GRANT'S
INTEREST RATE OBSERVER®

Vol. 30, No. 12d Two Wall Street, New York, New York 10005 • www.grantspub.com JUNE 15, 2012

Watch China

Johann Rupert, executive chairman and CEO of Richemont, the Swiss luxury-goods maker, let his conscience be his guide on Richemont's fiscal year-end earnings call on May 16. "Folks," Rupert told the dialers-in, "I'm not—they begged me, my colleagues, 'Please don't say it'—but I feel like I'm having a black-tie dinner on top of a volcano. OK? That volcano is China."

News that Hong Kong and China together absorbed 29.7% of Swiss watch exports in 2011 is the jumping-off point for this return engagement with Compagnie Financière Richemont SA. Exactly one year ago, *Grant's* built a bear case on companies such as Richemont and Prada (which proceeded to appreciate) and Tiffany and Sotheby's (which obediently went down) on the ground that they were derivatives of the Chinese faux miracle. "With art and luxury, we have no quarrel," it said here; "it's the money to buy them, we believe, that will presently be scarce."

What is luxury? It's something "you never really knew you needed," is the answer that Rupert ventured on the earnings call. "You never missed it, and then once you got used to it, you couldn't do without it. Now that need will remain. Love, passion, guilt, gift-giving, self-reward. It's been millennia, and it will continue." Certainly, the builder and guardian of the Cartier, Dunhill, IWC and Chloé brands has given the matter concentrated thought.

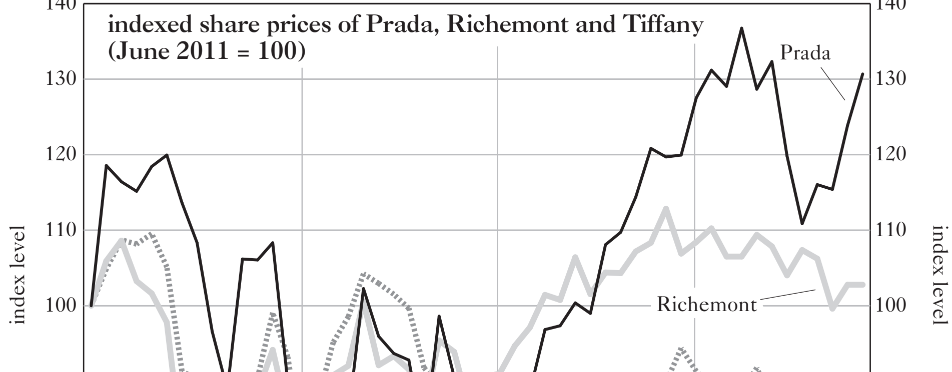
If luxury is eternal, so is the credit cycle, and Richemont has been booming in tandem with China. Thus, in the year ended March 31, the company's sales in Hong Kong and China reached €2.41 billion, up from €1.65 billion in 2011. In 2012, Hong Kong and China delivered 27.2% of Richemont's top line, up from 23.9% in 2011. Watch sales generated €4.4 billion of 2012 revenues, up from €3.32 billion in 2011. In the just-ended fiscal year, watches accounted for 49.7% of total sales, up from 48.2% in 2011.

Richemont's shares change hands at 2.6 times this year's sales and 13.9 times this year's earnings, compared to multiples of 4.2 times and 22.8 times for Prada (and rather lower multiples for Tiffany). Our bear case on Richemont is a top-down judgment on the prospect for conspicuous consumption in China. We don't mean to neglect Prada.

"Prada's first-quarter revenues broke down this way," colleague David Peligal reports: "62% for leather goods, 20% for footwear and 17% for ready-to-wear. Greater China's contribution to the first-quarter top line amounted to 24%, and it has been on the rise; Macau and Hong Kong plus the mainland accounted for 22% of sales in 2011 and 19% in 2010. If all goes according to plan—and when has it ever not?—the company will have 55 'direct-operated stores' in China by the end of 2013, up from 26 today."

There's nothing not to like in Richemont's recent operating history. Scanning the results of the past five

'On top of a volcano'



source: The Bloomberg

years, observes Peligal, you wonder what the so-called Great Recession was all about. At March 31, the balance sheet showed net cash of €3.18 billion, up €595 million in 12 months, and the good times continued to roll through the first month of the new fiscal year. "Although sales in the month of April were 29% above the comparative period, or 20% at constant exchange rates," said the unboastful year-end earnings release, "we are mindful of the unstable economic environment, particularly in the euro zone."

Or, "particularly in China and the euro zone," as we would have put it. A March briefing on high-end consumption, compiled by Industrial Bank Co. and the Hurun Report, identified 2.7 million high net worth Chinese who own an average of three cars and four watches, while 63,500 ultra-high net worth Chinese own an average of three cars and six watches. By our reading of *Women's Wear Daily,* there is a widely held view in the luxury-goods community that the number of China's rich will only grow—as, indeed, it has grown in the past decade.

"The opportunity that we perceive in China is an epic opportunity," François Graff, eponymous CEO of London-based Graff Diamonds, was quoted as saying in *WWD* in a late-May interview timed to publicize a Graff initial public offering. The IPO, sized at $1 billion, was slated not for London or New York but Hong Kong, where, according to Graff, the future will unfurl: "In the history of our company, we've seen many opportunities and pockets of wealth grow in various parts of the world, but the opportunity with the growth and wealth in China, and Asia in particular, is of such epic proportions that we thought we have to be on the doorstep of that growth with regards to our IPO." Bowing to a market gone cold, Graff called off its going-public debut on May 30.

As potential straws in the speculative wind, Hong Kong jewelers Luk Fook Holdings (590 HK on Bloomberg) and Chow Tai Fook Jewellery (1929 HK on Bloomberg) are both trading around their 52-week lows. And a May 29 *Wall Street Journal* dispatch quoted Karson Choi, chairman of Hong Kong luxury-watch retailer Halewinner Group, saying the purchasing patterns of his mainland Chinese customers have changed: "If, last year, they bought 10 watches, now they're buying eight." The Swiss watch federation confirms that Chinese sales downshifted in the first quarter of 2012. In last weekend's *Financial Times*, Erwan Rambourg, head of consumer and retail global research at HSBC in Hong Kong, was quoted as speculating that the deceleration in watch sales on the mainland might have something to do with recent Chinese political scandals.

"Gift-giving—or what you might call corruption in the West—has been a big driver of the market for years," Rambourg said. The gushing of the Chinese bank credit hose has perhaps been a bigger driver. All things have their season.

•