HollAnd Advisors

Holland Views – Swatch Group – CHF423, MCap: CHF21.5bn

Like Father, Like Son?

Whilst we endeavour to make as much of our research actionable on the date of publication as possible, occasionally we may publish research on a company where the conclusion is still open, as we'd rather the valuation were lower or that we knew a little more.

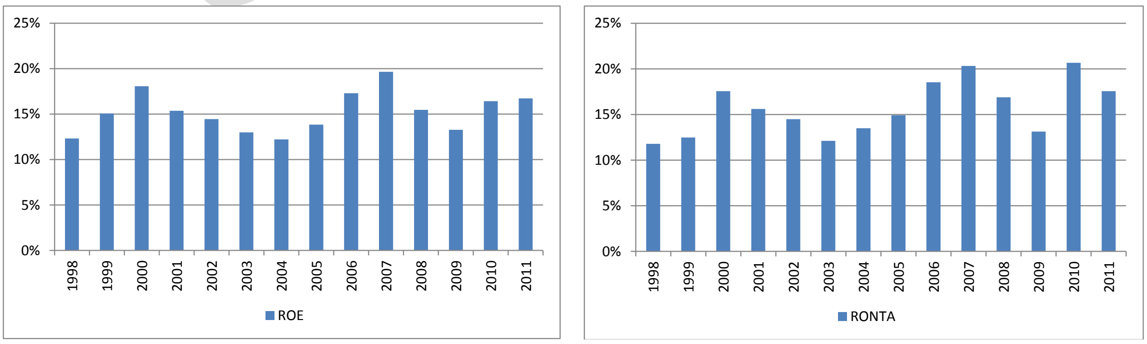
Swiss watch industry bellwether, Swatch Group, has many of the attributes that we seek-out in franchises and we think the business is worthy of your attention. The group's highly unusual combination of scale, engineering excellence and high-end brands was what initially piqued our interest. However, the business does not get our full seal of approval just yet as we wait for further convincing on some areas such as management succession (perhaps our biggest concern), potential downside risk from peak margins and – despite its strong historical returns performance - a possible low emphasis by current management on return on capital.

On close inspection, Swatch looks a very attractive business as it combines a vertically-integrated business model with high barriers to entry, innovation, and boasts a diverse portfolio of high-value global luxury brands. Above all, it has shown in its almost 30 year history that it is a resilient growth business, built largely organically. Such compounding characteristics are always attractive and currently on offer at an EV/EBIT of 11.6x. A reasonable, but not give away price.

Swatch's compelling investment attributes

- Long history of decent (and largely organic) sales growth (+6% compounded since 1990) and returns (15% average ROE since 2002)
- Book value has compounded 11% since 2002
- Has a prudent capital structure with a net cash position of CHF2bn (10% of MCap)
- Thirty-year history of growth, technological and industrial innovation and increasingly, high-end retailing prowess
- In particular, the revitalisation of the Omega brand in the late 1990s – detailed later - epitomises Swatch's culture of innovation leadership
- An "ok" starting-valuation: 15.2x trailing P/E

Fig.1: Swatch Group - a resilient business in the luxury sector



Source: Capital IQ, Holland Advisors

Group background

- Swatch Group is the dominant Swiss watch manufacturer
- The group today is a result of a concerted attempt to revive the Swiss watch industry back in 1983 and was created via the merger of two longstanding (but at the time, declining) Swiss watch businesses (ASUAG and SSIH) brought together by visionary manager Nicolas Hayek. His son Nick now runs the business, post his father's death in 2010
- The group successfully overcame the threat posed by Japanese quartz watches through low-cost manufacturing and a revival of high-end mechanical brands (esp. Omega)
- The group today remains closely-held (41%) by the original 'Hayek pool' of investors
- The business has been largely organically developed with an emphasis on brand redevelopment (Omega is the flagship brand accounting for over 40% of sales) and innovation
- Notably, and somewhat unusually, Swatch group also supplies the broader global watch industry (i.e. its competitors) with parts and fully-assembled watch modules ('movements') and has a quasi-monopoly in this area. However, in a bid to force competitors to share more of the industry's R&D costs, the company is seeking to restructure this arrangement (to allow more discretion in who it supplies) subject to imminent rulings from the Swiss competition authorities

Company financial targets

- **Sales:** Targeting CHF10bn in gross sales within 3-4 years (implying 10% compounded growth)
- **Investment:** Increase own-store sales from 18% currently to 30% in the medium term

Strengths/Operational Excellence

- **Internal Culture:** Swatch enjoys something of a unique business model and company culture, both of which were instilled by founder Nicolas G. Hayek.
    - While the business is typically viewed externally as a luxury-goods business, more notably, it sees itself first-and-foremost as an industrial company
    - Unusually, the business is vertically integrated. For example, the company sources from its in-house electronic production facilities, is a leading innovator in the industry (as shown by its near monopoly in so-called 'balance springs'), owns an array of high-profile brands and has an extensive network of retail outlets
    - It realises the importance (and synergies) of volume and scale to technological innovation and that <u>barriers to entry are (perhaps counter-intuitively) just as high in high-volume engineering as they are in high-end brands</u>. It remains one of the only luxury goods brands to combine both a high and low-end product range (Omega and 'Flik Flak')
- **Brands:** The group has a very strong brand portfolio (Omega, Breguet, Tissot, Longines, Swatch etc.) – a broad mixture of luxury and high-volume brands. These brands represent over 75 % of sales and profits
- **Scale:** The breadth of Swatch Group's intellectual capital is perhaps represented by its 28,000 workforce which is in stark contrast to LVMH's Watch & Jewellery division which is 1/10th the size at 2,800 (including approx. 500 from the Bulgari watch division recently acquired). This is not to imply that Swatch Group is inefficient – rather that its key competitors are much more asset-light, and in effect more like marketing and design businesses than true watch manufacturers

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