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## Swiss Watch Industry

Prospects and Challenges



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## Editorial

Dear Reader

Precision, quality, luxury, design, perfect workmanship, tradition, coupled with high tech: The watch industry combines traditional Swiss values in a traditional Swiss product, and as a highly export-driven sector conveys these values to the wider world. Not only is the watch industry a valuable ambassador for Switzerland as an industrial location, but with export revenues of more than CHF 20 billion it also constitutes a major pillar – one of immense economic significance to a number of the country's regions. The industry has achieved what many others dream of: Thanks to its comprehensive experience and concentrated expertise, Switzerland is now the world market leader in luxury watches. The profile of the Swiss watch industry is that of a fully developed cluster in which the individual players – from supplier, through brand, to retailer – work together like clockwork. Alongside the leading brands and a handful of major groups, hundreds of exceptionally creative, technically innovative, and artistically forward-looking SME help lay the basis for the Swiss watch industry's success.

The fact that the boom of recent years and the industry's significance are not matched by the amount of information and research available on the Swiss watch industry can only be attributable to another Swiss value: Discretion. With this study, Credit Suisse aims to shed light on an industry that is outstandingly well positioned but also faces a number of challenges. On the demand side, we take a close look at the durability of the boom in Chinese sales. We also identify which emerging-market countries the watch industry should be targeting for future exports. On the supply side, we analyze the consequences of the tougher supplier situation, the changes affecting the "Swiss Made" label, as well as the verticalization of distribution. With its strategic foresight, capacity to innovate, as well as strong partners by its side, the watch industry will overcome these structural challenges in a market that is likely to continue growing.

I wish you an enjoyable and stimulating read!

Urs P. Gauch



Head of SME Business Switzerland

## Management Summary

### Swiss watch industry is no.1 in luxury segment

(The Swiss Watch Industry in a Global Context, pp. 7–9)

The global watch market is dominated by only a handful of countries, the clear leaders being Switzerland and China. China is the world's biggest watch producer in volume terms. However, Chinese watches are mainly geared toward the lower end of the price range. In the luxury segment, on the other hand, Switzerland enjoys a near-monopoly position. Although the Swiss watch industry accounts for only around 2.5% of global production in terms of unit numbers, it is by far the leading exporter of watches in value terms. The industry is now Switzerland's third largest export sector after the pharmaceuticals industry and machinery. At 95%, almost its entire production is exported. Virtually no other sector is so focused on exports and consequently reliant on achieving success in an international environment.

### Industry a beneficiary of luxury products boom – current slowdown

(A Look Back at the Boom in the Swiss Watch Industry, pp. 10–12)

Pronounced dead back in the 1970s, the Swiss watch industry has staged an impressive rebound from the watch crisis. Thanks to a decision to refocus on high-end products (in particular mechanical watches), the Swiss watch industry benefited from a boom in demand for global luxury goods that began in the mid-1990s. Over the last 10 years, its exports have grown at an average annual rate of 7.2% – significantly faster than Swiss industrial exports as a whole. The 2010-2012 period was particularly impressive, with growth rates in double-digit territory. Although business has slowed markedly in recent quarters, exports remain at record levels by long-term standards.

### Asia is growth driver

(Geographical Diversification as a Success Factor, pp. 12–14)

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

### Political measures in China are dampening demand

(China: Flying High, Then Falling Off a Cliff?, pp. 15–18)

That the Chinese market constitutes not just a growth driver but also poses a certain cluster risk is evident from the economic slowdown that has recently affected the industry. After many years of spectacular growth, Swiss exports of small watches to China began to fall abruptly in the middle of 2012. Reasons include anti-corruption measures, restrictions on advertising, as well as slower economic growth in China. Given the rapid pace at which the Chinese market has developed in preceding years, the decline in Swiss watch exports should be seen as a normalization rather than a slump. On account of further improvements in people's living standards and the dismantling of trade barriers (under the free trade agreement), China is likely to continue growing as an export destination.

### Major potential in emerging markets – but obstacles too

(Emerging-Markets: Potential for a "Another China"?, pp. 19–22)

In overall terms, we expect further if slower growth in Swiss watch exports over the coming years. Thanks to rising incomes and growing prosperity, other emerging-market countries besides China will offer substantial growth opportunities for the watch industry. In particular, we would identify Vietnam, India, Russia, Ukraine, Malaysia, South Korea, and Mexico as potential sources of growth over the next few years. Brazil, South Africa, and Turkey also offer opportunities. Whether Swiss watch brands can indeed exploit the potential that is available according to our calculations remains to be seen, however. In specific terms, the high import tariffs and taxes (on luxury items) levied by some countries – such as Brazil and India – constitute significant barriers to market entry. The Credit Suisse Emerging Consumer Survey shows that fewer than one in 10 watches sold in these protectionist markets is a Swiss watch. Accordingly, the Swiss watch industry has a vested interest in the conclusion of free trade agreements with such countries.

### Switzerland is one of the leading markets

(Swiss Distribution Channels: the Significance of Retail Watch Sales, pp. 23–24)

As the official watch statistics are confined to foreign trade figures, the domestic market's importance to the Swiss watch industry is often underestimated. Our assumption is that the Swiss retail trade sold watches valued at an estimated CHF 2 billion-plus in 2012 (retail prices). That makes Switzerland itself one of the most important markets for the country's watch industry. Around one-half to two-thirds of the watches sold in Switzerland are destined for foreign tou-

rists. No other Swiss retail segment is as heavily dependent on tourism as the watch trade. Tourists – in particular those from China and the Gulf states – were also the primary driving force behind the recent boom in sales for the Swiss retail watch trade.

### **Vertical integration of production continues**

(The Supplier Situation Challenge, pp. 28–31)

In parallel with the dramatic changes on the demand side, the Swiss watch industry has undergone a significant structural transformation in recent decades – a process that is likely to continue over the medium term. One dominant trend is the vertical integration of production. Given the desire to control the entire value chain – from the tiniest component through the assembly of the watch – brands are buying up suppliers across the board, or are building up their own production capacity. The integration of these production stages is inevitably resulting in concentration within the industry. One key driver of this development is the Swatch Group's desire to halt the sale of movement components. The desire for exclusivity and a high degree of independence from suppliers, particularly at times of strong demand, is the driving force behind this trend.

### **"Swiss Made" is a challenge for small producers**

(The "Swiss Made" Challenge, pp. 31–33)

The planned tightening of restrictions on obtaining the coveted "Swiss Made" label is likely to contribute to the structural change within the industry. The "Swissness" bill passed in June 2013 requires at least 60% of the cost of manufacturing a "Swiss Made" product to have been incurred in Switzerland. In contrast with the previous industry-specific ordinance, the "Swissness" bill governs not only the watch movement and final inspection but also the production of all watch parts. Whereas the major Swiss watch manufacturers welcome the Swissness bill, it has also come under fire from producers of more economically priced watches in particular. They import a material share of the parts they require from abroad. In total, the Swiss watch industry imported parts with a value of CHF 2.1 billion in 2012 – equivalent to around one-tenth of watch exports. However, the import/export ratio is likely to be considerably higher for watches at the lower end of the price range. The new restrictions are likely to provide additional demand for domestic suppliers, particularly in relation to external watch parts, although supply bottlenecks pose a potential danger.

### **"Verticalization" also affects distribution**

(The Distribution Challenge, pp. 33–35)

As with production, distribution is also increasingly being taken in-house by the watch brands. In particular, a growing number of monobrand stores have opened since the end of the 1990s. However, such a strategy is associated with high costs; this makes it difficult to implement, especially for smaller, less well-known brands that do not have the backing of a group. Our analysis of the geographical spread of monobrand stores provides a good illustration of current relative strengths in the global market for Swiss watches. Their concentration on the Asian continent is particularly impressive. The major significance of tourist flows to the watch industry is also evidenced by the geographical spread of monobrand stores.

### **Positive prospects in general – problems for sections of the industry**

(Outlook, pp. 36–37)

In summary, we rate the medium-term prospects of the Swiss watch industry as positive in overall terms. In our opinion, the opportunities outweigh the risks. Given the wide variety of players in the Swiss watch industry, however, a more nuanced assessment is required. The major watch and luxury products groups are noted for their negotiating strength, and are therefore ideally positioned to benefit from the expected, continued growth in demand for luxury goods. Prospects are also very positive indeed for independent, well-established, traditional brands at the luxury end of the market. However, prospects for some smaller, independent producers – especially in the lower and mid-price categories – look trickier. They are likely to suffer most from the aforementioned structural challenges. All in all, we expect the concentration process within the Swiss watch industry to continue over the coming years.

## The Swiss Watch Industry in a Global Context

### The watch industry is an export driver...

With annual growth rates in double-digit territory, the watch industry has been an important driving force behind the Swiss export sector over the last three years. 2012 saw Swiss watch exports break through the 20 billion Swiss franc mark for the first time. Although the level of activity in the sector has slowed significantly since fall 2012, watchmaking remains one of Switzerland's most significant industrial sectors. With record export sales of CHF 21.4 billion in 2012 – equivalent to a 10.7% share of total exports of goods – the watch industry represented Switzerland's third largest export sector, behind the pharmaceuticals industry (CHF 58.5 billion, 29.2%) and just behind the machinery sector (CHF 21.5 billion, 10.7%).

### ... with an extremely strong international focus

The Swiss watch industry has a strong international focus – an estimated 95% of its production is exported – and is therefore exposed to global competition. Switzerland is not the only watch-producing country, although its watchmaking industry occupies a unique position. In this section, we take a detailed look at how the Swiss watch industry is positioned within the global market.

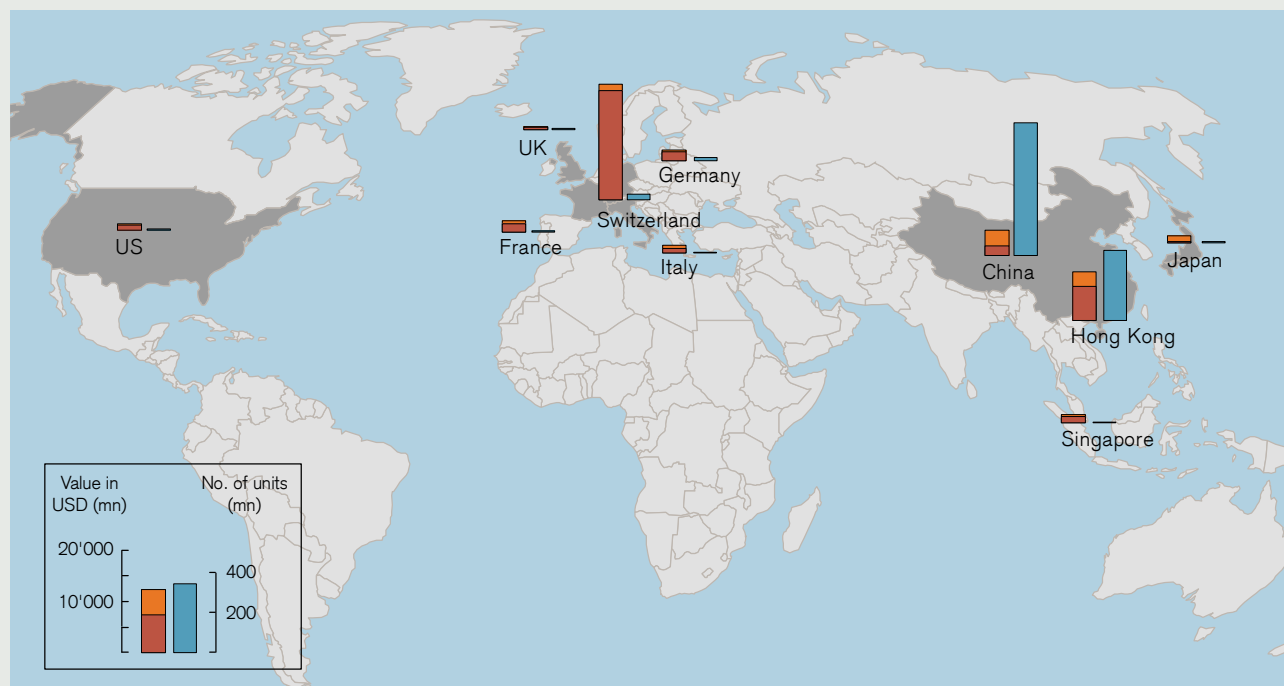
### Export data are an indicator of relative strengths in the global watch trade

No official statistics are available for global watch production.<sup>1</sup> The following analysis of relative strengths in the global watch industry is therefore based on international trade data. These differ from actual production data for several reasons, and a degree of caution should therefore be exercised when interpreting them (see box, p. 12). They nevertheless provide a good overview of the key players and their relative size in the global watch market.

Figure 1

#### The Top 10 Exporting Countries for Watches and Watch Parts

Left-hand column: Export sales in USD million, divided into small watches\* (red; wristwatches and pocket watches) and other watchmaker products (orange); right-hand column: Number of watches exported\* in million; 2012 (Italy: 2011)



Source: United Nations/Comtrade, Federal Statistical Office of Germany, Credit Suisse

<sup>1</sup> According to the Federation of the Swiss Watch Industry FH, this is likely to total around 1.2 billion units annually.

### Only a few countries of significance in watch market

Figure 1 shows clearly how the global watch industry is dominated by only a handful of countries. Ten countries – Switzerland, Hong Kong, China, Germany, France, Singapore, Italy, Japan, the US, and the UK – account for more than 90% of global exports of watches and watch parts, the first three being way ahead of the others. The fact that these 10 countries are simultaneously the most significant importing countries is evidence of the high degree of interdependence between their watch industries. The individual countries are to some extent specialized in different watchmaking products and steps in the production process.

### Switzerland the undisputed no.1 in value terms

In terms of export sales, the Swiss watch industry is the biggest by far at country level. At company level, three Swiss watch and luxury groups – Swatch Group, Richemont, and Rolex – are the clear world market leaders. Together the three groups account for an estimated 45% of global watch sales.<sup>2</sup> 94% of Swiss watch export sales, amounting to CHF 21.4 billion (USD 22.9 billion), were generated from finished small watches in 2012. This high volume of sales is generated from comparatively few, yet expensive watches. With exports of 29.3 million units – plus the watches sold on the domestic market – Switzerland accounts for just 2.5% or so of global watch production. The average export price of a Swiss watch in 2012 was USD 737.

### China is biggest producer of (economically priced) watches

In volume terms, China is the world's largest exporter of watches. In 2012, the country exported 678.5 million finished watches – 23 times more than Switzerland. At USD 5.1 billion, however, China generated 4.5 times lower sales of watches and watch parts than Switzerland. The reason is that the two countries operate in different market segments. With an average export price of USD 3, Chinese watches are on average massively cheaper than Swiss watches. 99% of all units exported from China and 96% of export sales of small watches are attributable to quartz watches made from non-precious metals or other materials (primarily plastic watches). In Switzerland, this type of watch accounts for only about 17% of export sales. In China's case, however, the main exports are watch parts (movements, cases, wristlets, etc.) and clocks (e.g. pendulum clocks, alarm clocks, stopwatches) rather than watches. These categories together generate more than 60% of total export sales.

### Hong Kong is hub of global watch trade

Hong Kong likewise enjoys a leading position on the global watch market. The former British colony is the second biggest exporter of watches and watch parts after mainland China in volume terms and after Switzerland in value terms (2012: 357.2 million small watches exported, export sales of USD 9.6 billion). However, it should be noted that Hong Kong produces very little itself; instead, it acts as a hub for the global watch trade. As a Special Administrative Region of the People's Republic of China, Hong Kong is an independent customs territory and operates its own trade policy. The port city does not levy any customs duties, making it a favored storage and distribution center for watch producers. It maintains particularly active and close relationships with Switzerland and the Chinese mainland (Figure 2). Foreign (e.g. Swiss) watches are re-exported from Hong Kong to the rest of Asia, including China. Conversely, many of the quartz watches and watch parts produced in China are shipped overseas via Hong Kong, in particular to the US, but also to Switzerland or back to China.

### Other European countries are of comparatively little significance

As in Switzerland, watchmaking also has a long-established tradition in Germany, France, and Italy. However, in none of these countries does the industry play as significant a role as in Switzerland – whether in international terms, or for the national economy as a whole. Many tradition-steeped European watch brands such as Cartier and Panerai currently operate production facilities in Switzerland. French and German watch export sales currently stand at around USD 2 billion each, around 10 times lower than those of Switzerland. The German watch industry generated 95% of its exports from watches and clocks in 2012. France, however, is more closely focused on the supplier industry. Parts (including wristlets in particular) account for 22% of export sales. In Italy too, watch parts are of major significance with a share of around 36% of export sales. In the case of both countries, the Swiss watch industry is the largest customer for watch parts.

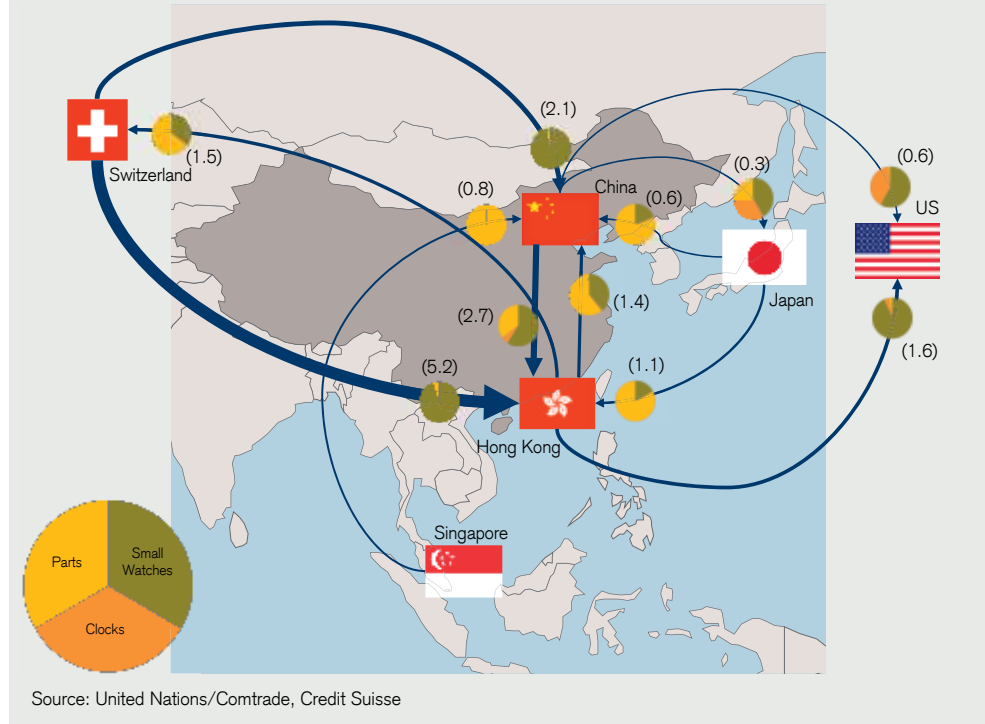
<sup>2</sup> Source: Vontobel Equity Research (2013): *Vontobel Luxury Goods Shop*, Zurich.



Figure 2

**Key Trade Relationships for China and Hong Kong in the Watch Market**

Picture shows three most important export and import relationships for China and Hong Kong in value terms. Thickness of the arrow is proportionate to 2012 foreign trade sales (value in parentheses in billion USD). Small watches = wristwatches and pocket watches; Clocks = longcase clocks, alarm clocks, pendulum clocks, time-measuring instruments, etc; Parts = movements, cases, wristlets, dials, etc.

**Japanese watch brands mainly produce abroad**

In the shape of Citizen, Seiko, and Casio, three Japanese groups – alongside Swiss firms – are among the most important players on the global watch market in sales terms. The comparatively low level of watch exports from Japan may therefore come as a surprise at first sight. However, it should be noted that the Japanese watch industry has shifted much of its production to other Asian countries such as China and Thailand, from where the products are exported.

**Switzerland a monopoly player in luxury segment, its main competition coming from other luxury goods**

In conclusion, it is therefore fair to say that a form of duopoly prevails on the global watch market. China is the undisputed market leader in the cheap watches segment, while Switzerland operates as a virtual monopoly player at the luxury end. This structure has developed over recent decades; however, it is not set in stone. Efforts are being made by the Chinese watch industry to gain a foothold in the high-end segment too. At present, however, most of the Swiss watch industry's competition in the high-end segment comes from other categories of luxury goods rather than foreign competitors.

## Demand Trends: Review and Prospects

### A Look Back at the Boom in the Swiss Watch Industry

**Impressive comeback by an industry that had been declared dead**

As demonstrated in the previous section, the Swiss watch industry is currently at the top of the tree in international terms. During the watch industry crisis of the 1970s/80s, however, it stood on the verge of collapse. Over the last 25 years, the industry achieved an impressive comeback that is reflected in particular in strong growth in exports (Figure 3). In the following section, we illustrate some of the reasons for this success.

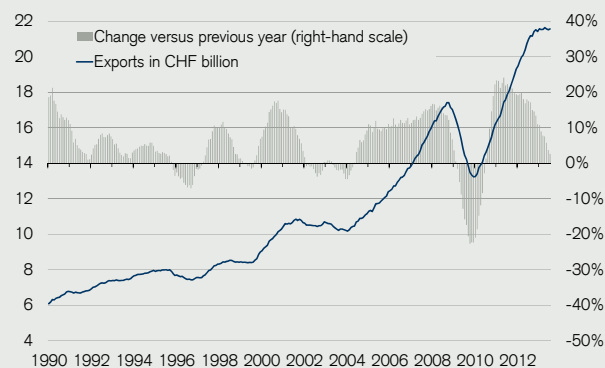
**Doubling of Swiss watch exports since turn of the millennium**

In 1990, watch exports amounted to CHF 6.8 billion; 10 years later, the figure was CHF 10.3 billion – equivalent to average annual growth of 4.3%. During this period, the watch industry therefore grew approximately on a par with the Swiss export industry in overall terms (+4.6% p.a.). Business then accelerated markedly following the turn of the millennium. Between 2000 and 2008, watch exports rose by an average of 6.5% per year before momentum suddenly came to a halt following the global financial and economic crisis (-22.3%). Unlike the crisis of the 1970s/80s, however, the 2009 crisis proved short-lived. As early as the following year, the watch industry returned to its growth trajectory at lightning speed. Double digit-growth rates were recorded in 2010, 2011, and 2012 (+22.2%, +19.4%, +11.0%) respectively – despite the strength of the Swiss franc and the euro crisis. At CHF 21.4 billion, export sales hit a new record. Over the last 10 years, watch exports (+7.2% p.a.) therefore grew at a significantly more dynamic pace than overall Swiss goods exports (+4.0% p.a.). Since fall 2012, however, there is evidence of a clear slowdown in the growth momentum. This slowdown is primarily due to developments in China (see "China: Flying High, Then Falling Off a Cliff?").

Figure 3

#### Swiss Watch Exports

12-monthly total in CHF billion, year-on-year change in percent

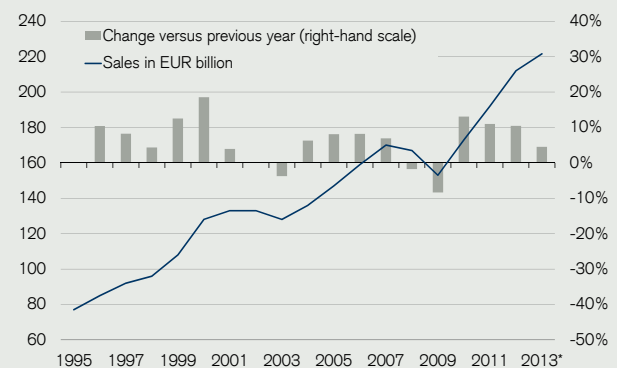


Source: Swiss Federal Customs Administration, Credit Suisse

Figure 4

#### Sales of the Worldwide Luxury Goods Industry

In EUR billion; year-on-year change in percent; \*2013: Forecast



Source: Bain & Company

**Thanks to successful repositioning...**

The success of the Swiss watch industry over the last couple of decades is attributable in particular to structural change within the industry and a refocusing on high-value products that began in the mid-1990s. With the spread of electronic communication devices such as computers and cell phones – which indicate the time more precisely than (mechanical) watches – the significance of the watch as a means of keeping the time became increasingly negligible. The Swiss watch industry succeeded in identifying this paradigm shift from an early stage and found new selling points that are aimed more at the symbolic and emotional aspects of the product (e.g. esthetics, technical know-how, brand reputation). The watch increasingly became an economic, cultural, as well as social status symbol. In particular, mechanical watches that had been situated toward the lower end of the price scale prior to the big watch crisis increasingly turned into prestige and luxury items as time progressed. The "Swiss Made" label, which embodies

values such as exclusivity, tradition, and quality, served as an important marketing tool (see "The Swiss Made Challenge").

### ... the industry was a major beneficiary of the boom in global demand for luxury goods

The repositioning of the Swiss watch industry occurred amidst the ascendancy and globalization of the luxury goods industry as a whole. Driven by the rising share of prosperous sections of society, the global luxury goods industry grew strongly during the last two decades. Between 1995 and 2012, worldwide sales of luxury items (fashion and accessories, watches and jewelry, perfumes and cosmetics, gourmet food) nearly tripled, from EUR 77 billion to EUR 212 billion (Figure 4). Around 23% of the global market is attributable to what is termed "hard" luxury – primarily watches and jewelry.<sup>3</sup>

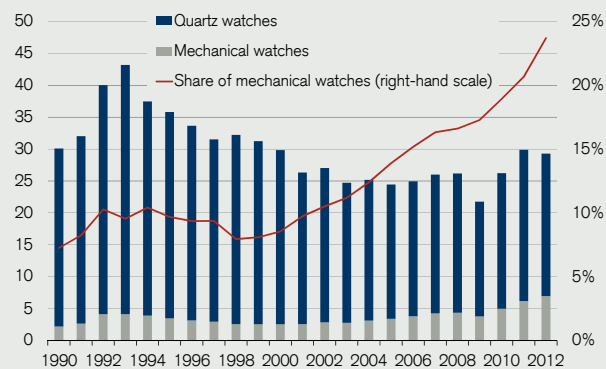
### Export structure reflects repositioning in upscale segment

The structural change in the Swiss watch industry toward luxury products is clear to see from the export numbers. In unit terms, Switzerland currently exports around one-quarter fewer watches than 20 years ago (Figure 5); however, the watches it exports nowadays carry a higher value. The average export price of a Swiss watch more than quadrupled between 1992 (CHF 160) and 2012 (CHF 691) (Figure 6). The sharp rise in prices is largely explained by the growing significance of mechanical watches. One in every four watches currently exported from Switzerland contains a mechanical movement; at the start of the 1990s, this share was less than 10%. Mechanical watches tend to be more expensive than quartz watches (2012: CHF 2,211 CHF vs. CHF 219). The price differential is due in particular to the more complex technology and requisite expertise involved. Mechanical watches are also becoming more desirable as a luxury item and therefore increasingly expensive over time, as illustrated by the export statistics. Their share of export sales has risen significantly more sharply since the end of the 1990s than their share of volume exported, and currently stands at around 76%. In the 1990s, the figure was still below 50%.

Figure 5

#### Exports by Type of Watch, Number of Units

Million units; share of mechanical watches as a percent of the total

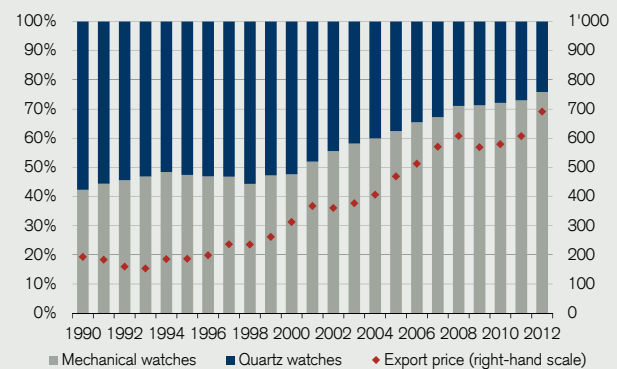


Source: Swiss Federal Customs Administration, Credit Suisse

Figure 6

#### Exports by Type of Watch, Value

As a percent of total small watch export sales; average export price of small watches in CHF



Source: Swiss Federal Customs Administration, Credit Suisse

### Lower-price segments also contributing to success

The growth of the Swiss watch industry since the 1990s was primarily based on a repositioning in the high-price segment. However, it should be noted that the industry's success is not solely down to luxury watches. One of the Swiss watch industry's advantages is the fact that it is highly diversified and also offers products aimed at the mid and lower-price segments. Although these watches generate only around 13% of export sales, they account for more than 80% of the volume exported by the Swiss watch industry. With this comparatively high volume, the lower and mid-price segments create a high degree of visibility for Switzerland as a country of origin and thus smooth the way for products in the higher-price segments. In addition, the volume facilitates economies of scale and therefore ensures profitability of production facilities

<sup>3</sup> Source: Bain & Company (2013): *Worldwide Luxury Markets Monitor, Spring 2013 Update*, Fondazione Altgamma, Milan.

at sector level. This also benefits higher-priced watches (e.g. those that come with an ETA movement, which is manufactured on a mass-produced basis).

### Foreign Trade Statistics and the Limits of Interpretation

Foreign trade statistics are one of the few data sources that enable an up-to-date picture to be obtained of the production and demand situation in the watch industry. Accordingly, much of the analysis in the present study is based on foreign trade data. However, the figures should be interpreted with caution given that...

1) *... a country's exports are not necessarily the same as its output*

- The goods produced for the respective home market are not recorded.
- The export data do not permit a distinction between exports of goods actually produced in the country and exports of goods that were initially imported from abroad (re-exports).

2) *... exports to one country are not necessarily the same as sales to end-consumers in that country*

- In the absence of end-demand, exported watches can remain in storage with the foreign wholesaler or retailer.
- The export data do not allow a distinction between products that are sold domestically in the destination country and products that are exported from there to other markets (re-exports and purchases by foreign customers).

## Geographical Diversification as a Success Factor

**Compared with other sectors, the watch industry is highly diversified in geographical terms...**

The Swiss watch industry's above-average success over the past decade is also explained by the fact that its sales markets are highly diversified compared with Switzerland's other export industries. One reason is the fact that the watch industry was active in tapping the rapidly growing emerging markets from an early stage. We measure this diversification using the Herfindahl index, based on individual destination countries' share of total exports. The lower the index, the more diversified the exports in geographical terms. As [Figure 7](#) shows, the watch industry is the third mostly highly diversified of Switzerland's exports sectors in country terms after chemicals/pharmaceuticals and foods. The high degree to which sales markets are diversified in geographical terms enables the sector to benefit from growth opportunities in a wide range of countries and regions of the world. At the same time, it reduces exposure to individual country-specific risks (including economic risks).

**... and therefore benefited from the emerging markets' hunger for luxury goods**

The geographical diversification of the Swiss watch industry's sales markets, as measured by the Herfindahl index, improved continuously between the start of the 1990s and 2009. This development in part reflects the growing importance of emerging countries to Swiss watch brands. The industry's rapid recovery following the financial and economic crisis and strong growth in exports over the last three years are largely explained by an already extensive presence in emerging markets in which demand for luxury goods was experiencing a veritable boom at the time.

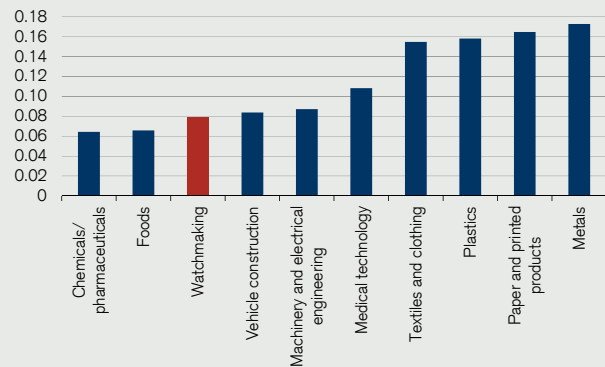
**Growth of the last decade driven by Asia**

Asia made by far the greatest contribution to the growth in Swiss watch exports over the last decade ([Figure 8](#)). In overall terms, Asian countries were responsible for around 70% of the growth in exports in the 2000-2012 period. The biggest growth fillip came from Hong Kong and China, which together generated more than 40% of the growth. Singapore, the United Arab Emirates (UAE), South Korea, Taiwan, Saudi Arabia, and Japan are also among the 15 countries that provided the biggest contributions to growth. A further 24% of the growth came from European countries, led by France and Germany. 6% came from the Americas, half of which was accounted for by the US.

Figure 7

**Country Diversification of Exports by Sector**

Herfindahl index, 2012 (the lower the index, the greater the degree of geographical diversification); max. = 1, min. = 1/n, n = number of countries (237)

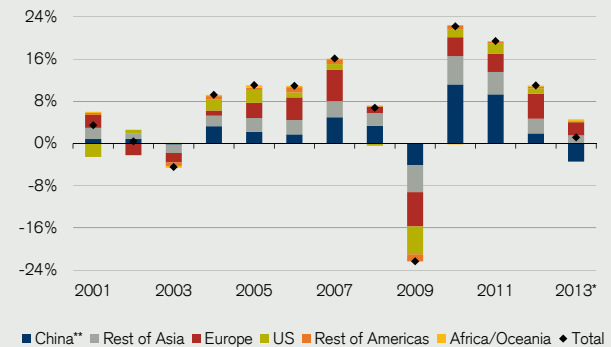


Source: Swiss Federal Customs Administration, Credit Suisse

Figure 8

**Contributions to Growth by World Regions**

Swiss watch exports in CHF: Year-on-year change in percent, contribution to growth in percentage points; \*2013: January to July; \*\*Includes Hong Kong, Taiwan, and Macao



Source: Swiss Federal Customs Administration, Credit Suisse

### China/Hong Kong becomes most important market

In 2000, the US was the principal export market for the Swiss watch industry with an 18% share of total exports, (Figure 9), ahead of Hong Kong (14%), and Japan (9%). The Chinese mainland's significance as an export market was negligible at that time (0.4%). With the strong growth of Asia, however, the geographical structure of Swiss watch exports altered dramatically within a decade. The Asia trading hub of Hong Kong dethroned the US as primary export market in 2008. 20% of export sales were generated in the Chinese Special Administrative Region in 2012 – twice as many as in the US. Thanks to a surge in growth, mainland China moved up to third place in 2011 and accounted for 8% of Swiss watch exports in 2012. If Hong Kong, Macao, and Taiwan are also included, around 30% of watch exports currently go to the Chinese market. This represents almost a doubling of the share compared with the year 2000. Although the growing significance of the Chinese market poses a degree of cluster risk for the industry, it also creates major opportunities for growth (see "China: Flying High, Then Falling Off a Cliff?").

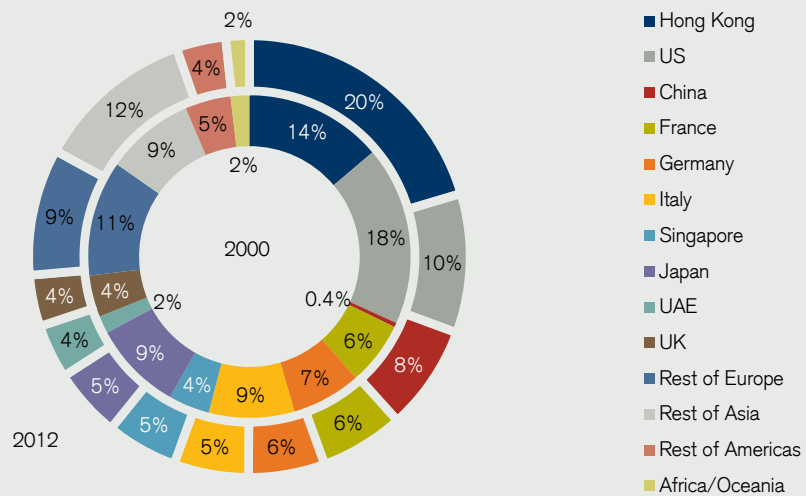
### Tourist destinations play an important role

As shown in the box "Foreign Trade Statistics and the Limits of Interpretation", exports to one country do not necessarily equate to sales to domestic end-customers. In certain markets, foreign tourist business plays a significant role. Besides Switzerland (see "Swiss Distribution Channels: Significance of Retail Watch Sales"), this also applies to Hong Kong, Singapore, and Dubai (UAE), for example. European countries such as France, which includes Paris – the world capital of luxury, as well as Germany and Italy, benefit from luxury product shopping by foreign tourists. This explains these countries' relatively high share of Swiss watch exports (Figure 9).

Figure 9

**Main Export Markets of the Swiss Watch Industry**

Share of total exports in percent; inner circle: 2000, outer circle: 2012



Source: Swiss Federal Customs Administration, Credit Suisse

**Excursus: Largely Independent of the Exchange Rate****Watch industry only minimally dependent on exchange rates**

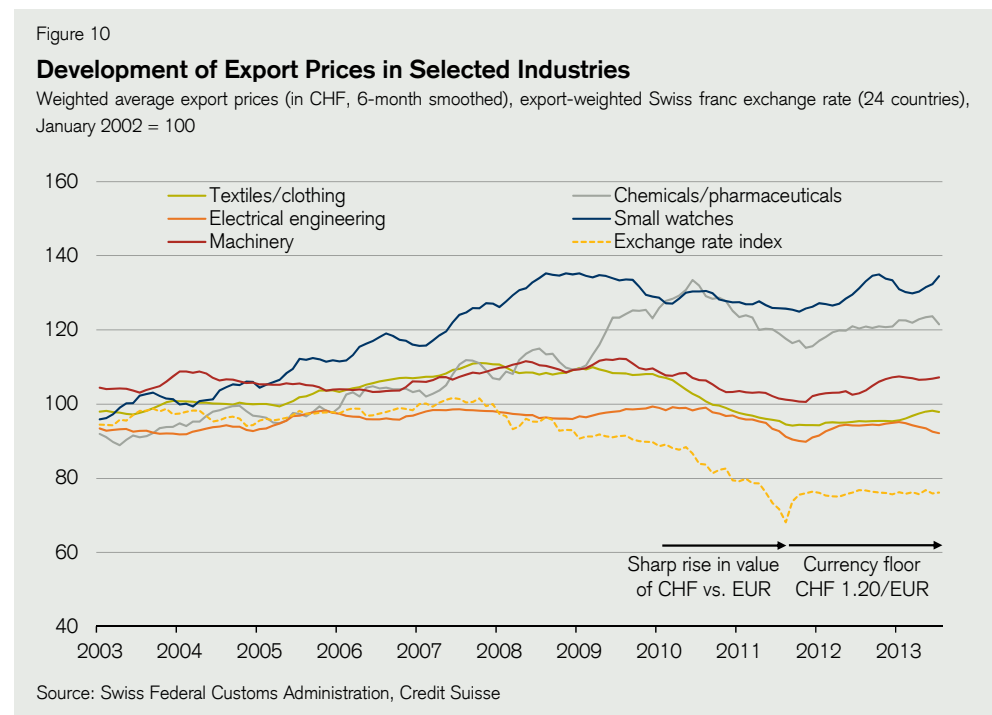
The Swiss watch industry is a highly successful export sector. In price terms in particular, the watch industry was able to position itself strongly in the international arena and push through export prices largely independently of exchange rate fluctuations. This distinguishes the watch industry from selected Swiss export sectors (Figure 10). Even before the sharp rise in the value of the Swiss franc from 2010 onward, average export prices (measured in CHF) in the textiles, electrical engineering, and machinery industries already correlated with the exchange rate. In the textile industry in particular, export prices fell as soon as the Swiss franc rose in value versus other currencies.<sup>4</sup> The correlation between export prices and the exchange rate in these sectors showed another significant increase between 2010 and the middle of 2013. Even the chemicals/pharmaceuticals industry, whose export prices tended to run counter to the exchange rate between 2002 and 2010, revised its export prices sharply downward from 2010 onward as the Swiss franc gained strength. Not so the watch industry, which was able to keep the average price of exports at a relatively stable level even during the period of currency appreciation in 2010-2011.

**Reasons: market leadership, rise in demand, inflation in key sales markets...**

One reason why the sharp rise in the value of the Swiss franc in 2010-2011 (in particular versus the euro) had virtually no impact on the Swiss watch industry was the industry's leading position. Swiss producers hold virtually a monopoly position in the upper price segments of the watch market (see "The Swiss Watch Industry in a Global Context") and therefore have major scope for price-setting. Another factor was the rapid rise in demand (Figure 3), which entailed correspondingly higher prices. The fact that foreign demand was able to influence the price of exports is evident from developments between fall 2012 and spring 2013. During this period, a declining number of exported watches was accompanied by a decrease in prices of exports (Figure 10). The relatively high degree of independence from exchange rates shown by the price of exports in the 2010-2011 period was also supported by price developments in the destination countries. The most important exports markets for the Swiss watch industry – Hong Kong, the US, and China – recorded relatively high rates of inflation, especially in 2011 (Hong Kong: up to 8%; US: up to 4%; China: at times more than 6% in year-on-year terms). The

<sup>4</sup> To measure the price of exports in a sector, we use the mean value index produced by the Swiss Federal Customs Administration. To calculate the mean value index of a category of goods, it uses tariff lines whose export value per kilo develops in a similar way to real prices. However, the mean value index is not fully adjusted in structural terms; nor is it adjusted for quality or inflation.

Swiss watch industry is likely to have utilized the high general level of inflation in the three countries for corresponding price adjustments.<sup>5</sup>



#### ... as well as changes in export structure and increased focus on luxury

The development of export prices in the Swiss watch industry in the 2010-2011 period also reflects structural changes in foreign demand. During this period, the share of mechanical watches in terms of the number of units exported rose from just under 19% to 21% (2000: 9% and 2012: 24%; Figure 5). The switch to mechanical watches was instrumental in increasing average export prices. The fact is that, in comparison with electronic watches, mechanical watches are found mainly in higher-price categories that exhibit stronger growth in prices (see "A Look Back at the Boom in the Swiss Watch Industry"). The Swiss watch industry's growing focus on luxury also amplified the dependence of export prices on prices of precious metals. In the 2010-2011 period, the price of gold in particular rallied strongly. This made it more expensive to produce gold watches, which had a knock-on effect on prices of exports.

### China: Flying High, Then Falling Off a Cliff?

#### China: From zero to third-largest market

In 2000, Swiss exports of small watches to China amounted to just CHF 16.8 million. Since then, the value of annual exports has multiplied by a factor of 97 and totaled CHF 1.6 billion in 2012 (Figure 11). The fall in exports in 2009 caused only a temporary halt in this rapid growth. Despite a difficult economic environment and the rise in value of the Swiss franc, China continued to fly high until the middle of 2012.

#### Expanding middle and upper classes the driving force

The sharp rise in watch exports since the turn of the millennium was primarily driven by the rise in purchasing power and rapid expansion of China's middle and upper classes. Between 2000 and 2010, wealth per adult in China grew by an average of 12% per year. In 2012, the total wealth of China's population stood at USD 20,200 billion – equivalent to the prosperity of the US in 1970 – or 9% of the world's total wealth.<sup>6</sup> As living standards improved, China's population became increasingly conscious of brands and watches in particular. According to a survey by KPMG, Swiss watches are among the most highly favored luxury items for Chinese con-

<sup>5</sup> Should the inflation effect more than compensate for the appreciation of the Swiss franc, this would result in higher average export prices in CHF.

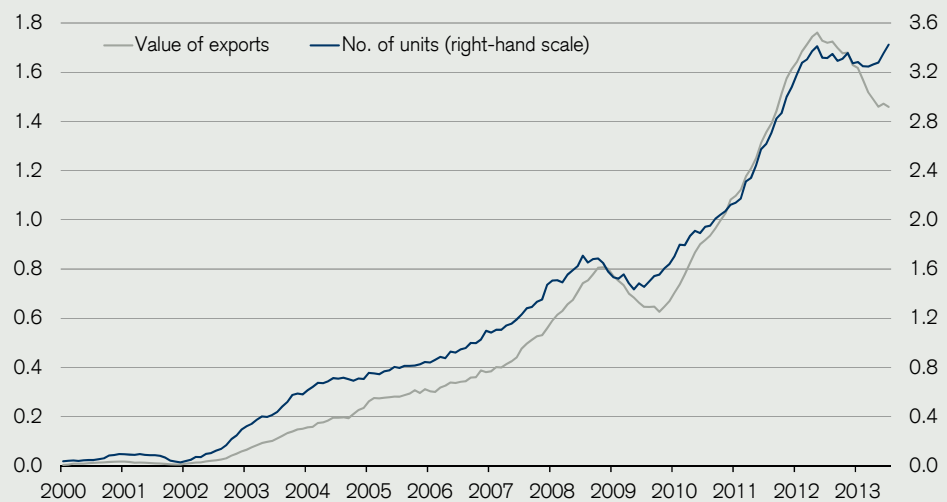
<sup>6</sup> Source: Credit Suisse Research Institute (2012): *Global Wealth Databook 2012*, Zurich.

sumers.<sup>7</sup> Luxury watches soon established themselves as a favored gift for government officials and party functionaries in China. Gifts are estimated to account for around 30% of luxury product sales in China, one third of which are destined for officials.<sup>8</sup> Another growth driver worth a particular mention is China's accession to the World Trade Organization in 2001. The associated dismantling of trade barriers made it easier to sell watches. However, the Chinese authorities continue to impose a customs tariff of between 11% and 23% on watches as well as a 20% sales tax on luxury products, making imports of most Swiss watches at least one-third more expensive.

Figure 11

**Swiss Small Watch Exports to China**

12-monthly total value of exports in CHF billion (left-hand scale) and exports in million units (right-hand scale)



Source: Swiss Federal Customs Administration, Credit Suisse

### Less expensive watches exported to China since mid-2012

Watch exports to China underwent an abrupt trend reversal in mid-2012. In June 2012, the value of exports fell for the first time in two-and-a-half years. Whereas the 12-monthly total value in July 2013 was around 17% below the figure for May 2012, the number of units showed a minimal increase in the same period; this indicates that more economically priced watches were exported to China in the second half of 2012 and first half of 2013.

### Political measures dampen demand

The negative trend reversal and shift in demand to more economically priced watches were partly due to political measures. In July 2012, the Chinese administration announced that government officials would in future no longer receive public funds for luxury goods. These measures are primarily aimed at combating corruption and curbing the practice of giving gifts to officials. This was compounded by the fact that advertising for luxury goods in certain cities such as Beijing became subject to partial restrictions in April 2011. Thus foreign "cult" products, for example, can no longer be advertised. Also, terms such as "upmarket", "luxurious", "luxury", "royal" and "must-have" are no longer allowed in adverts. One of the reasons for this measure is likely to be the widening income gap, which conflicts with the political objective of a harmonious society. June 2013 saw the new government restate these key political objectives.<sup>9</sup> The Chinese economy's below-average growth since the end of 2011 is also likely to have a dampening effect on demand for Swiss watches.

### Normalization rather than slump

The decline in exports between June 2012 and July 2013 should be regarded as a normalization of the market rather than a slump, given the double-digit annual growth rates that preceded it. First, exports of Swiss watches to China have stabilized since mid-2013. Second, the Chi-

<sup>7</sup> Source: KPMG (2013): *Consumer Markets – Global Reach of China Luxury*, Hong Kong.

<sup>8</sup> Source: Forecasts by Asia specialists at Bank of America Merrill Lynch. From: *Tagesanzeiger* (January 23, 2013): *Uhrenexporte nach China nehmen ab*.

<sup>9</sup> A new party president was appointed in November 2012 and a new government formed in June 2013.



nese market continues to offer the Swiss watch industry more opportunities than threats. For that reason, the market is also likely to expand in future – if not quite as strongly as in previous years.

**Rising living standards and dismantling of trade barriers present opportunities**

Expansion of the Chinese market is likely to be primarily driven by a continued improvement in the standard of living for China's population as well as the progressive removal of trade barriers. Although China's growth has slowed, it is nevertheless set to remain well into positive territory in the years ahead. Based on our forecasts, China's gross domestic product will expand by around 7.5% both this year and next. According to the Global Wealth Report published by Credit Suisse, the number of millionaires in China will double to two million by 2017. Opportunities also abound at a political level. As part of the free trade agreement, China assured Switzerland that it would reduce tariffs on watches in stages by 60% over 10 years and would offer better protection against fake goods (e.g. protecting the "Swiss Made" label).

**Political developments constitute biggest risk**

The biggest risk stems from political developments in China. The fall in Swiss exports since the introduction of anti-corruption measures shows that political measures play an important role for the watch market. Although the administration currently levies taxes of around 20% on luxury watches, it intends to tax luxury goods at an even higher rate as part of its tax reform. This is to inhibit the previous penchant for purchasing luxury goods in China. In contrast with the reduction in customs tariffs, the higher sales tax is expected to dampen domestic purchasing by Chinese consumers and prompt them to shop abroad instead (see box, p. 18). However, the extent to which a simultaneous reduction in customs tariffs and increase in sales tax will impact on domestic purchases, and therefore exports of watches to China, remains unclear. The risk due to political developments in China should nevertheless be seen in the context of the country's overall development. The expectation is that in the longer term the effect of political measures will be more than offset by the rapidly growing prosperity of China's population.

**Chinese watch production and consumer preferences pose additional risks**

An additional risk factor is the expected increase in competitive pressures on the Chinese luxury watch market. China is now the world's largest producer of watches in the lower price categories (see "The Swiss Watch Industry in a Global Context"). However, Chinese manufacturers are also attempting to gain a foothold in higher-end segments and to benefit from expansion of the market. The fact that the free trade agreement with Switzerland only allows the reduction in watch-sector tariffs to take place in stages gives Chinese watch producers additional time and scope to position themselves accordingly. The consumer preferences of the Chinese population also play an important role. China's population is expected to continue showing strong interest in luxury goods and watches in future.<sup>10</sup> However, changes in purchasing habits are expected due to a greater wealth of experience among luxury shoppers. Thus there are signs that less ostentatious styles, as well as smaller, rare luxury brands, are in demand in China at the moment.<sup>11</sup> This is also likely to influence Swiss watch exports and entail changes in the structure of exports.

10 Source: McKinsey (2012): *Luxury Without Borders: China's New Class of Shoppers Take on the World*.

11 Source: idem.

### Chinese Tourists Exploiting Lower Prices Abroad

The export figures themselves underestimate China's significance as a market for Swiss watches (see box, p. 12). Sales to Chinese tourists are also significant.

Travel by China's population has increased sharply in recent years. Whereas Chinese tourists made 10 million trips abroad in 2000, the number had risen as high as 83 million in 2012. With USD 102 billion spent on travel in 2012, China became the world's biggest country of origin for tourism.<sup>12</sup> Key reasons for the increase in the Chinese propensity to travel include the growing prosperity of the population, simplified procedures for obtaining visas, as well as the rise in the value of the renminbi versus various currencies such as the US dollar and euro.<sup>13</sup>

As tariffs and sales taxes increase sharply in China, many Chinese tourists are taking advantage of the opportunity to buy watches abroad at a lower price. In 2012, 37% of Chinese tourists purchased a watch while on their travels. Around half of them bought a watch in Taiwan, Macao, or Hong Kong, the biggest market for the Swiss watch industry. Europe, with its hot spots of Switzerland and Paris, accounted for 25% of watch purchases.<sup>14</sup>

Switzerland is steadily gaining ground as a travel destination. In particular to avoid the problem of widespread fake goods, Chinese tourists often buy their watches directly in Switzerland. The country has improved its position in the list of most popular international luxury travel destinations for Chinese tourists from sixth (2012) to fourth (2013), and now lies only behind France, the US, and Singapore.<sup>15</sup> This development is evidenced by the rapid increase in overnight stays by Chinese visitors to Switzerland. From 144,000 in 1999, the number of recorded overnight stays in Switzerland grew to as many as 815,000 in 2012. The number of overnight stays by Chinese visitors has therefore grown by around 17% per year during the last 10 years. Lucerne, Zurich, Interlaken, and the Geneva region accounted for 81.5% of Chinese overnight stays in 2012. By far the highest number of overnight stays was recorded in the Lucerne/Central Switzerland region, which at the same time is one of the world's biggest hubs for watch sales (see "[Swiss Distribution Channels: the Significance of Retail Watch Sales](#)"). This region accounted for around one-third of overnight stays by Chinese visitors to Switzerland during the last three years. In summer 2012, Swiss Watch & Luxury Magazine conducted a survey of around 750 tourists from China. The poll found that many Chinese visitors are young executives aged between 30 and 40, are mainly middle class, and 80% of them speak Mandarin only. They spent around CHF 350 per day in Switzerland, spending relatively little on food and accommodation but relatively large sums on shopping.<sup>16</sup> In addition, 80% of Chinese tourists traveled with a group. Group travel is especially lucrative for watch retailers, as it enables them to agree commission deals with individual tour group leaders. In future, however, Chinese tourists are expected to travel on an increasingly individual basis, rather than as part of a group, on account of their increasing purchasing power and improved understanding of English.<sup>17</sup>

12 Source: UNWTO (2013): *World Tourism Barometer 2013*.

13 Source: McKinsey (2012): *Luxury Without Borders: China's New Class of Shoppers Take on the World*.

14 Source: KPMG (2013): *Consumer Markets – Global Reach of China Luxury*, Hong Kong.

15 Source: Hurun Report (2013): *Chinese Luxury Consumer Survey 2013*.

16 Source: Hotelrevue (February 23, 2012): *Chinesen entdecken die Schweiz*.

17 Source: Kurt Haerri, President of the Swiss-Chinese Chamber of Commerce. In: Bilanz (March 11, 2011): *Strukturwandel im China-Geschäft: "Beim Übermachten wird gespart"*.

## Emerging Markets: Potential for “Another China”?

### Where is future sales potential located?

In the preceding chapter we examined the Swiss watch industry's performance to date and future prospects in the Chinese market. Now we take a wider perspective to analyze the outlook for other markets. Are there further countries where demand for Swiss watches has the potential to rise to the same extent as in China?

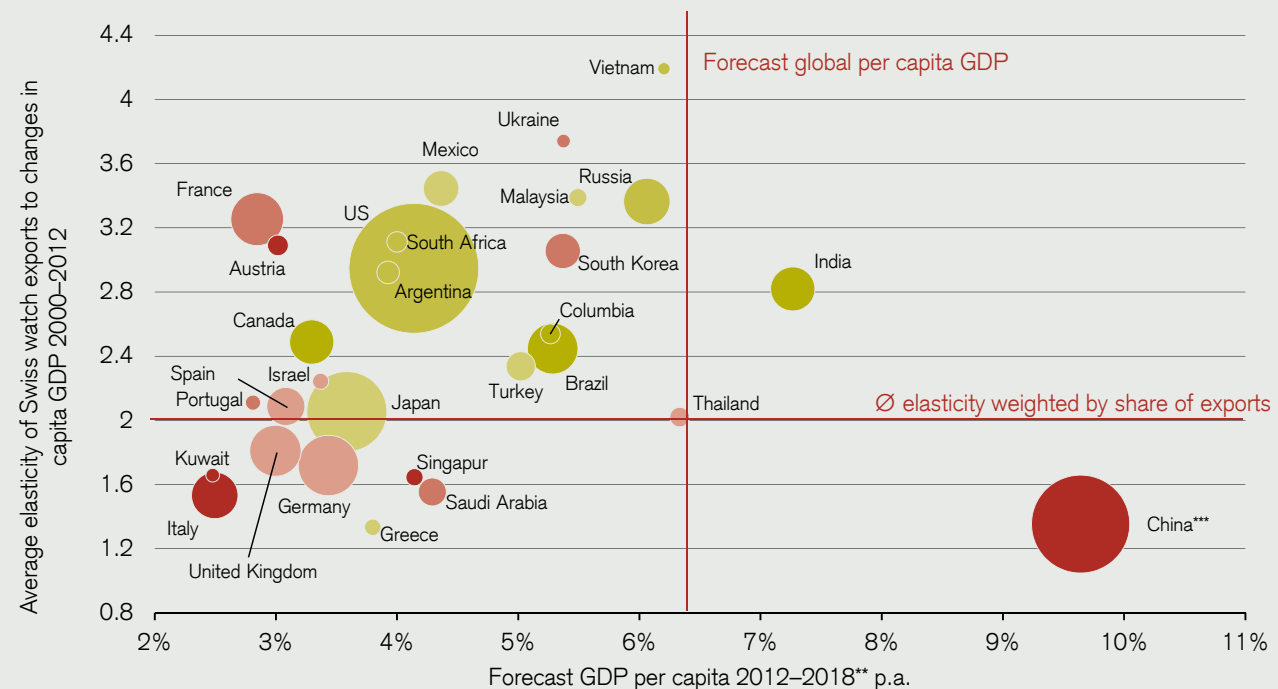
### Demand depends upon increasing affluence, income elasticity and market penetration

Swiss watches are, for the most part, luxury goods. Economic theory defines this segment as goods for which demand increases disproportionately as incomes rise. The growth in affluence and the income elasticity of demand<sup>18</sup> are thus two key factors in assessing a country's potential demand. The higher the growth outlook and elasticity, the greater the potential demand. Current market penetration is likewise a factor: the lower this figure, the more upside potential exists. Whether such potential can actually be realized is another issue, and depends on many political, sociological and cultural factors.

Figure 12

### Medium-term Growth Prospects for Swiss Watch Exports to Selected Countries

Top 30 export markets for the Swiss watch industry in 2012 plus selected emerging markets<sup>19</sup>; bubble size: GDP 2012; color: market penetration, defined as the value of exports of Swiss watches into each country divided by GDP, 2012, red = high, green = low



Source: Swiss Federal Customs Administration, International Monetary Fund, Credit Suisse

\*Only countries with significant elasticity results are depicted; \*\*Based on the IMF's "World Economic Outlook" of April 2013; \*\*\*Includes Hong Kong, Taiwan, and Macao

### Per capita GDP is the best indicator for changes in watch exports

Our analysis uses the exports of small watches as an indicator of demand for Swiss watches, and per capita GDP as the income variable. Our calculations show that growth in per capita GDP is the best available economic indicator to explain trends in watch exports. As expected, the average elasticity of Swiss watch exports in relation to per capita GDP from 2000 to 2012 was greater than 1 in all countries observed, confirming the luxury quality of the Swiss watch industry (Figure 12). Nonetheless, we should not draw hasty conclusions about future growth from the chart; the income elasticity rates shown reflect the past and thus serve only as refer-

18 Income elasticity of demand indicates by what percentage demand for a certain good changes when income rises or falls by 1%. By definition, luxury goods have an income elasticity that is greater than 1, i.e. demand rises disproportionately as income increases. For example, if watches have an income elasticity of 2, and income rises by 2%, then demand for watches would rise by 4%.

ence points. The income elasticity of demand is not fixed and can change over time. Moreover, medium-term forecasts of per capita GDP growth are by nature uncertain.

**Which countries are gaining significance, which are losing?**

Setting these limitations aside for a moment, let us consider a mental experiment: given the same elasticity and GDP forecasts, how might an individual country's share of total Swiss watch exports change by 2018? [Figure 13](#) provides an answer to this question. The results show the individual countries' forecast relative gains and losses in significance, without predicting absolute growth in exports. Given the generally positive forecasts for average GDP and elasticity, the model assumes positive export growth in all countries over the next five years.

**China and the USA expanding their shares, Europe losing ground**

Under the above conditions, the most dynamic export markets over the next five years will be those with high income growth forecasts and/or high elasticity. China, for example, despite its comparatively low elasticity<sup>19</sup>, is likely to account for an increasing share of watch exports given its outlook for high GDP growth. The same is true for the USA, but for the inverse reasons – lower GDP growth, but higher elasticity. As the two main export markets become relatively larger, the pie becomes smaller for the remaining countries. Mature markets in industrialized countries whose elasticity and income growth are below average are at particular risk to lose significance. The prime candidates here are Italy, the UK and Germany.

**Huge potential in some emerging markets – but pitfalls too**

According to our model, emerging markets such as Vietnam, India, Russia, the Ukraine, Malaysia, South Korea and Mexico will gain the most in significance for the Swiss watch industry over the next five years. Some Latin American countries, such as Brazil, Columbia and Argentina, as well as South Africa, Turkey and Thailand, should also rise in the export rankings. Some of the above-mentioned countries are already relatively well established export markets for the Swiss watch industry: South Korea, Russia and Mexico featured among the 15 main export markets in 2012 ([Figure 13](#)). However, most other emerging economies represent minor markets with low penetration, but great potential for the Swiss watch industry. One reason for this is the high import duties and (luxury) taxes which some countries impose on watches.<sup>20</sup> If trade barriers and other hindrances to market entry were to be eliminated, the Swiss watch industry could tap great potential in these markets too. This explains why the sector is so interested in concluding further free trade agreements. Switzerland has had a free trade agreement with the Ukraine since June 2012, and similar negotiations with Russia, India, Vietnam, Thailand, Malaysia and Indonesia are under way. At the beginning of August 2013, the Swiss-Russian bilateral agreement on the mutual recognition of hallmarks for watches made of precious metals entered into force, which should make it easier to export Swiss luxury watches into Russia. On the other hand, Switzerland has yet to enter into official negotiations for free trade agreements with Brazil and Argentina.

19 For this analysis, the Chinese market includes Hong Kong, Taiwan and Macao. Since Hong Kong serves as a key distributor in the international watch trade, the income elasticity of demand from China is probably understated and the market penetration overstated.

20 For example, Brazil: 25% duty and 65% tax; Indonesia: 10% duty and 40% tax; India: 10% duty and 36% tax; Argentina: 20% duty and 25% tax; Mexico and Russia: 20% duty (source: Vontobel Equity Research (2013): *Vontobel Luxury Goods Shop*, Zurich).

Figure 13

**Expected Development of Top Export Markets by 2018**

Share of Swiss exports of small watches (value) in %, 2012; expected change in share by 2018:

↗↗ large increase in share, ↗ increase in share, ↘↘ large decrease in share, ↘ decrease in share

\*No significant elasticity

		Share 2012	Expected change in share by 2018
1	China (incl. Hong Kong, Taiwan, and Macao)	30.7%	↗
2	USA	10.3%	↗
3	France	5.8%	↘
4	Italy	5.5%	↘↘
5	Singapore	5.5%	↘
6	Germany	5.1%	↘↘
7	Japan	5.1%	↘
8	United Arab Emirates	4.2%	*
9	United Kingdom	3.7%	↘↘
10	South Korea	2.3%	↗↗
11	Spain	1.9%	↘↘
12	Saudi Arabia	1.6%	↘↘
13	Russia	1.3%	↗↗
14	Austria	1.2%	↘
15	Mexico	1.0%	↗↗
16	Australia	0.8%	*
17	Netherlands	0.7%	*
18	Turkey	0.6%	↗
19	Qatar	0.6%	*
20	Thailand	0.6%	↗
21	Canada	0.6%	↘
22	India	0.6%	↗↗
23	Belgium	0.6%	*
24	Portugal	0.5%	↘↘
25	Kuwait	0.4%	↘↘
26	Malaysia	0.4%	↗↗
27	Israel	0.4%	↘
28	Greece	0.4%	↘↘
...			
31	Ukraine	0.3%	↗↗
...			
34	Brazil	0.3%	↗
35	Argentina	0.3%	↗
...			
39	South Africa	0.2%	↗
...			
54	Colombia	0.1%	↗
...			
64	Vietnam	0.1%	↗↗

Source: Federal Customs Office, International Monetary Fund, Credit Suisse

## Excursus: the Significance of Swiss Brands in Emerging Markets

### Emerging Consumer Survey delivers findings on demand for watches in eight emerging economies

### Swiss share of the market is high in Saudi Arabia, low in India and Brazil

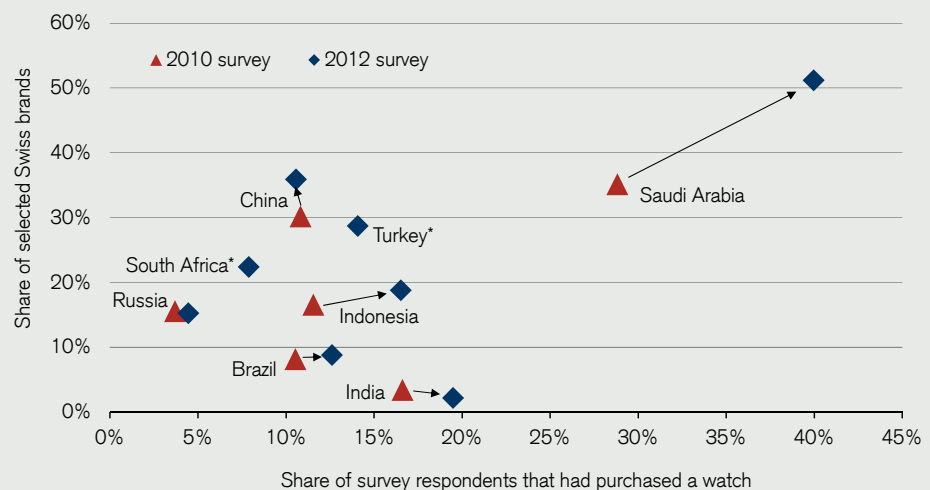
Another indicator of demand for watches in the developing markets is the Emerging Consumer Survey, conducted annually on behalf of Credit Suisse since 2010 in eight selected emerging economies (China, India, Russia, Brazil, Indonesia, Turkey, Saudi Arabia and South Africa)<sup>21</sup> Survey respondents are questioned about their actual and planned spending in various consumer segments, among which are luxury goods in general and watches in particular.<sup>22</sup>

Figure 14 depicts the percentage of respondents in each country that had purchased a watch in the 12 months preceding the survey. Respondents were also asked to name the brand of watch purchased, giving us a rough idea of the market share of Swiss watches. The survey results correspond relatively well with our analysis of market penetration above. Saudi Arabia stands out with a relatively high market penetration: in 2010, one out of three watches purchased was a Swiss timepiece; by 2012 the figure was one out of two. In comparison, one out of three Chinese respondents had bought a Swiss watch in 2012. India and Brazil reported the lowest shares of Swiss watch purchases. In India, more than half of the watches purchased in 2012 were local brands (e.g. Titan, Fasttrack, Sonata), while in Brazil, most were domestic brands or foreign brands with assembly operations in Brazil (e.g. Citizen, Orient). As mentioned above, high barriers to market entry (including import duties) account for this situation. As for general market penetration for watches, the survey indicates that most of the emerging economies under review have further upside potential. Saudi Arabia had the highest percentage of respondents that had purchased a watch in the 12 months preceding the survey in 2012, at around 40%. In all other countries, the figure was less than 20%.

Figure 14

### Emerging Consumer Survey: Market Share for Swiss Watches

Watch purchasers as a percentage of survey respondents, 14 selected Swiss watch brands<sup>23</sup> as a percentage of watches purchased; number of survey respondents = 2,500 (China, India), 1,500 (other countries); \*Turkey and South Africa: no survey conducted in 2010



Source: Credit Suisse Emerging Consumer Survey

21 Source: Credit Suisse Research Institute (2013): *Emerging Consumer Survey Databook 2013*, Zurich.

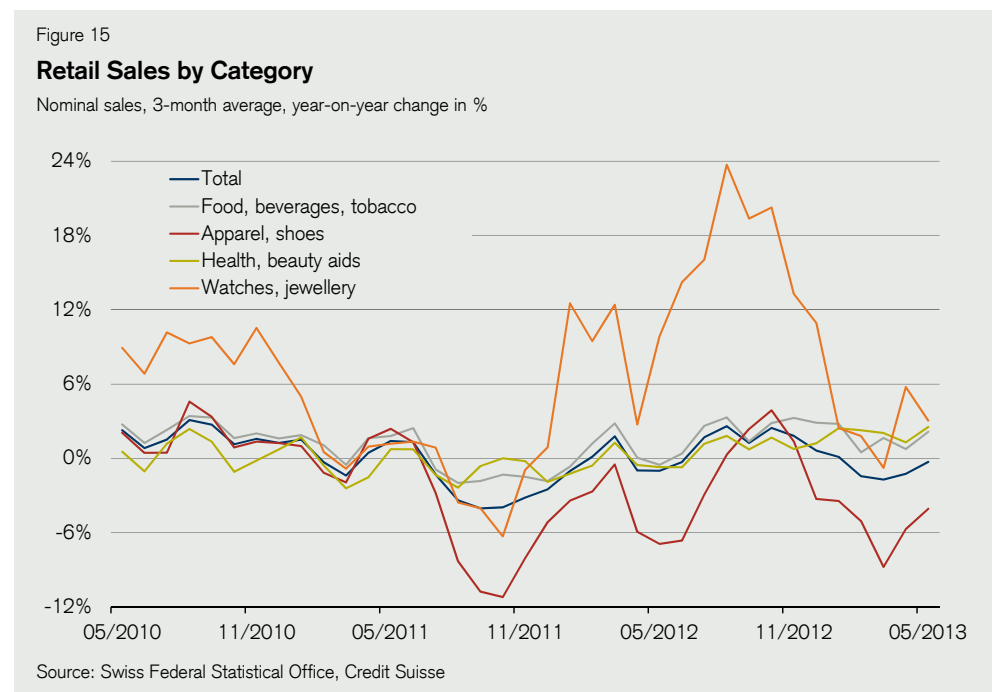
22 The survey is a sample and the respondent structure may diverge substantially from a country's overall population structure (e.g., 70% of the respondents live in suburban communities).

23 These are – with two exceptions – the Swiss watches that are among the 50 most valuable Swiss brands in 2013, according to consultancy firm Interbrand.

## Swiss Distribution Channels: the Significance of Retail Watch Sales

### 2012 sales exceeded CHF 2 billion

The Swiss retail watch trade is an important distribution channel for domestic watch companies. The Federation of the Swiss Watch Industry (FH) estimates that the Swiss market absorbs some 5% of timepieces produced. Although exact sales figures for the retail watch industry are not available, federal VAT statistics suggest that watch and jewelry retailers turned sales of CHF 2.8 billion (including export sales) in 2011. Since this figure includes sales of jewelry, actual revenues from watches were somewhat lower.<sup>24</sup> Given the stately increase in sales of jewelry and watches in 2012 (Figure 15), we can deduce that the Swiss retail industry sold watches for an estimated value of CHF 2 billion (end price). This figure seems realistic, considering sales through alternative data sources such as the Federation of the Swiss Watch Industry (FH)'s "5% estimate" or retail sales statistics from the Swiss Federal Statistical Office (SFSO).<sup>25</sup>



### Tourists account for a majority of watch purchases

A large portion of the watches sold by Swiss retailers are purchased by foreign tourists. The exact share of sales to tourists is unknown, but is estimated at half to two-thirds of total sales. Other watches are sold by retailers not to end-consumers, but to foreign distributors. Thus the retail trade – in addition to watchmakers and wholesalers – plays an important role in the export industry. VAT statistics indicate that the retail watch and jewelry business turned sales of CHF 2.8 billion in 2011, of which exports account for CHF 1.2 billion. However, since this figure excludes sales to tourists who do not reclaim Swiss VAT, the true export sales figure is probably higher. No other Swiss retail segment – except perhaps for souvenir shops – is as dependent on tourism as the watch trade, which is reflected in the sector's regional structure. Employees in the retail watch business – measured in relation to population – are concentrated in hot spots of Swiss tourism such as Gstaad, Zermatt, Interlaken, Lucerne, Geneva, Zurich, Davos, the Engadine and Ticino (Figure 16).

### The watch and jewelry segment is the growth champion of the retail trade

Tourists were also the main driver of the recent boom in retail sales of Swiss watches. After a weak year in 2011, sales soared in 2012 with an increase of nearly 14% for the full year. In some months, sales growth even surpassed 20% (Figure 15). The watch and jewelry segment

<sup>24</sup> There are also certain demarcation problems. On the one hand, some watch retailers are active in other areas besides pure retailing, such as watchmaking. On the other hand, other retail outlets, such as department stores and souvenir shops, sell watches (at least low-price brands).

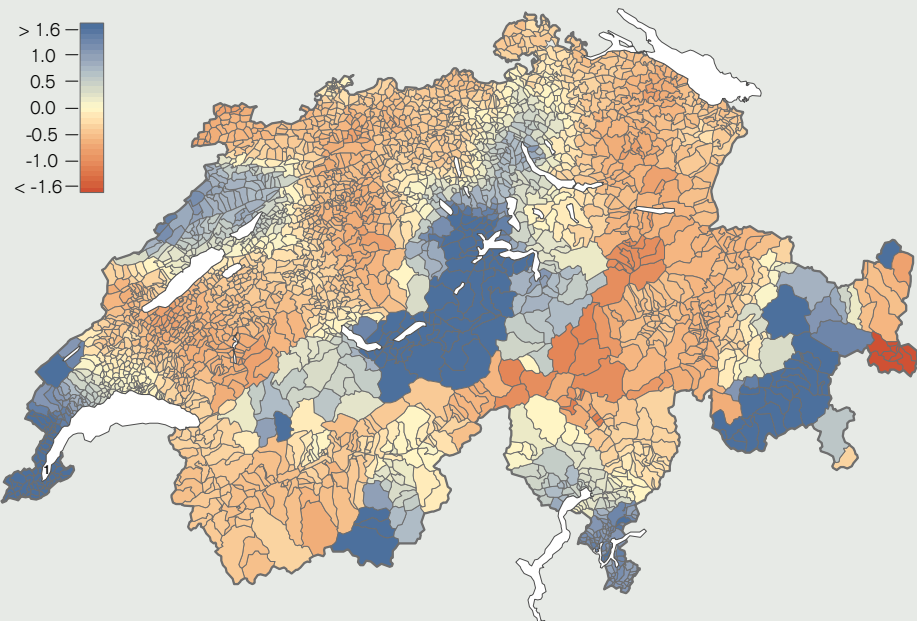
<sup>25</sup> The latter reported a 3.5% share of the "luxury goods and accessories" segment in 2012, which corresponds to estimated sales of CHF 3.4 billion. However, sales of jewelry and accessories (e.g. leather goods or travel needs), which are included in this category, should be omitted.

has been the growth champion of the retail trade in recent years, since in contrast to other segments it has suffered very little from price erosion and cross-border shopping. Sales received a boost from the shopping spree by tourists from the Gulf states and China (see box, p. 18). In contrast to the general malaise affecting Swiss tourism – overnight stays declined by around 2% in 2012 – the number of tourists from these regions posted impressive growth. Overnight stays by guests from China (including Hong Kong and Taiwan) rose by around 21% while those from the Gulf states increased by 24%.

Figure 16

### Retail Sales, Watches and Jewelry: Regional Supply Density

Retail Provision Index (RPI): blue = above-average capacity, red = below-average capacity, 2008



Source: Credit Suisse: Retail Outlook 2011 (p. 22 ff), Swiss Federal Statistical Office, Geostat



## Structural Change and Challenges

### Shifts in demand trigger structural change

As the Swiss watch industry was confronted by the drastic changes in demand discussed in the first part of this report, it was simultaneously subject to large-scale structural change over the last few decades. Three important structural developments impacted the sector and will continue to shape it in the medium term: the supplier situation and growing trend to vertical integration of production, the increasingly strict criteria for the “Swiss made” label, and structural transformation at the distribution level. The following pages give an overview of the sector structure and an explanation of the challenges facing the various sector players.

### Overview of Sector Structure

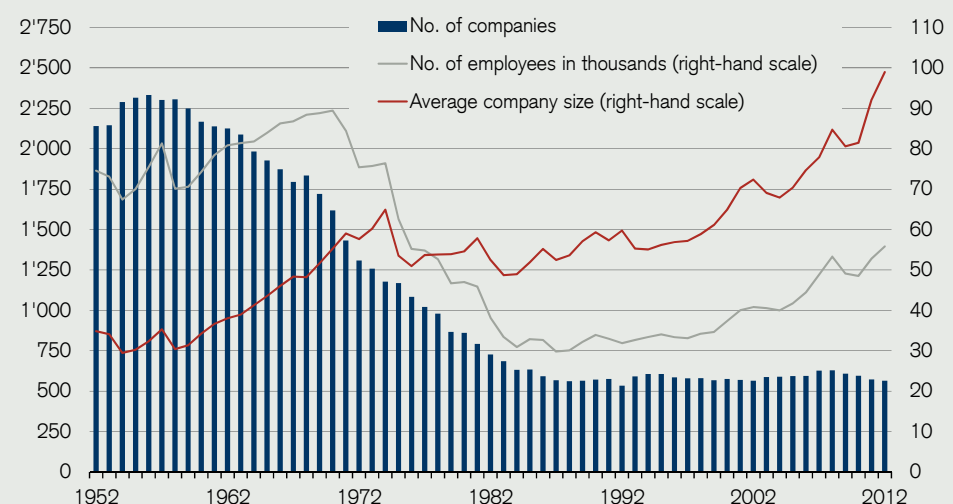
#### Over 55,800 employees in around 560 companies – consolidation in progress

The definition of the watch industry and the key figures for the sector differ depending on the source consulted. In the following pages we tend to use the data provided by the Swiss Watch Industry Employers' Association (CP), which are gathered annually and thus provide a timely analysis of structural change in the sector. The last survey by the Employers' Association (CP) indicates that there were 564 companies active in the Swiss watch industry at the end of September 2012 (Figure 17) – including branches, the total is 620. On the date of the survey, these firms employed 55,816 staff members, which corresponds to 1.3% of Switzerland's workforce and 5.3% of jobs in the secondary sector. The long-term consolidation trend evident in the sector accelerated sharply over the last three years. While employment rose dramatically, the number of companies has been falling steadily since 2009. Accordingly, individual companies have been growing in size: the average company size rose from 65 employees in 2000 to 99 in 2012. A key factor in this development is the increasing trend towards vertical integration of production (see “The Supplier Situation Challenge”).

Figure 17

#### Companies and Employees in the Swiss Watch Industry

Number of companies (excluding branches); number of employees in thousands; average number of employees per company



Source: Swiss Watch Industry Employers' Association (CP), Credit Suisse

### A variety of activities along the value chain

The watch industry comprises not only manufacturers of finished watches, but also a large number of its suppliers. This includes manufacturers of movements (and their parts) as well as producers of other watch parts such as hands, cases, dials, wristlets, etc.<sup>26</sup> In 2012, 26% of

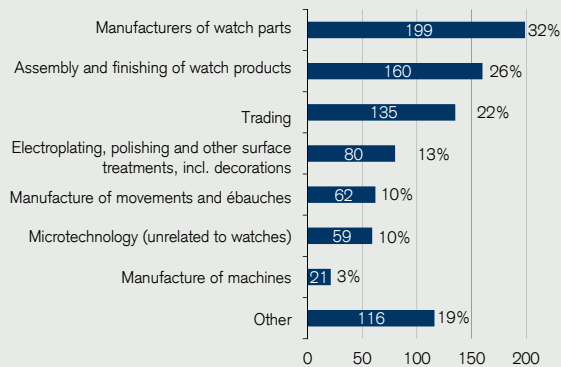
26 These components are grouped under the term “external parts”.

the surveyed companies were involved in manufacturing finished watches, 10% in producing ébauches and movements and 32% in the manufacture of other watch parts (Figure 18). Moreover, 20% of the companies were also active in trading. A broader definition of the watch industry could include suppliers of watch-specific surface treatments (e.g. polishing, engraving or galvanizing) and machines.<sup>27</sup>

Figure 18

### Companies by Activity

Number of companies (including branches), total companies = 620; a company may be active in more than one segment

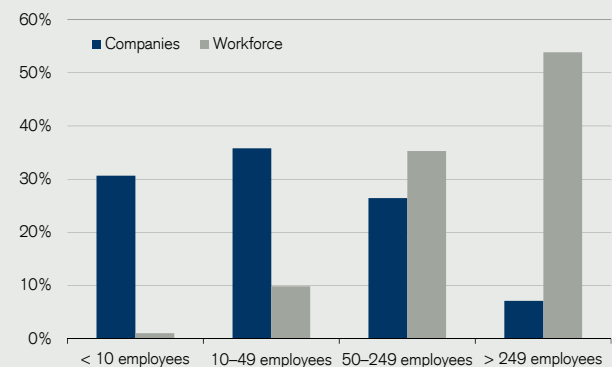


Source: Swiss Watch Industry Employers' Association (CP), Credit Suisse

Figure 19

### Distribution by Company Size

Number of companies (including branches) and employees by company size (by number of employees) in %, 2012



Source: Swiss Watch Industry Employers' Association (CP), Credit Suisse

### Not all watchmakers are the same

Manufacturers of finished watches can be divided roughly into four groups. "Manufacturers" are those who produce virtually the entire watch themselves.<sup>28</sup> They manufacture their own movements (aside from any specific components) and produce most of the other parts as well. They assemble their watches in-house and market them under their own brand name. In contrast, "établisseurs" purchase parts (movements and external parts) from suppliers, assemble them and sell the finished product under their own brand name. A "termineur" finishes the watch on behalf of a watch brand that provides the necessary parts. Finally, a "private label" company designs and produces watches for other companies (such as fashion designers), which then arrange for marketing under their own brand name.

### Large vs. small and mid-sized companies, groups vs. independent firms

The Swiss watch industry contains a small number of large and very large companies, and a large number of small and mid-sized companies. Some 93% of these companies have fewer than 250 employees; 31% have fewer than 10 (Figure 19). The large companies, however, have a major impact on the sector. Some have a workforce of several thousand employees. In total, the large companies account for significantly more than half of all workers in the watch industry. Thus the employment concentration for the sector is higher than the average for Swiss industry, in which around one-third of workers are employed by a large company. Four watch and luxury goods groups dominate the Swiss watch industry: Swatch Group, Richemont, Rolex and LVMH, which own a majority of the best-known watch brands and numerous manufacturers of watch parts. Moreover, the sector includes a large number of smaller, independent watchmakers and suppliers.

### Concentration in the Jura Arc

The watch industry is also characterized by pronounced geographical concentration. The overwhelming majority of companies and employees are located in the so-called "arc horloger" comprising the regions around the Jura Arc (Figure 20). The six cantons of Neuchâtel, Bern, Geneva, Jura, Vaud and Solothurn host over 90% of the companies and employees in the sector (Figure 21). Neuchâtel is the watchmakers' canton of choice, particularly with the two traditional

<sup>27</sup> The survey by the Swiss Watch Industry Employers' Association (CP) includes some microtechnology companies that are members of an association affiliated with the CP, but do not (only) serve the watch industry (they may, for example, work with medical technology or electronics firms).

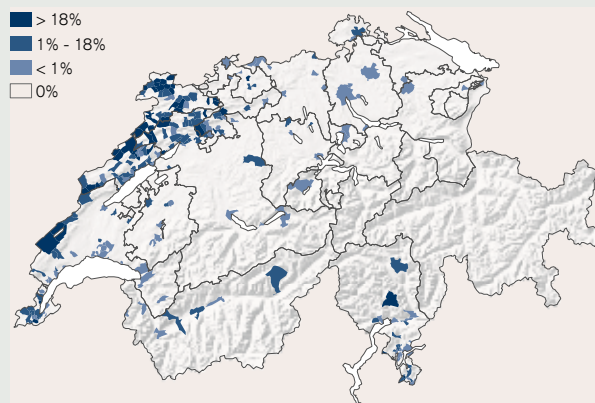
<sup>28</sup> Source: Berner, G.A. (1961): *Illustriertes Fachlexikon der Uhrmacherei*. Available online at [www.fhs.ch/berner](http://www.fhs.ch/berner)

centers of the craft, La Chaux-de-Fonds and Le Locle. In 2012, 27% of the sector's employees and 31% of its firms were active in canton Neuchatel. In canton Bern, the watch industry is most present in the region around Biel and in the Bernese Jura. The watch industry in Geneva is specialized in luxury watches, while the canton of Jura focuses on external parts. In the canton of Vaud, the industry is concentrated in the Vallée de Joux, where companies have specialized in mechanical movements and complex mechanical watches. Key locations beyond the Jura Arc include Ticino – specializing in finishing watch products (“terminage”), Valais (“terminage”, quartz movements) and the canton of Schaffhausen. Given its proximity to the frontier, many watch industry workers are cross-border commuters, particularly from France. The most recent survey by the SFSO in 2008 showed that such workers made up 32% of total sector staff. The figure is probably higher now, but exact figures are not available.

Figure 20

### Regional Significance of the Watch Industry

Percentage of NOGA category 2652<sup>29</sup> of the total workforce per municipality, 2008

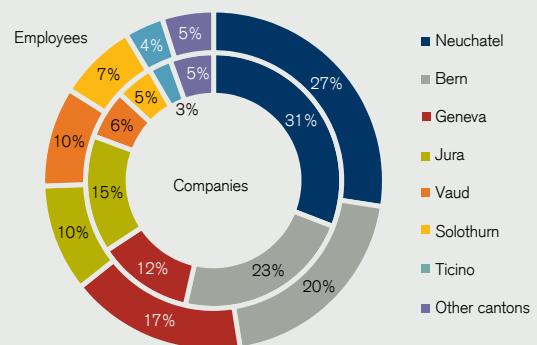


Source: Swiss Federal Statistical Office, Geostat, Credit Suisse

Figure 21

### Employees and Companies by Canton

Outer circle: percentage of total workforce; inner circle: percentage of total companies; 2012



Source: Employers' Federation of the Swiss Watch Industry (CP), Credit Suisse

### Does the surge in employment signal a shortage of qualified workers?

Driven by brisk demand, the Swiss watch industry has invested heavily in building up and extending its production capacities in recent years. Industry leader Swatch Group alone made investments of CHF 580 million in 2011 and CHF 500 million in 2012.<sup>30</sup> This capacity increase was accompanied by a surge in staff numbers. In the overall Swiss watch industry, more than 7,200 jobs were created from 2010 to 2012 (+15%, Figure 17), most of these in cantons Neuchatel (2,000, +15%) and Bern (1,600, +16%). A disproportionate increase in jobs was registered in Ticino (400, +25%) and Jura (1,100, +24%). With a total workforce numbering 55,816 in 2012, Swiss watch industry staffing reached a height last seen in 1975, and demand for workers is likely to continue rising in the years ahead. A 2012 study by the Swiss Watch Industry Employers' Association (CP)<sup>31</sup> reveals that the sector expects staffing (in the technical segment) to increase by another 15% by 2016. All professional categories anticipate growth: particularly micro-mechanics and watchmakers, but also professions involving external parts (e.g. dial makers). These trends raise concerns in the industry that qualified workers will become scarce. However, the Employers' Association (CP) study concludes that there is basically a balance between the supply of and demand for trained specialists, and that with the proper educational measures – additional emphasis on dual training paths and in-house staff development – there should be enough workers to meet the forecast need.

29 This definition of the watch industry is somewhat more restrictive than that of the Employers' Association (CP). Category 2652 of the General Classification of Economic Activities (NOGA) includes manufacture and assembly of watches, clocks and movements, as well as the manufacture of watch and clock parts (hands, cases, dials etc.) and other components (components of non-assembled movements).

30 Mainly to expand production capacities in Switzerland, but also abroad, e.g. for extending its trading network.

31 Source: Swiss Watch Industry Employers' Association (CP) (2012): *Enquête 2011–2012 sur les besoins en personnel. Rapport final*, La Chaux-de-Fonds.

## The Supplier Situation Challenge

### Trend to greater level of vertical integration

Since the 1990s, watch companies have been making increasing efforts to in-source as many steps in the production process as possible. This vertical integration is taking place either by acquiring independent suppliers or by expanding their own production capacities. The manufacturers' objective is to have the greatest possible control over the entire value chain and to decrease their dependence on external suppliers. Vertical integration gives producers more flexibility to respond to market developments, while clarifying the firm's positioning versus competitors and enabling it to optimize production planning. From a marketing viewpoint, fully integrated production also affects the product's image, since it promotes exclusivity. Finally, it enables manufacturers to avoid the supply bottlenecks that occur regularly in times of high demand.

### Major brands already largely vertically integrated

The largest watch companies have already implemented vertical integration to a considerable extent. The Swatch Group was the first company to initiate the process at the beginning of the 1990s, and others, such as Richemont and later LVMH, as well as independent brands such as Patek Philippe and Rolex, subsequently adopted the strategy.

### Swatch decision to stop deliveries drives vertical integration

The main driver of vertical integration in the Swiss watch industry was the Swatch Group's decision to limit deliveries of ébauches, movements and assortments to competitors (see box, p. 29). These are key strategic components in the manufacture of mechanical watches. A sharp increase in demand had triggered supply bottlenecks throughout the industry, and Swatch Group found a solution by reserving the capacities of its subsidiaries ETA (movements) and Nivarox-FAR (assortments) for its own brands. The group announced that it would shortly reduce its supply of ébauches to competitors, and ultimately stop altogether.

### Main components of mechanical movements are the ébauche and assortment

At this point it may be useful to define certain technical terms. Put simply, a watch movement consists of two groups of parts, the ébauche and the assortment. The ébauche is the base for the movement; the assortment, which consists of pallets, escapement wheel, balance spring and balance, is attached to it. The balance spring is the strategic element: combined with the pallets, escapement wheel and balance, it maintains the watch's accuracy.

### ETA produces an overwhelming majority of movements

The decision by the Swiss Competition Commission (WEKO) to partially approve the reduction in deliveries from Swatch subsidiaries to competitors could pose a problem for smaller companies. Swatch subsidiary ETA is estimated to have served over 70% of the market for mechanical movements over many years. Much of the remainder of watch movements are "ETA generics", except for companies in the upper and uppermost segments such as Rolex and Patek Philippe, who manufacture their own. Thus the sector is highly dependent on ETA.

### Swatch aims to stop deliveries by Nivarox-FAR as well

The Swatch Group also intends to limit supplies of assortments to competitors. Nivarox-FAR possesses highly advanced know-how in its area, having developed a new production process for finishing balances on a large scale. Nivarox-FAR accounts for an estimated 90% of the market for assortments. It will take a considerable amount of resources and time for any other firm to reach a competitive level of quality and prices, particularly in the area of balance springs. Given the current market conditions, WEKO has overruled the decision to limit deliveries by Nivarox-FAR. In the longer term, however, the sector will have to address the issue of assortment manufacture. The Swatch Group's knowledge lead and financial assets will keep it ahead of its competitors in movements and components for years.

### Only limited alternatives to Swatch Group

When Swatch Group announced in 2004 its intention to limit and ultimately stop deliveries, some companies decided to develop and manufacture their own mechanical movements. However, this strategy is very costly and time-consuming, and thus not an option for smaller manufacturers. In order to achieve economies of scale, smaller firms must attempt to find a partnership solution for production of the required components. Another option would be to purchase movements from a different supplier, but the few remaining independent suppliers of mechanical movements produce much lower quantities than ETA, and their prices are usually much higher. Thus, in order to operate independently of ETA, companies need not only the appropriate financial means but also ongoing development, which requires time. Some will have to feel the pinch from the delivery stop more acutely before taking action.

### Swatch Decision to Stop Deliveries: Key Milestones

- In 2002, Swatch subsidiary ETA SA announced that it would limit its supplies of ébauches to companies outside the Swatch Group as of 2003. Deliveries would stop altogether as of 2006. Thereupon WEKO launched an investigation regarding abuse of a dominant market position. At that time, 75% of all Swiss made mechanical movements were based on ETA ébauches.
- In 2004, the investigation reached a conclusion: ETA was ordered to continue supplying ébauches to competitors through 2010, but was authorized to gradually reduce delivery volumes each year. This transition period was granted to give competitors time to find alternative suppliers.
- In November 2008, WEKO opened a preliminary investigation when ETA announced price increases and changes in payment methods that triggered a series of complaints from customers.
- In the spring of 2010, Swatch Group informed WEKO of its intention likewise to cease supplying competitors with finished movements and assortments in the near future, citing delivery bottlenecks at ETA and Nivarox-FAR caused by a sharp increase in demand for Swiss watches.
- In June 2011, WEKO launched a second investigation of Swatch Group regarding abuse of a dominant market position and, as a precautionary measure, ordered ETA and Nivarox-Far to continue supplying third-party customers during the investigative process, though allowing limitations as of 2012.
- As of that date, ETA was permitted to reduce its deliveries of finished movements to producers of finished watches to 85% of the 2010 level. Deliveries of movements to refiners, who do not produce finished watches, could be reduced to 70% of the 2010 level. Nivarox-FAR could limit its deliveries of assortments to 95%.
- In May 2012, WEKO ordered a one-year extension of the precautionary measures at the existing conditions.
- To resolve this issue, WEKO and the Swatch Group signed an agreement in the spring of 2013 that would have allowed the Swatch Group to gradually reduce deliveries of movements and assortments to third-party customers by 2021 and 2015, respectively.
- In July 2013, WEKO retracted the agreement and called for renegotiations. While it seems that a 10% reduction in deliveries of movements by 2014 is acceptable, WEKO found that in the current market environment and in the absence of real alternatives, it was too early to begin scaling back deliveries of assortments. The precautionary measures in this area expire at the end of 2013, so deliveries of assortments to third-party customers must resume at full scale as of 2014.

### Watch components a key element of exclusivity

In addition to the end of deliveries from Swatch, market considerations are fueling the trend towards vertical integration. Today, watches are more than simple timepieces: they are perceived as status symbols and therefore must increasingly differentiate from competitors as their prices rise. Positioning begins with the inner workings, extends across the appearance of the watch and includes the image of the product. Standing out from the competition requires exclusivity, and for watches the movement plays a central role in this regard. Many luxury brands recognized this early on and began to expand or acquire their own capacities and know-how for producing movements and other essential components.

Figure 22

**Vertical Integration in the Watch Industry since 2000**

Selected majority participations in supplier companies; colors correspond to the acquiring company

Year	Hands	Dials	Wristlets	Movements and parts thereof	Cases	Others
2000	Universo	Stern		Pignons Juracie	Bruno Affolter	
		Linder		Brandelet		
		Beyeler				
2001			HGT Petitjean		HGT Petitjean	Boninchi
			Artelink		Calame & Cie	Ergas
2002		Rubattel & Weyermann				
2003				DTH		
2004				Rolex Biel	Pol-Art	
2005			Prestige d'Or*			
2006		MOM Le Prélet		Minerva		
		Valor Lopez et Villa		STT		
2007	Indexor		Donzé-Baume	THA	Donzé-Baume	Leschot*
				Roger Dubuis	Finger*	
2008				François Golay		H. Moebius & Sohn
				SFT/Soprod		Burri
2009						
2010				Tanzarella		
				Novi		
2011		ArteCad		Fabrique du Temps		Profusion
		Les Cadraniers				
		Donzé Cadrans				
2012		Léman Cadrans		La Joux-Perret	Simon & Membrez	Termiboites
		Natéber				Varin-Etampage
						Varin-Varinor
2013						Prototec
					Joseph Erard	

Source: Factiva, Federation of the Swiss Watch Industry (FH), companies, Credit Suisse

\*Acquired by Bulgari, which was taken over by LVMH in 2011.

**Makers of movements are main acquisition targets**

Figure 22 depicts the acquisitions of suppliers in the watch industry over the last 13 years (with no claim to completeness). It is readily apparent that acquisition activity was particularly brisk in 2008 and 2011, years of exceptionally high demand and subsequent supply bottlenecks. It is equally obvious that the preferred targets were companies that manufacture movements or components. In light of the situation described above, this comes as no surprise. The movement is the crucial and most complex phase of production when it comes to implementing a company's own manufacturing facilities. Consider, as a useful comparison, an automobile company that produces its own engines.

### Dials also play an important role

The second most often acquired companies are manufacturers of dials. The dial is the largest visible surface of the watch, making it a large part of the design and essential for the recognizability factor. Thus it is understandable that watch manufacturers target these companies in the vertical integration process. Significantly fewer acquisitions took place in other segments.<sup>32</sup>

### The dangers of consolidation

Developments in the watch industry should remain dynamic for some time to come, with a clear trend towards vertical integration. Whether this change is efficient for the overall market is debatable, from an economic viewpoint. It may be in the interest of a corporation to control as much of the value chain as possible, in order to increase its market influence and exclusivity and to be immune to capacity bottlenecks and stricter conditions imposed by suppliers. However, competition theory as well as practice stipulate that competition stimulates business and promotes innovation. This is just as true for end-consumer products as for intermediate products. From this point of view, there is concern that vertical integration will eliminate economies of scale and innovative potential.

## The “Swiss Made” Challenge

### “Swiss made” drives the watch industry

In the Swiss watch industry, the “Swiss made” label has proven immensely valuable as a seal of quality and marketing instrument. In recent years, other sectors have recognized the value of the “Swiss” label. The label was sometimes misapplied, giving rise to lawsuits from the business sector, public debate and media attention. The Swiss Federal Council and the Parliament countered by drawing up the “Swissness” legislative amendment.

### Stricter criteria governing use of Swiss name

On 21 June 2013, some six years after the first application for an official designation of Swiss origin, Parliament passed the “Swissness” amendment. A referendum against it is highly unlikely,<sup>33</sup> since business basically supports protecting the designation of Swiss origin, and the “Swiss” brand enjoys great popularity with the citizenry. The “Swissness” amendment is to be used as the foundation for new regulations governing the use of the Swiss name on watches.

#### “Swiss Made”: Current Regulations versus “Swissness” Amendment

The current “Ordinance regulating the use of the name ‘Swiss’ on watches” of 1971 sets the criteria by which a watch may qualify as “Swiss made” as follows:

A watch is considered Swiss if

- its movement is Swiss, i.e.,
  - o the movement is assembled in Switzerland,
  - o the movement has been inspected by the manufacturer in Switzerland and
  - o the components of Swiss manufacture account for at least 50% of the total value, without taking into account the cost of assembly;
- its movement is cased up in Switzerland, and
- the manufacturer carries out the final inspection in Switzerland.

In order to merit the “Swiss made” label, the “Swissness” amendment requires that for industrial production (e.g. watches), at least 60% of the production costs are attributable to operations carried out in Switzerland; this may include the costs for assembly, research and development, and legally or industrially regulated quality assurance and certification. Moreover, at least one essential manufacturing process must take place in Switzerland.

In contrast to the existing ordinance, the “Swissness” amendment applies not only to the movement and final inspection, but to every component of the watch (including wristlets and cases).

<sup>32</sup> The “Other” category includes suppliers from various segments. These are smaller components such as crowns and stones for movements.

<sup>33</sup> The deadline to register a referendum is 10 October 2013.

### “Swissness” amendment applauded by “haute horlogerie”...

Representatives of Switzerland's “haute horlogerie” welcome the “Swissness” amendment. These mainly large watchmakers produce most of the components of their watches in their own works on Swiss soil. An earlier critique of the preceding regulations was that certain components such as dials, cases and wristlets were excluded from the reckoning. The “Swissness” amendment addresses these concerns. However, the 60% minimum still falls short of the target suggested by the Federation of the Swiss Watch Industry (FH), which would prefer that the required Swiss portion of the production cost be raised to 80%. Discussions between the FH, law enforcement and the department of justice should result in a draft revision to the sector's own ordinance of 1971.

### ... but not by manufacturers of watches in lower price segments

Not all market players are as enthusiastic about the “Swissness” amendment as the “haute horlogerie”. Small and mid-sized Swiss watch companies that produce watches in the low and medium price segments, in particular, protested the 60% minimum before the parliamentary vote.<sup>34</sup> They objected to this definition of “Swissness” because they source a majority of their watch components abroad.

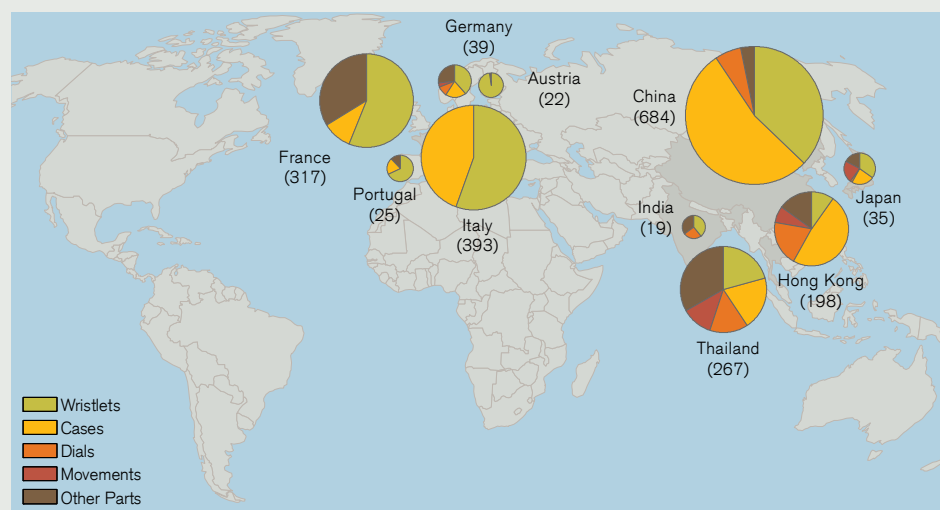
### Key suppliers are based in Europe and Asia

The watch industry imported parts for a total value of CHF 2.1 billion in 2012, which represents around one-tenth of the value of their exports. The import-export ratio is likely to be much higher for Swiss watches in the lower price segments; however, exact figures are not available. Suppliers of wristlets, cases, dials and movements are located mainly in China, Italy, France, Thailand and Hong Kong (Figure 23). These countries combined accounted for 88% of Swiss imports of watch parts in 2012. While imports from European countries were mainly wristlets in 2012, China and Hong Kong delivered mainly cases. The high share of movements imported from Thailand is noteworthy, considering the “Swissness” regulations. In fact, various Swiss watchmakers have established factories in Thailand, from which they import incomplete small movements into Switzerland and assemble them here. In this way, such movements – most of which are electronic – qualify for the “Swiss made” label according to the 1971 ordinance.

Figure 23

#### Watch Components: Largest Supplier Nations to the Swiss Watch Industry

Total 2012 imports in CHF million (value in parentheses), breakdown by part type



Source: Swiss Federal Customs Administration, Credit Suisse

### The challenges of supply bottlenecks and production investments

The main reason that less expensive Swiss watch brands import components from abroad is that the production costs associated with these components are lower. Under the new “Swissness” criteria, these watch brands will be obliged to replace most of their foreign suppliers with

<sup>34</sup> The “IG Swiss Made” interest group was founded to protest the 60% minimum. Most of the members of the interest group prefer to remain anonymous, but Mondaine and Ronda, at least, are identified as the initiators and members.



domestic ones in order to continue to qualify for the “Swiss made” label. Since many Swiss suppliers are already operating at high capacity, greater demand for watch components will trigger longer delivery times and higher prices. Some watchmakers will have to pump investment into their own production capacities as protection against the inevitable supply bottlenecks, thus intensifying the trend towards vertical integration in production, particularly of watch components. Higher production costs and investments are likely to work through to higher prices for end products. Such price increases – or the threatened loss of the “Swiss made” label – may have an adverse impact on the competitiveness of the affected brands versus foreign watchmakers. Against this backdrop, smaller and mid-sized watch companies have announced their participation in the discussions surrounding the revision of the sector's own ordinance from 1971 to voice their concerns.

## The Distribution Challenge

### Vertical integration is also an active force in distribution

Distribution is a multi-faceted challenge for watch brands: well-known, financially solid brands must determine to what extent and in which markets they prefer to handle distribution themselves, while smaller brands must determine whether the costly vertical integration process in distribution is a strategic option at all. If not, they must evaluate the most efficient method of gaining access to markets, especially growth markets in emerging economies. Basically, vertical integration of distribution offers many advantages. As a result, vertical integration trends at both the distribution and production levels (see “The Supplier Situation Challenge”) have increased in recent years.

### Traditional distribution strategy increasingly ceding to new forms...

The transformation in watch distribution comprised numerous steps. Traditionally, a watch brand aiming to access a new market would enter into cooperation agreements with local distributors, thus establishing a link with retailers. The manufacturer and wholesaler would share the financial risk as the latter would purchase products from the former and assume a portion of the marketing costs. In return, distributors would often receive exclusive marketing rights in a particular market. Under this distribution model, the manufacturer would usually benefit from the wholesaler's local network and know-how.

### ... first at the wholesale level...

The trend towards vertical integration of distribution in the watch industry was initiated in the 1990s, and began at the wholesale level. At that time, watch brands belonging to big groups such as Swatch and Richemont began to establish their own distribution subsidiaries, thus siphoning business from independent wholesalers. However, even with this distribution model the watch companies do not completely abandon local distributors. Many brands use a combination of both distribution channels (subsidiaries and independent wholesalers) depending on the market environment.

### ... and later at retail level

Towards the end of the 1990s, an increasing number of brands, mainly from the high end and luxury segment, went a step further and began to establish retail shops. Their preferred format is a monobrand boutique, or flagship store. This trend gathered strength throughout the 2000s. Either the watchmakers manage the flagship stores themselves, or they license the operation. A less common approach is the multibrand boutique, which offers several brands from the same group. The Swatch Group's “Hour Passion” and “Tourbillon” boutiques are prominent examples. Note that flagship stores are not a new idea, but have long been part of the distribution concept for certain brands. The historical Geneva “salons” hosted by Patek Philippe, for example, date from the 19th century.

### Vertical integration of distribution offers advantages...

The advantages of vertically integrating distribution are mainly in marketing. A monobrand boutique offers a wide range of tools with which to positively influence public perception of the brand, raise brand awareness and unify a global marketing approach. A manufacturer can present its entire collection at a flagship store. Companies can offer their staff brand-specific training and thus better communicate brand values to customers. The company can more easily control pricing with its own stores, while improving the efficiency of logistics. Manufacturers can more closely trim the volumes produced and supplied to the actual needs at distribution points and thus avoid overproduction or shortages. In addition, they have greater control over the marketing of their unsold products on the gray market (resellers, discounters). An increase in cus-

customer knowledge is one of the greatest advantages of a direct distribution strategy. Finally, the brand retains the retail margin in-house.

**... as well as disadvantages for brands that adopt this strategy**

Vertical integration of distribution may also bring disadvantages. It entails relatively high investment costs. In order to achieve the necessary customer frequency, sales points are generally in central locations in major cities, where rental prices are generally highest. Competition between watch brands for the best locations drives prices even higher. For this reason, only companies that have the necessary financial options can aspire to vertical integration of distribution. Still, profitability is not the sole consideration; some locations serve primarily to establish a market presence. A store on Zurich's Bahnhofstrasse or Geneva's Rue du Rhône is considered essential by some brands.

**Independent retailers facing a major change**

Vertical integration of distribution is forcing independent multibrand stores to rethink their strategy. Since flagship stores need not necessarily be managed by the manufacturer itself, retailers have the possibility to specialize in one brand as a licensee, or to manage several stores for individual brands. However, as this is not an option for every retailer, a certain consolidation is on the cards in the longer term.

**The end-consumer is affected as well**

Increasing vertical integration of distribution has two effects on customers. On the one hand, monobrand boutiques offer an enhanced shopping experience and wider range of products from that particular brand. Post-purchase support is a particular strength here, thanks to the brand-specific competence of the sales staff and the watchmakers, who are often on-site. On the other hand, the flagship store trend means customers must make an extra effort to gain an overview of the selection available across the sector.

**Most monobrand boutiques are located in Asia**

The geographical distribution of monobrand boutiques illustrates the current balance in global demand for watches (Figure 24)<sup>35</sup>. The highest concentration is found in Asia, which is hardly surprising as it is the largest export market for Swiss watches. Over one-third of these boutiques are located in China alone (including Hong Kong and Taiwan). The Arab region (Dubai) and major European cities (Paris, London) also display a high concentration of monobrand boutiques. There is a notably low concentration in Scandinavia, where interest for Swiss watches appears to be low despite the population's purchasing power. Flagship stores in the USA tend to be located in the main shopping and tourist destinations of Los Angeles, Las Vegas, Miami and New York.

**Some brands have multiple boutiques in Asian cities**

Our research highlights the vitality of the Asian market: in cities such as Beijing, Shanghai and Dubai, some brands have several boutiques, while in Western cities they operate just one flagship store. Even brands such as Breitling and Hublot, which in comparison to other brands are just beginning to vertically integrate their distribution processes, are opening most of their boutiques in Asia. The brands are also accessing markets that appear less than glamorous at first glance, such as the Mongolian capital of Ulaanbaatar, where Hublot and Omega have opened monobrand boutiques. However, this move is based on strategic foresight that is well-founded: according to the IMF, Mongolia should rank among the countries with the highest economic growth in the years to come, partly due to its rich supply of natural resources. If such a country expands rapidly and develops into an international hotspot, the first retailers on the ground will have an invaluable advantage.

**Monobrand boutiques are the admission card to the emerging markets**

The disproportionately high significance of certain countries in the list of monobrand boutiques may be surprising given their currently low shares of Swiss watch exports. This is the case with emerging markets such as India, Malaysia, Indonesia and South Africa. But it sends a strong signal that watch brands believe in the potential of these markets (see "Emerging Markets: Potential for 'Another China'?") and reflects the fact that traditional distribution strategies are difficult to implement in these countries due to a lack of infrastructure.

<sup>35</sup> The chart shows the monobrand boutiques of 12 watch brands in the mid-price to luxury segments that are among the 50 most valuable Swiss brands according to the 2013 rankings by consultancy firm Interbrand. Their locations were taken from the information available on company websites.

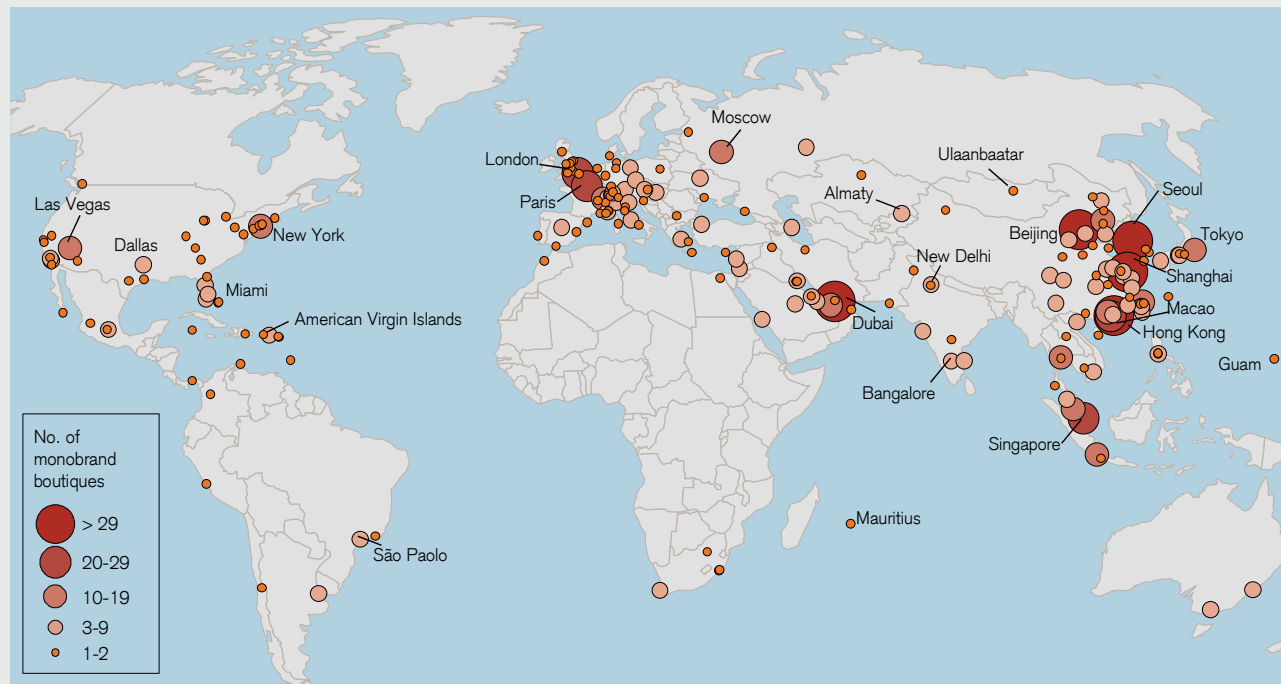
### Tourist destinations: great significance

The geographical distribution of monobrand boutiques also highlights the great importance of tourists for the watch industry. Small Caribbean islands such as St. Barthélemy and Barbados, or Guam in the middle of the Pacific, host monobrand boutiques of several Swiss brands for the tourist seeking an exclusive watch. On the African continent, besides in South Africa, flagship stores can only be found in Egypt and Morocco, two countries with relatively high tourist streams.

Figure 24

#### Geographical distribution of monobrand boutiques for selected Swiss watch brands

Location of monobrand boutiques of the 12 most valuable Swiss watch brands according to Interbrand; circle size: number of boutiques per city; as at mid-July 2013



Source: company websites, Credit Suisse

### Distribution is a particular challenge for small independent brands

Distribution can be challenging for smaller watchmakers that are not affiliated with a larger group, since direct distribution strategies are rarely financially feasible. Moreover, in contrast to groups that boast many well-known and sought-after brands in their portfolio, smaller watchmakers have less bargaining power with independent retailers, since their less well-known brands represent a certain financial risk for the distributor. Large watch groups, on the other hand, can encourage retailers to add additional models to their selection, or discourage them from selling brands of other watchmakers. Large groups also have more leverage when making stipulations about product presentation.

### Nonetheless, there are also distribution opportunities for smaller brands

Vertical integration of distribution by major brands also opens up opportunities for smaller brands. It creates space on the shelves of independent multibrand boutiques, where smaller brands can improve their market presence. One way to improve their competitiveness is to join with other brands in cooperative distribution groups, but this option is not often observed. Other possibilities are to employ agents as representatives or to concentrate on markets in which the company already has good personal contacts. The latter, however, bears the risk that geographical diversification will be limited.

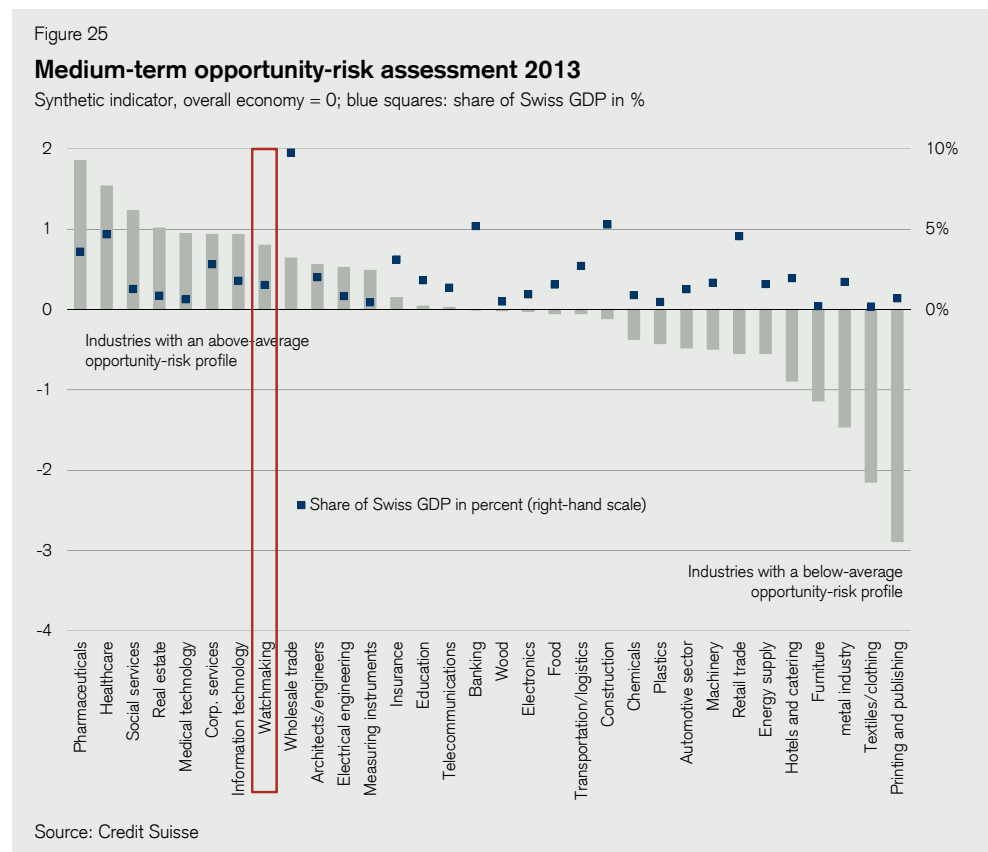
## Outlook

### Current deceleration not alarming

After three years of impressive growth, business in the Swiss watch industry has slowed considerably since autumn 2012. Watch exports in the first seven months of 2013 reported only meager year-on-year growth (+1.1%). Growth rates in the double digit percentages, as posted by the sector from 2010 to 2012, are not sustainable in the long term, so the current deceleration should not necessarily be interpreted as a bad sign – more as a “normalization” process or “consolidation at a high level”. It is also a way to reduce the delivery and capacity bottlenecks that accumulated over the last few years across all segments of the industry.

### Above-average medium-term opportunity-risk assessment...

In our view, the medium-term outlook for the Swiss watch industry is still positive, on balance. Our annual opportunity-risk assessment for the watch industry compared to other sectors is above the average for 2013 (Figure 25).<sup>36</sup> We believe that opportunities outweigh risks. The years ahead should see ongoing, albeit slower, growth in global demand for luxury goods.<sup>37</sup> As our analysis concludes in the section “Emerging Markets: Potential for ‘Another China’?”, there is still enormous potential for the Swiss watch industry, particularly in the emerging markets where the standard of living is forecast to rise.



### ... but there are risks too

While the outlook for the Swiss watch industry is largely positive, certain challenges will remain throughout the coming years. One of these is competition not only from foreign watchmakers, but from other forms of luxury goods. Is there a danger that watches – like other status symbols in the past – will fall out of fashion? The risk seems negligible: the watch’s function as a time-piece is less relevant in the era of mobile phones and computers. For the owner, it is more of a

<sup>36</sup> For further information on our opportunity-risk assessment, see Credit Suisse (2013): *Swiss Issues Industries – Sector Handbook 2013: Structures and Prospects*.

<sup>37</sup> Bain & Company estimates annual growth at 5–6% for 2014–2015. Source: Bain & Company (2013): *Worldwide Luxury Markets Monitor, Spring 2013 Update*, Fondazione Altgamma, Mailand.

social signal, communicating the wearer's external values such as status or personality. The taste for Western status symbols in the emerging markets is likely to remain high, and in contrast to other luxury goods, such as automobiles or artwork, a watch can be worn and displayed at all times. Moreover, a watch is the only universally accepted piece of jewelry for men. Nevertheless, preferences can change over time, so it is certainly possible that a general trend away from luxury and back towards modesty and frugality may emerge. For this reason, the Swiss watch industry has to keep a close eye on trend patterns so as to respond promptly and appropriately. Another challenge for the sector is to maintain diversity – both in sales markets and in product offerings. We have identified three trends at structural level that shaped the Swiss watch industry in the past, and that are likely to remain critical issues in the medium term: the supplier situation (Swatch delivery stops) and the trend towards vertical integration of production, the stricter definition of “Swiss made”, and the vertical integration of distribution.

### **The outlook varies for individual sector players**

Given the wide variety of players in the Swiss watch industry (see “[Overview of Sector Structure](#)”), the outlook also varies across the sector. Prospects are particularly bright for the large watch companies and luxury goods firms. Their size and financial resources give them significant bargaining power – both with suppliers as well as in distribution. Their size also gives them more opportunities in geographical diversification than smaller companies possess, giving them the ideal position to benefit from growth in a wide variety of markets. Among the independent watchmakers, the outlook depends upon the company's positioning. For well-established, traditional brands in the upper price segments, the future is bright. Since these companies already manufacture a large portion of their mechanical movements themselves, their dependence on external suppliers (especially Swatch Group) is limited. The picture is more doubtful for some of the smaller independent watchmakers, especially those in the low- and mid-price segments, whose bargaining power with suppliers and distributors is limited. These are likely to suffer most from the above-mentioned structural challenges. We identify good medium-term potential for suppliers, who stand to benefit from the vertical integration trend in production and the tightening of the “Swiss made” regulations. Suppliers who have strategically important know-how (in both movements and assortments) for particular brands will continue to increase in value. On balance, we expect the concentration process in the Swiss watch industry to continue in the years ahead.

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