley Research estimates. Consensus from Thomson as on Dec 12 2018

We are lowering our DCF-implied PT from CHF 83 to CHF 73. Below, we set out our assumptions for our DCF.

1. Five years of explicit forecast (2019e to 2023e).

2. Revenue growth gradually decelerating to +3.1% in year 10 while EBIT margins reach 18%.

3. Capex-to-sales ratio of 6.8% by year 10 and Capex/Depreciation ratio reaching 1.4x.

4. Terminal growth rate of 2.5% and a 8.0% WACC (based on a 9.0% cost of equity using a beta of 1.2 and on a 4.0% pre-tax cost of debt).

The main changes to driving a decrease from CHF 83 to 73 in our DCF model relate to: 1) more conservative forecast of change in net working capital explaining most of the change in the DCF based PT and 2) lowered near-term sales growth and EBIT margin progression on the back of the declining sentiment in Greater China, as reflected by the latest commentary by the HK based watch and jewellery retailers.

Exhibit 66: Richemont: DCF valuation

DCF (In EUR)

Key Assumptions

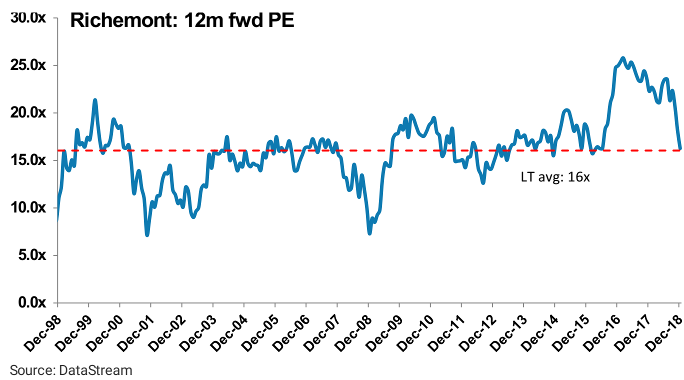
WACC	8.0%
Terminal Growth Rate	2.5%

DCF

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	TV
Year ending June 30th	**2019e**	**2020e**	**2021e**	**2022e**	**2023e**	**2024e**	**2025e**	**2026e**	**2027e**	**2028e**	
Sales	13,967	14,796	15,456	16,222	17,184	18,106	18,973	19,773	20,494	21,124	
Sales growth (%)	*+27.2%*	*+5.9%*	*+4.5%*	*+5.0%*	*+5.9%*	*+5.4%*	*+4.8%*	*+4.2%*	*+3.6%*	*+3.1%*	***+2.5%***
EBIT	2,369	2,468	2,592	2,762	3,015	3,190	3,357	3,514	3,658	3,786	
EBIT as % of sales	*17.0%*	*16.7%*	*16.8%*	*17.0%*	*17.5%*	*17.6%*	*17.7%*	*17.8%*	*17.8%*	*17.9%*	**18.0%**
Tax Rate	*19.9%*	*20.5%*	*21.0%*	*21.0%*	*21.0%*	*21.0%*	*21.0%*	*21.0%*	*21.0%*	*21.0%*	***21.0%***
Tax	472	506	544	580	633	670	705	738	768	795	
Profit after tax	1,896	1,962	2,048	2,182	2,382	2,520	2,652	2,776	2,890	2,991	
Depreciation and amortisation	679	712	736	764	809	853	894	931	965	995	
Change in Working Capital	-1,007	-255	-276	-319	-397	-397	-395	-391	-385	-377	
Capital Expenditure	-838	-888	-927	-973	-1,031	-1,086	-1,173	-1,259	-1,344	-1,427	
Asset Disposals/Other	0	0	0	0	0	0	0	0	0	0	
Free Cash Flow	**730**	**1,530**	**1,580**	**1,654**	**1,763**	**1,890**	**1,978**	**2,057**	**2,126**	**2,182**	**40,800**
Discount factor	0.978	0.905	0.838	0.776	0.719	0.666	0.617	0.571	0.529	0.490	0.490
Present Value of Cash Flows	714	1,385	1,325	1,284	1,268	1,258	1,220	1,175	1,124	1,069	19,981
Enterprise Value	31,802										
EV Adjustments	4,689										
Market Value	36,491										
Implied Value per Share (CHF)	**73**										

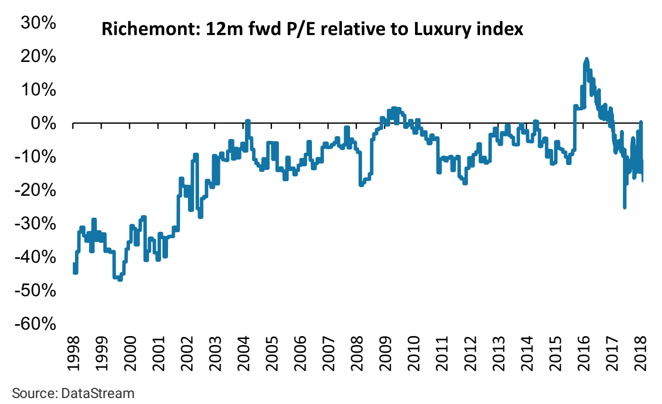
Source: Morgan Stanley Research estimates (e)

Exhibit 67: Richemont: 12m fwd PE



Source: DataStream

Exhibit 68: Richemont: 12m fwd PE relative



Source: DataStream

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STOCK RATING CATEGORY	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MISC
Overweight/Buy	**1156**	**37%**	**295**	**40%**	**26%**	**541**	**38%**
Equal-weight/Hold	**1405**	**44%**	**342**	**47%**	**24%**	**641**	**45%**
Not-Rated/Hold	**46**	**1%**	**7**	**1%**	**15%**	**7**	**0%**
Underweight/Sell	**555**	**18%**	**85**	**12%**	**15%**	**226**	**16%**
TOTAL	**3,162**		**729**			**1415**	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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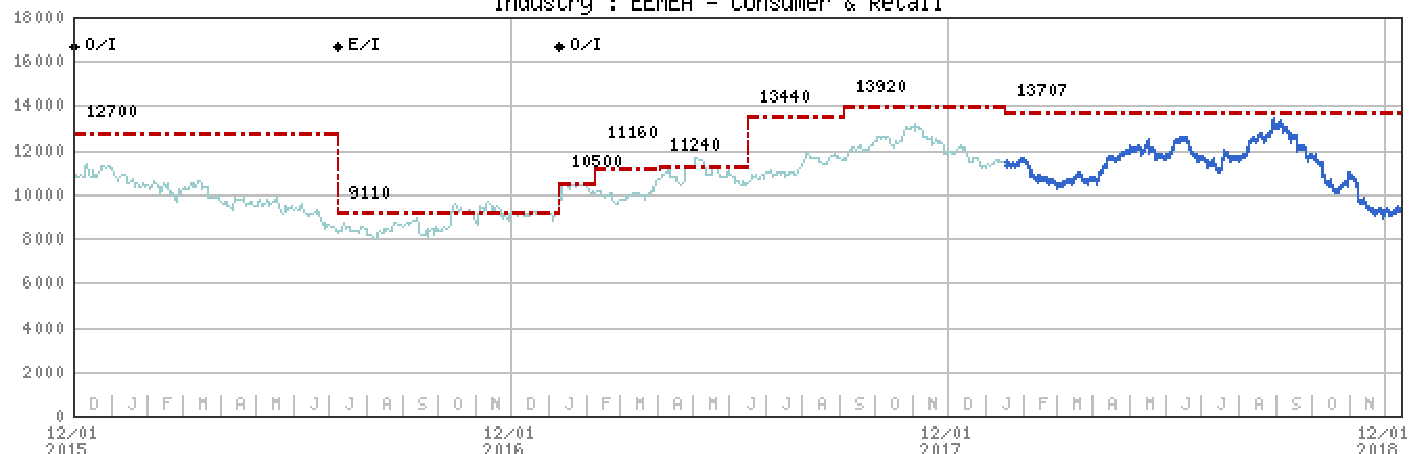
Stock Price, Price Target and Rating History (See Rating Definitions)



Stock Rating History: 12/1/15 : O/I; 7/8/16 : E/I; 1/10/17 : O/I

Price Target History: 11/16/15 : 12700; 7/8/16 : 9110; 1/10/17 : 10500; 2/8/17 : 11160; 4/3/17 : 11240; 6/16/17 : 13440; 9/5/17 : 13920; 1/17/18 : 13707

Source: Morgan Stanley Research   Date Format : MM/DD/YY   Price Target --   No Price Target Assigned (NA)

Stock Price (Not Covered by Current Analyst) ——   Stock Price (Covered by Current Analyst) ——

Stock and Industry Ratings (abbreviations below) appear as ♦ Stock Rating/Industry View

Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) No Rating Available (NA)

Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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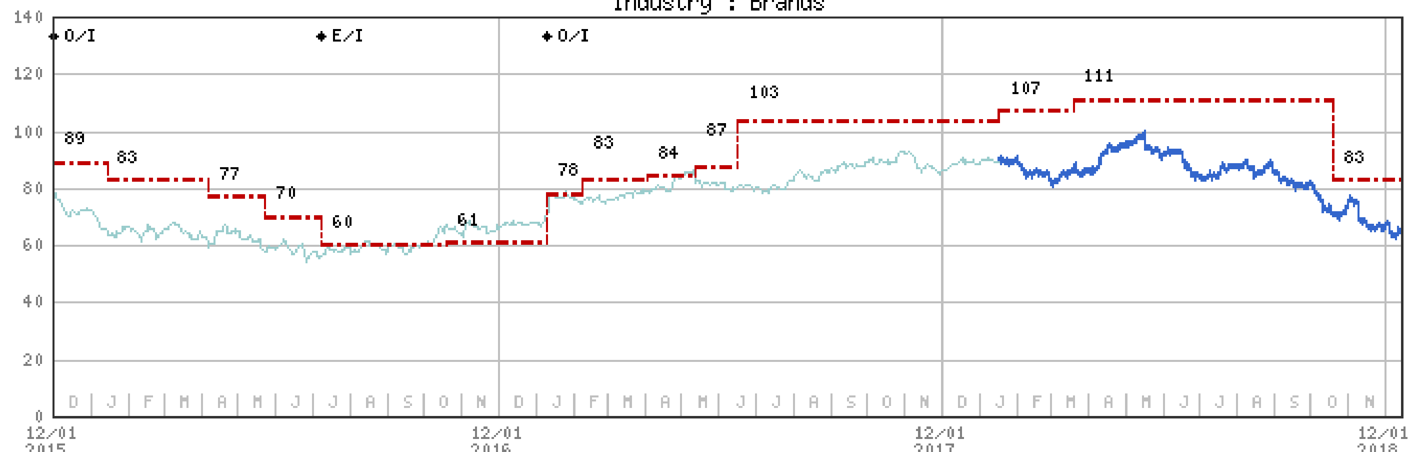
Richemont SA (CFR.S) - As of 12/13/18 in CHF
Industry : Brands



Stock Rating History: 12/1/15 : O/I; 7/8/16 : E/I; 1/10/17 : O/I

Price Target History: 11/16/15 : 89; 1/14/16 : 83; 4/7/16 : 77; 5/23/16 : 70; 7/8/16 : 60; 10/20/16 : 61; 1/10/17 : 78; 2/8/17 : 83; 4/3/17 : 84; 5/12/17 : 87; 6/16/17 : 103; 1/17/18 : 107; 3/19/18 : 111; 10/19/18 : 83

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target -- No Price Target Assigned (NA)
Stock Price (Not Covered by Current Analyst) — Stock Price (Covered by Current Analyst) —
Stock and Industry Ratings (abbreviations below) appear as ◆ Stock Rating/Industry View
Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) No Rating Available (NA)
Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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Stock Rating History: 12/1/15 : U/I; 1/17/18 : E/I; 3/19/18 : O/I; 10/19/18 : E/I

Price Target History: 11/16/15 : 343; 1/20/16 : 310; 3/18/16 : 300; 7/8/16 : 250; 10/20/16 : 260; 6/16/17 : 323; 9/19/17 : 331; 1/17/18 : 415; 3/19/18 : 475; 5/10/18 : 530; 10/19/18 : 375

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target -- No Price Target Assigned (NA)
Stock Price (Not Covered by Current Analyst) Stock Price (Covered by Current Analyst)
Stock and Industry Ratings (abbreviations below) appear as ◆ Stock Rating/Industry View
Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) No Rating Available (NA)
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INDUSTRY COVERAGE: Brands

COMPANY (TICKER)	RATING (AS OF)	PRICE* (12/14/2018)
Edouard Aubin		
Dufry AG (DUFN.S)	E (02/26/2018)	SFr 95.50
Hermes International S.C.A. (HRMS.PA)	E (08/07/2018)	€485.80
Kering (PRTP.PA)	E (05/19/2017)	€404.40
LVMH Moet Hennessy Louis Vuitton SA (LVMH.PA)	O (01/17/2018)	€251.95
Richemont SA (CFR.S)	E (12/17/2018)	SFr 63.56
Swatch (UHR.S)	U (12/17/2018)	SFr 290.20
Elena Mariani		
Adidas (ADSGn.DE)	E (05/04/2016)	€195.50
Burberry (BRBY.L)	E (10/16/2015)	1,751p
GrandVision NV (GVNV.AS)	E (09/01/2017)	€19.17
Hugo Boss AG (BOSSn.DE)	U (09/19/2017)	€56.88
Luxottica (LUX.MI)	O (06/13/2017)	€51.84
Moncler SpA (MONC.MI)	E (09/19/2017)	€27.55
Pandora A/S (PNDORA.CO)	E (01/25/2018)	DKr 295.70
Prada SpA (1913.HK)	U (09/19/2017)	HK$25.75
Salvatore Ferragamo SpA (SFER.MI)	E (04/29/2015)	€17.99
Tod's SPA (TOD.MI)	U (04/29/2015)	€39.34

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