INVESTMENT ANALYSIS OF THE HOUR GLASS

28 August 2016

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Investment Thesis

1. Are the long-term economic characteristics of the business attractive and can they be evaluated with some certainty?

Believe that luxury watch is an evergreen product. Believe that even with brand owners opening their own mono-brand boutiques and the secular trend towards online shopping, retailers still have a role to play.

2. Is management effective, rational, visionary and see itself owing a sense of duty to shareholders?

Management preached and practiced the fundamentals of good retailing. Management has exhibited drive (tempered with rationality) to grow the business. Management has returned reasonable dividends to shareholders.

3. Over an extended period, can the business employ large amounts of incremental capital at very high rates of return?

As a luxury retail business, amid weak consumer sentiment in the past five years, THG managed to earn a decent ROIC of about 14%. Expect that in the next five years, THG would slow down on business expansion and capital deployment. Expect that over time, ROIC could face downwards pressure from competition posed by brand owners' online retail platforms.

4. Is there a margin of safety in the share price?

Based on earnings yield target of 9%, a safe entry price would be S$0.57.

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Demand is highly dependent on consumers feeling confident and wealthy.	▪ During the Asia Financial Crisis, THG suffered a 40% drop in revenue. ▪ In the years leading up to the Global Financial Crisis, luxury industry benefitted greatly from the boom in wealth creation. With the onset of the Global Financial Crisis, Swiss watch exports dropped >20% in the period from Jan09 to Apr09. As countries practice quantitative easing, demand for watches reverted back to pre-crisis levels. ▪ As the global recession prolongs, confidence falters, leading to a slowdown in luxury spending. THG's management is taking the somber view that the high-growth in luxury spending of the last decade has come to an end and is readying for a low-growth market environment.
Mainland Chinese uplifted luxury sales in the past decade.	▪ Estimated that Chinese spending accounted for about 50% of Swiss watch exports in 2011. ▪ China's anti-graft and anti-extravagance campaign has however impacted luxury spending by mainland Chinese. Evidenced by closure of mono-brand boutiques in North Asia. ▪ Chinese shoppers accounted for about 20% of THG's sales in FY2014.
Retailers' competitive position is weak versus brand owners.	▪ Brand owners (especially listed giants: Richemont and Swatch) are pursuing vertical strategies and are opening their own mono-brand boutiques. This trend could threaten the survivability of multi-brand retailers. ▪ Competition among retailers for brand owners' goodwill weakens retailers' competitive position. For example, Cortina opened Singapore's largest Rolex boutique and the world's largest Patek Philippe boutique. ▪ In times of high demand, retailers have to compete for brand owners' production output. ▪ Brands can exact overly-demanding requirements e.g. in-store visibility, retail prices.
Risk that consumers purchase directly from brand owners through brand owners' online retail platforms.	<u>Factors in favour of online watch purchase:</u> ▪ Younger generation will increasingly shop online for a widening range of products. ▪ For brand owners, online shops are a natural extension of their vertical strategies. Customers may visit boutiques to "feel", then buy online from brand owners directly. Online sales allow brand owners to maintain consistent prices and cut out the middleman. ▪ Swatch retails online. <u>Factors in favour of retailers:</u> ▪ Retailers buy in bulk from brand owners and provide an essential platform for customers to feel the physical product. For these two value propositions, retailers are unlikely to be extinct. ▪ Boutiques (vs online stores) provide a VAT-discount advantage to overseas travellers, instant gratification and perhaps some old world charm for the more prestigious watch brands. With these three competitive advantages, retailers may

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	be able to compete effectively against brand owners' online stores—skillful retailing (perceptive taste, site selection, inventory management, customer cultivation) becomes even more important. <u>Assessment</u> ▪ While competition from brand owners' online shops may reduce the profitability of retailers, my bet is that a skillful retailer (which THG is, in my view) will still be able to generate decent economic returns.

2. Is management effective, rational, visionary and see itself owing a sense of duty to shareholders?

Management preached and practiced the fundamentals of good retailing. Management has exhibited drive (tempered with rationality) to grow the business. Management has returned reasonable dividends to shareholders.

Management over the years has steadfastly preached a long-term strategy.

- To out-conceptualise competition.
- To develop people.
- To develop long-term relationships with values-aligned brand owners (especially independently-owned family enterprises).
- To deliver good customer service.
- To pursue value-accretive growth.
- To maintain a conservative capital structure. THG maintained a net cash position and debt-equity ratio of <20% in the last five years.

S$'mn / YE Mar	FY2012	FY2013	FY2014	FY2015	FY2016
Debt	3	41	40	61	63
Equity	304	340	377	422	452
Debt / equity	**1%**	**12%**	**11%**	**14%**	**14%**
Cash	54	80	116	98	94
Net cash	**51**	**39**	**76**	**37**	**31**

Management has exhibited a track record of being high-class merchandisers.

- Opened Malmaison and L'Atelier.
- Secured exclusive licences from Ulysse Nardin and Parmigiani Fleurier for South East Asia.

Management over the years has emphasised on inventory management and efficiency. Historical gross profit margin and inventory turn compare favourably with Cortina.

- Challenge of inventory management: when demand is strong and resulting in limited supply of watches to multi-brand retailers, multi-brand retailers have to pay higher product prices. On the other hand when demand is weak, inventory destocking by multi-brand retailers compresses gross profit margin.
- THG maintained gross profit margin at about 24% in the last five years, about similar with Cortina.
- THG maintained inventory turn at about 2.0x in the last five years, outperforming Cortina's ~1.5x.

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THG					
S$'mn / YE Mar	FY2012	FY2013	FY2014	FY2015	FY2016
Consumer sentiment	Strong	Weak			
Gross profit margin	**24%**	**24%**	**23%**	**23%**	**24%**
COGS	461	458	526	569	540
Stocks	231	266	263	298	320
Inventory turn*	**2.2x**	**1.8x**	**2.0x**	**2.0x**	**1.7x**

*Computed based on average stocks.

Cortina					
S$'mn / YE Mar	FY2012	FY2013	FY2014	FY2015	FY2016
Gross profit margin	**24%**	**23%**	**21%**	**22%**	**23%**
COGS	259	284	326	317	284
Stocks	180	224	217	215	216
Inventory turn*	**1.5x**	**1.4x**	**1.5x**	**1.5x**	**1.3x**

*Computed based on average stocks.

Management has exhibited both drive and rationality to expand and grow the business.

- Expanded watch boutique network from 24 boutiques in FY2008 to 38 boutiques in FY2016.
- Acquired Watches of Switzerland for S$13mn in FY2015.
- Recognised that THG does not have sufficient scale to open boutiques to compete with local players in China. Instead, target Chinese consumers through boutiques in countries further away from China (Australia, Thailand (Phuket) and Japan).

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Watch Boutique Network	FY2008	FY2012	FY2016
Singapore	7	12	18
Malaysia	5	4	8
Thailand	4	3	6
Japan	2	1	1
Hong Kong	1	1	2
Australia	5	3	3
Total	**24**	**24**	**38**

Management has made mistakes.

- Impairment loss in the investment in Gems TV Holdings.
- Shed unsuccessful brands e.g. Gerald Genta, Daniel Roth, Montblanc in Australia, A.Lange & Sohne in Tokyo.
- Jury is still out on whether Laduree franchise is a good investment.

In the context of THG investing for growth and flat profits, management has returned reasonable dividends to shareholders.

- THG's dividend payout hovered around S$14mn (about 25% of net profit) in the last five years. This should be seen in the context where THG was investing for growth and where profit was flat due to weak consumer sentiment. Nonetheless when net profit improved in certain years, THG increased dividend payout.

S$'mn	FY2012	FY2013	FY2014	FY2015	FY2016
Dividends declared	14.1	12.9	14.1	15.5	14.1
Net profit / Div %	55 / 26%	53 / 24%	55 / 26%	58 / 27%	52 / 27%
FCF / Div %	25 / 56%	3 / 430%	53 / 27%	30 / 52%	10 / 141%

3. Over an extended period, can the business employ large amounts of incremental capital at very high rates of return?

As a luxury retail business, amid weak consumer sentiment in the past five years, THG managed to earn a decent ROIC of about 14%. Expect that in the next five years, THG would slow down on business expansion and capital deployment. Expect that over time, ROIC could face downwards pressure from competition posed by brand owners' online retail platforms.

While THG expanded its business scale in the last five years, operating profit was flat due to a weak demand environment.

- Demand turned weak in FY2013, with low confidence in the economy and China's anti-extravagance campaign curtailing Chinese demand for luxury goods. Amid this weak demand environment, THG expanded its watch boutique network from 24 boutiques in FY2012 to 38 boutiques in FY2016, driving revenue growth.
- While revenue grew, operating profit was flat, as COGS and other operating expenses increased by a larger extent. Amid a weak demand environment, THG has not been able to achieve significant operating leverage despite an expansion in the scale of its business.

S$'mn	FY2012	FY2013	FY2014	FY2015	FY2016
Consumer sentiment	Strong	Weak			
Revenue	607	602	683	735	708
Revenue Δ (FY15 vs FY12)	*+21%*				
Other income	5	6	6	6	7
COGS	461	458	526	569	540
COGS Δ (FY15 vs FY12)	*+23%*				
COGS % of revenue	76%	76%	77%	77%	76%
Opex	83	86	95	102	114
Opex Δ (FY15 vs FY12)	*+23%*				
Opex % of revenue	14%	14%	14%	14%	16%
Op profit	68	64	68	70	60
Op profit Δ (FY15 vs FY12)	*+3%*				

THG earned a decent ROIC of about 14% in the last five years. Development of

- ROIC-based on FCF is low, below 10% in four of the last five years. This is due mainly to investment in additional stocks (of which some would be for new boutiques), which greatly reduces operating cash flow in each year.

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online retail platforms by brand owners could however negatively impact THG's economics in future.

- ROIC-based on NOPAT, which excludes the impact of investment in additional stocks, is decent, exceeding 10% albeit declining. The decline in ROIC is due to a large increase in operating capital but flat NOPAT.
- In the last five years, THG's ROIC-based on NOPAT (at 14%) is about double of Cortina (7%).
- In my view, Cortina's low ROIC reflects a competitive retail market and multi-brands retailers' weak position against brand owners.

THG ROIC based on FCF

S$'mn	FY2012	FY2013	FY2014	FY2015	FY2016
FCF	25	3	53	30	10
Operating assets	359	430	473	538	567
Operating liabilities	42	40	48	44	45
Operating capital	317	390	425	494	522
ROIC-based on FCF*	**8%**	**1%**	**13%**	**7%**	**2%**
*Computed based on average operating capital.					
Stocks	231	266	263	298	320
Change in stocks	+40	+35	(3)	+35	+22

THG ROIC based on NOPAT

S$'mn	FY2012	FY2013	FY2014	FY2015	FY2016
Operating profit	68	64	68	70	60
Share of associates results	1	2	3	6	7
Op profit + associates	69	66	71	76	67
Effective tax rate	19%	18%	20%	21%	19%

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NOPAT	56	54	57	60	54
ROIC-based on NOPAT*	**19%**	**15%**	**14%**	**13%**	**11%**
*Computed based on average operating capital.					

Cortina ROIC					
S$'mn / YE Mar	**FY2012**	**FY2013**	**FY2014**	**FY2015**	**FY2016**
Op profit + associates	26	21	23	21	11
Effective tax rate	15%	19%	17%	19%	25%
NOPAT	22	17	19	17	8
Operating assets	225	286	287	285	268
Operating liabilities	24	28	24	20	14
Operating capital	201	258	263	265	254
ROIC-based on NOPAT*	**11%**	**7%**	**7%**	**6%**	**3%**
*Computed based on average operating capital.					

4. Is there a margin of safety in the share price?

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- For the first quarter of FY2017, THG's net profit fell 22% as revenue decreased by 7%.
- Inferring from 1Q2017 financial performance and anticipating that consumer sentiment will continue to be weak, project average net profit for the next 10 years (S$36mn) to be 30% lower than FY2016 (S$52mn).
- Based on earnings yield target of 9%, a safe entry price would be S$0.57.

Current Market Capitalisation		S$'mn
Share price (S$)		0.72
No. of shares (mn)	(A)	705
Current market capitalisation		**508**

Earnings Forecast		S$'mn
FY2016 net profit		52
Average net profit for next 10 years	(B)	**36**

Safe Entry Price		S$'mn
Earnings yield target	(C)	9%
Market cap target	(D) = (B) / (C)	400
Share price target (S$)	(D) / (A)	**0.57**