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## **Kamla Dials & Devices Ltd (KDDL)**

- Perfectly scalable, wide-moat business at an inflection point

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\* Disclosure – I am invested in KDDL



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Few nations sound synonymous with anything. True, certain rare minerals are only available from specific territories and certain produce can be grown only in certain geographies. But these are mostly nature oriented, god gifted deeds. When it comes to products that are made, even fewer nations can claim monopolies or near-monopolies on anything. Italians still rule the world of supercars, but they can be challenged by the likes of Porsche, Aston-Martin and a few others. French wine is no longer supreme. But the watches of Switzerland? The Swiss just own the mechanical watch market.

The awe that Swiss watches inspire today are not without its share of legendary history. By 1980, following the launch of cheap and highly accurate quartz watches by the Japanese, demand for Swiss pin lever watches had plummeted. As a result, Swiss watch employment declined by two-thirds from 90,000 to 28,000 as 60% of all watch companies shuttered their businesses. The remaining manufacturers disposed their tools and equipment required for the manufacture of mechanical timekeepers, replacing them with machinery to produce quartz watches.

It took the industry close to a decade to react and to find a solution to the Japanese incursion and thankfully, there were a few good men in the industry. ***The secrets to success were then laid in beliefs.*** Beliefs that the beauty of mechanical timekeepers lay not solely in their functional utility, but in the patrimony of a four hundred year culture and tradition. In beliefs that the soul of the human being injected into the craft of a timekeeper inspires emotions that an entirely mass produced, machine assembled object cannot.

With this strongly sowed belief, the Swiss regrouped. They salvaged extant brands and revived others. They encouraged the young to enter watchmaking. To elevate the prestige of watches, they educated watch buyers about the challenges of making chronometers and complications. They added style and mystique. ***Above all, they exploited genuine history and longevity.***

The outcome?

Some of the most revered brands such as Rolex, Omega, Cartier, Rado, Breitling, Longines, Tag Heuer, Patek Philippe, Jaeger-LeCoultre and an industry that is ***today worth approx. \$24 billions.***

It is the new found wealth that seeks to show it and the taste for western status symbols in the emerging markets has been on the high. For instance, for most part of the previous decade, the ***Chinese have been consuming 40% of Swiss watches*** exported every year. I am not going to follow this up with an Indian prediction for the next decade. But, nevertheless, the sheer opportunity size and the longevity of the opportunity in India cannot be ignored.

KDDL (Kamla Dials & Devices Ltd) is an Indian Watch component manufacturer and the owner of Ethos – India's largest retailer of Luxury watches. **I believe that KDDL has built a scalable business model on back of legendary brands and with a visionary management on top. There is enough empirical evidence to suggest that the business can be perfectly scaled and I believe that KDDL is at an inflection point.**

## A short brief on Luxury Watch industry

### Main watch exporting countries (Direct exports)

Countries	Units in millions	Change in %
China	634.4	-4.2%
Hong Kong	331.5	-6.5%
Switzerland	28.1	-3.6%
Germany	18.8	+13.8%
USA	9.2	+7.3%
France	6.9	+7.9%

Watch industry, unlike many others is an inverted pyramid. The profit centers and the value of the opportunity lie very skewed at the top. ***The top 3% of the volumes (95% of them Swiss) contribute to 60% of the value.***

This top 3% is dominated by 4 groups – Swatch Group (Omega, Rado, Tissot ..) , Rolex Group (Rolex, Tudor), Richemont Group (Montblanc, Cartier ..) and LVMH Group (Tag Heuer, Bulgari ..). The entire supply chain that includes component manufacturers, brand owners, distributors and retailers is well established and profitable globally.

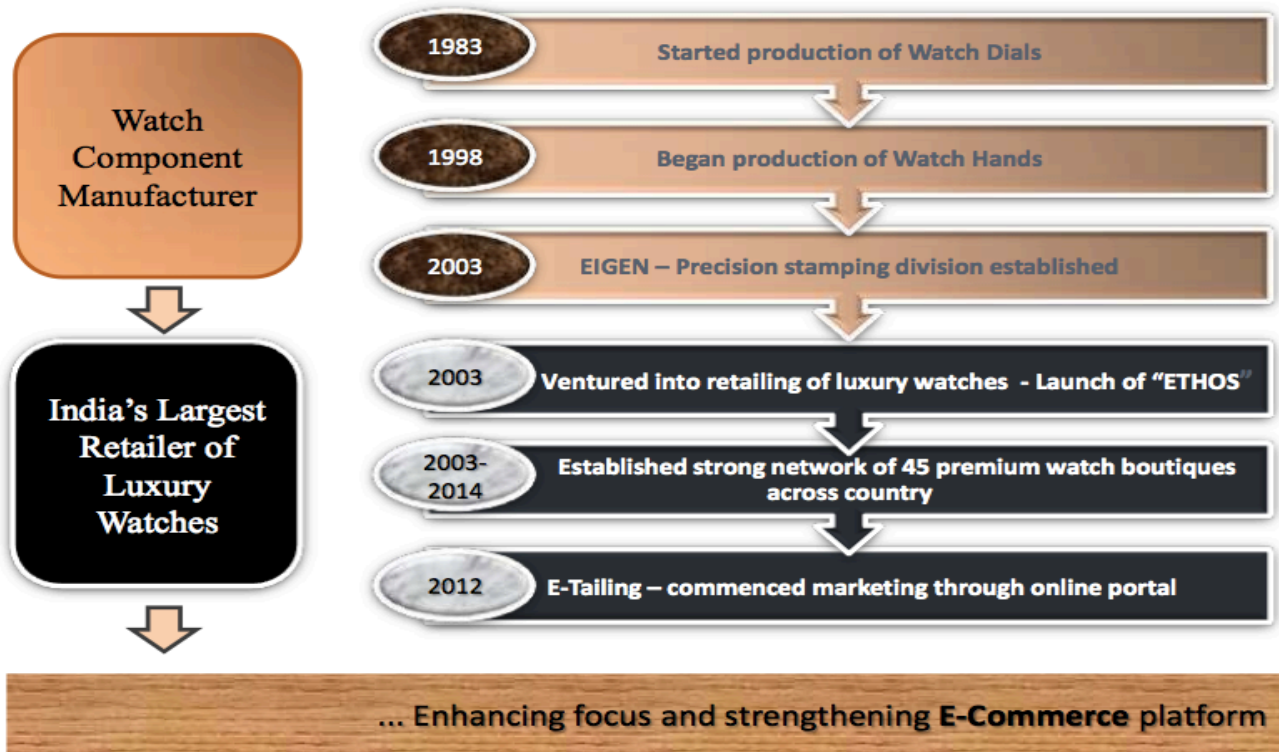
Next to the brand owners, the retailers have a major stake in the industry and some of the large established Asian retailers include Hengdeli Holdings (HKG : 3389), Oriental Watch Holdings (HKG : 0398), Emperor Watch and Jewellery Ltd (HKG : 0887) and The Hour Glass (SGX : AGS). All of these large retailers are ***proven & sustainable businesses, profit generating and cash rich.*** The above-mentioned names are most active in Mainland China, HK, Singapore, Australia, Japan and Thailand.

### About KDDL

KDDL is a diverse company focusing on the business of Watches and Precision Engineering. It has 3 distinct business divisions – 1) Watch component manufacturing 2) Stamping division 3) Watch retailing.

KDDL standalone is made of component manufacturing and stamping division while KDDL consolidated includes its subsidiary watch retailing division too.

Evolution -



KDDL Standalone division -



KDDL Standalone is predominately made of Watch dial and Watch hands manufacturing. This is a 30-year-old established business division, which has been *highly sustainable and reasonably but consistently profit making*.

In this division, KDDL exports the components to undisclosed (per agreement) Swiss brands and to makers such as Titan Industries and Timex in India. Around 75% of the revenues come from exports and this division contributes to roughly 78% (around INR 91 Cr) of the KDDL standalone revenues with the rest coming from the stamping division.

## Stamping division –

2 decades of operational experience in manufacturing high precision watch hands and dials to international quality has helped KDDL develop a set of capabilities, which it is trying to tap using EIGEN, its stamping division.

In the last few years, Eigen has established its position in development and manufacture of high precision press tools and precision stamped components and has executed many prestigious orders in Telecommunications, Electronics, Medical, Electrical, Automotive and Aero Industries in the domestic as well as in the Global Market. EIGEN has already developed tools for the many components for the mobile phone gadget manufacturers and various Medical applications.

The revenue contribution is currently very miniscule (INR 15 Cr) but the management claims strong growth for this segment.

## Luxury watch retailing Division

This is undoubtedly the crux of this investment thesis.

KDDL as mentioned above has been manufacturing Watch components to its Swiss clients since 1983 and the big break came in 2003, when the Indian government opened the domestic market to imported Luxury watches.

Ethos was one of the first movers and today by far the **largest Luxury watch retailer in India with 46 stores across 13 cities. The next closest completion has 8 stores in just 1 region (NCR).** Majority of the competition is made of **single-city, family-owned, single or multiple store** operators. It is not an understatement to state that Ethos is the only Luxury watch retail chain in India.

## Brand Portfolio & Agreement





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The brand portfolio contains more than 50 international premium and Luxury brands ranging from INR 5,000 to INR 50,00,000. Ethos has partnered with all of the 4 major Swiss watch manufacturers and possibly has the largest collection of Luxury watches in India today.

There are 3 different types of partnerships with brands – **1) Non-Exclusivity 2) Exclusivity 3) Non-Exclusivity with First right**

Quite obviously, the biggest brands with the likes of Omega, Rolex, Cartier do not provide exclusivity to any retailer and form the Non-Exclusive portfolio. The brands with which Ethos has exclusivity are usually the new entrants into the market. These brands are called “House” brands, which include Carl F Bucherer (Luxury), Louis Erard, Edox and Cover. The third and smaller part of the portfolio is the brands with which Ethos does not have any exclusivity but first right on any location. This category includes Raymond Weille and Frederique Constant.

### **Retail Store Formats**

Ethos currently operates 3 distinct store formats – 1) Ethos 2) Ethos Summit 3) Mono-brand boutiques

#### **Ethos –**

Ethos store format is primarily aimed at Premium and Premium to Luxury segment with a price range of INR 5,000 to INR 2 Lacs. This category contributes to around 70% of the INR 2,500 Cr premium and luxury watch retailing in India.

This is primarily aimed at the HNI segment in India and there are 38 Ethos store format in India across cities.

#### **Ethos Summit –**

This store format is entirely aimed at the high-end Luxury section and the starting price of the watches is at INR 2 Lacs and goes up to about INR 50 Lacs. The target audience is composed of the Ultra-rich category and there are 8 Summit stores in India.

While this market is smaller at 30% of the overall Premium and Luxury, the growth rates tend to be higher than Premium category.

#### **Mono brand boutiques –**

Mono brand boutiques are basically stores that are operated in partnership with the brand owners. For the purpose of count, **these stores are classified under the Ethos category** and they sell both premium and luxury range of a particular brand. In many of the mono brand boutiques, KDDL also sells other brands.





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KDDL gets better terms for Mono Brand Boutiques than for a multi-brand store since it enhances the vision for a particular brand. For this reason, the brands are also more interested in showcasing their best pieces and providing a very wide range of collection at better terms. Exclusive launches, Limited edition watches and some specific models are available only at mono brand boutiques.

Currently, KDDL operates mono brand boutiques for Swatch, Tissot, Rolex, Rado, Fossil and Casio.

## **Investment Rationale**

### **Prolonged, Large market opportunity -**

During FY 15, the total number of Passenger Vehicles sold in India was around 2.6 million, almost the same as in FY 11, four years ago. In the same time period, the sales of Audi, BMW and Benz combined grew by 45% from around 20,000 units to around 34,000 units. The same has grown by more than 8 times from just under 4,000 units since 2007.

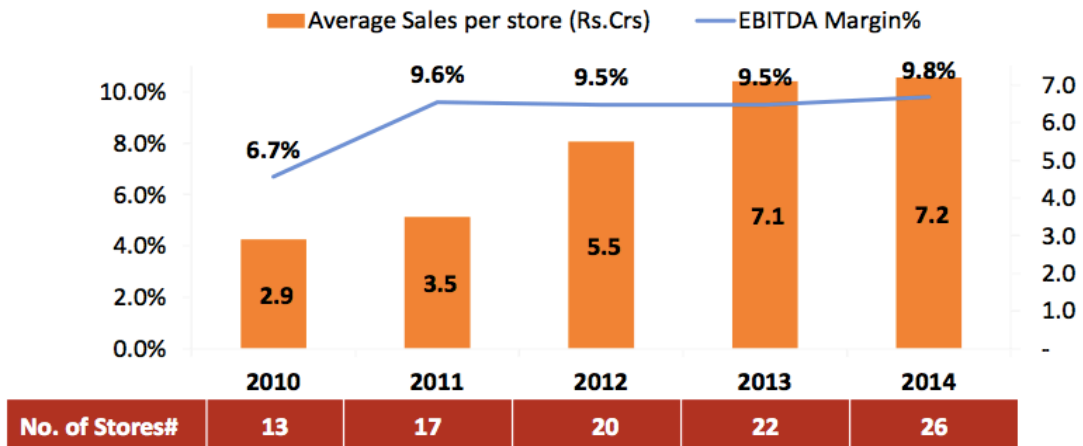
The driving force behind the above multiple in sales is India's growing HNI population, which was reported at around 200,000 in 2012 and which is expected to grow 7-fold to 1.5 million by 2020. This is the consumer segment that will drive the growth of Luxury watches in the country.

To better understand the opportunity, let's take Hengdeli (World's largest retailer of Luxury watches) for instance. Hengdeli reported sales of close to INR 300 Crore 14 years ago in 2001. Ethos, which I ***expect to report revenues of around 280 Crore in FY 15 is at a stage where Hengdeli was 14 years ago.*** Since 2001, Hengdeli's Luxury watch sales have ***grown by 40 times*** to around INR 10,000 Crore in 2014. China's luxury watch sales were estimated to have grown by around 15 times during the previous decade.

I am not trying to position Ethos as the Hengdeli of India. Neither am I predicting that Ethos will trace the same path as Hengdeli. But the sheer opportunity size, the direction and the longevity of the story cannot be understated or ignored.

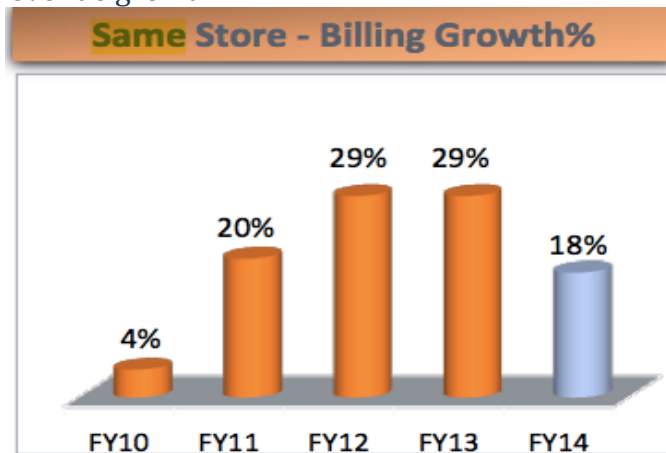
Officially imported Luxury watch market in India is estimated at around INR 2500 Crore currently and has ***grown by around 20% over the last 4 to 5 years.*** This opportunity is expected to grow at around 18% for the next 4 years to about INR 5000 Crore and if the macro environment improves considerably, the growth can be extraordinary.

**Growth in Mature stores and same-store sales –**



A store that has been in operation for two full years is categorized as a mature store and by this time period, the store is expected to be well above the break-even point. If the store does not perform to its expectation, especially in this time period, the management closes or shifts the store.

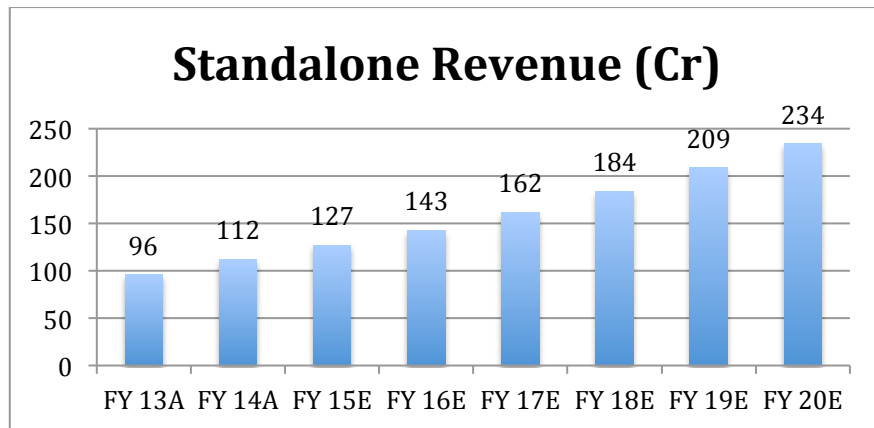
Currently out of the 46 stores that Ethos has in its network, only 26 are mature stores. Majority of the rest, which are likely to pass the initial churn are expected to mature in the next 2 year time period, thus aiding the revenue growth.



While the number of stores and more specifically the count of mature stores increase on one hand, the revenue growth will be aided by same-store sales growth. ***Ethos has showcased one of the best and consistent same-store sales growth rates over the last 4 to 5 year time period when consumption has been under tremendous stress and retailing landscape has witnessed increased competitive intensity.***



**Steady standalone revenue growth with margin expansion –**



The manufacturing of watch components and the precision engineering division predominantly form the KDDL Standalone revenues.

KDDL, in its component division plans to move up the value chain by getting into manufacturing of higher quality and more complex mechanical parts for its current clientele. I expect the growth from this division to be around **14% PA for the next 4 to 5 year time period, strongly driven by value and not volume**. I expect the growth in division to be very steady and to be margin expansive. The management plans to spend 12 Cr in this division on buying new equipment needed to manufacture high value items.

The precision engineering division makes fine stamping which can serve the instrumentation needs of industries such as defense, aerospace, white goods etc.. The management sees strong potential in this segment. While the current **revenue contribution is around INR 20 Cr (FY 15E)**, **I expect it to grow at 20% for the next 4 to 5 years**.

**Pioneering Luxury e-commerce – From Brick & Mortar to Click & Brick –**

In this world of Amazons and Flipkarts, Luxury watch brands have stayed away almost entirely from selling online. **The Luxury brand owners officially restrict online sales** and have stuck to Brick & Mortar model.

I believe that the status quo will be maintained for a long time to come and there are two key reasons –

- 1) Considering the exclusivity & experience that they bring to the buyer and the price points the watches sell at, Brick & Mortar model looks more suitable. People will buy Luxury watches only after feeling them, experiencing them and being explained by the manager how the watch is unique and what its history is.
- 2) There is no incentive for the buyer to shop online for an Omega Seamaster since the brands make sure that there is no price differential across sales channels, store formats

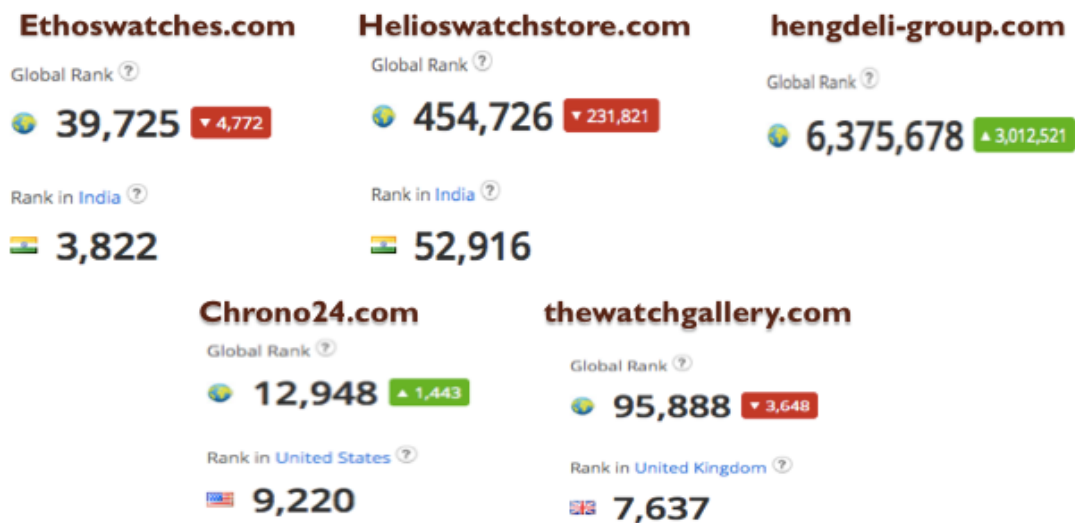


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and even geographies. For instance, Omega Seamaster Planet Ocean is priced at **4.5 Lacs in Bangalore, GBP 5,200 in London and close to about \$6,500 in NYC.**

The only segment conducive to online sales will continue to be the mass market and entry-level fashion brands, which fall under the price range of INR 20,000, with a vast majority happening in the INR 500 to INR 5,000 range.

In such a scenario where brand owners officially restrict sales and buyers lack reason to shop online, **Ethos has pioneered a way to seamlessly integrate online and offline channels.** At a time when even the World's largest retailer of luxury watches (Hengdeli) does not have a established e-commerce platform and virtually online Luxury selling in India is non-existent, Ethos has built a **robust e-commerce platform generating leads contributing to 25% of sales.**



\*Chrono24 is the largest private marketplace for buying and selling used luxury watches

\*Leading independent luxury watch retailer in UK

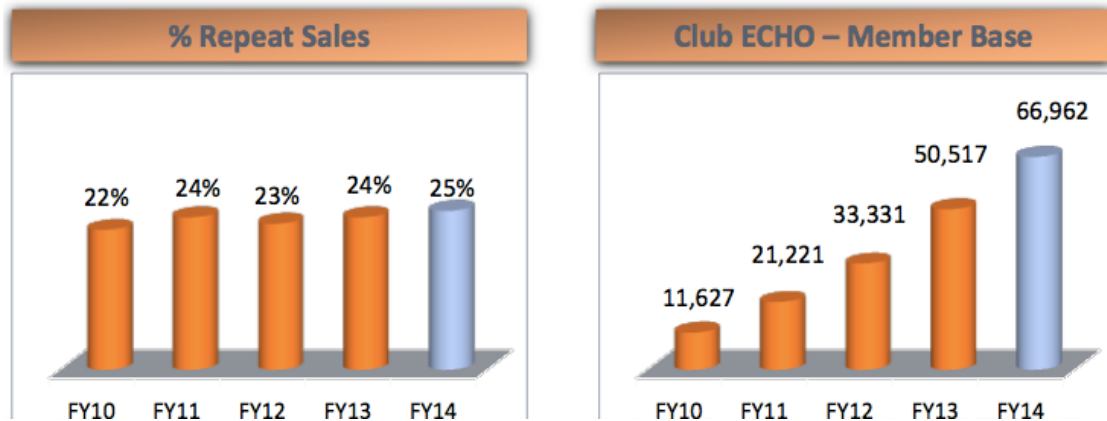
Ethos' online strategy is to position Ethoswatches.com as an informative and catchment tool using which buyers can research and browse watches and chat/talk with the technical back-end team. Once the customer is provided with sufficient information from the call center, he is gently nudged to visit a store that is closer to him, where a sales manager will be waiting for his arrival. That is when the cue passes on to the store to awe the customer with in-store experience, to make him more knowledgeable about the watch, to make him wear it and to seal the sale.

***I think that this O2O model (Offline2Online) provides the best leverage for a luxury retailer on its ecommerce channel and KDDL is currently the one to have perfected it.***

### ECHO – Customer Engagement & Repeat Purchase –

This is largely a qualitative factor that provides **strong conviction on KDDL's capability to ride the market opportunity over a long term.** What differentiates a good and a great business is its ability to realize the value of a customer over his/her lifetime. There are many businesses that

provide good customer experience during a sale but there are only a few that make the customer a repeat customer and profits immensely as he moves up the chain.



When a customer buys a watch from Ethos, he is invited to join a loyalty program called Club Echo. This loyalty program enables Ethos to engage with the customer on a regular basis by offering them special deals, by keeping them informed on new and limited editions, by inviting them for international Watch exhibition events and by sending them informative materials. So what it effectively does is that it allows Ethos to connect with its customers, to know & celebrate their happy occasions and overtime to inculcate a passion for watches, leading to repeat purchases.

Its repeat customers are the ones who transition from a Titan to a Tissot, from Tissot to a Rado or from a Rado to an Omega, all with Ethos.

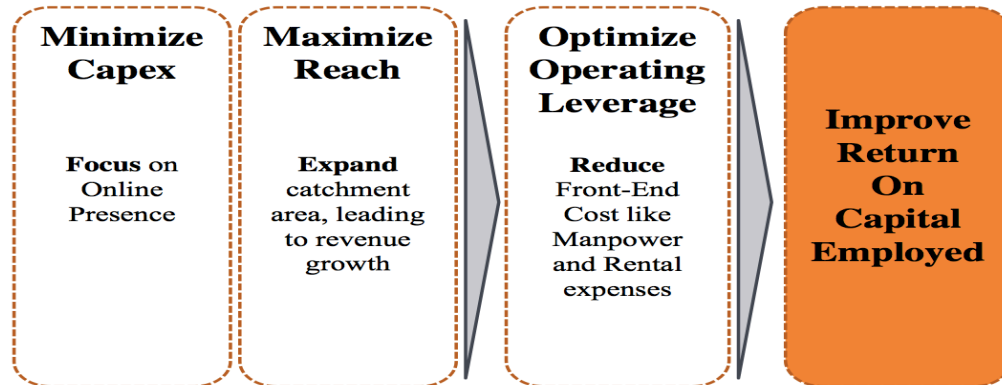
### **Visionary, Effective and Rationale Management -**

Yashovardhan Saboo is the promoter and current CEO of KDDL. Mr. Saboo is a management graduate from IIM-Ahmedabad and has been into the Watch component making industry since 1983 and into Luxury watch retailing since 2003. He has been at the forefront of both component manufacturing and luxury retailing in India.

He has run the business in a conservative, yet exploratory way for the last 30 years. The way in which Ethos engages with its customers, understands them, and generates repeat-buying, the successful implementation and running of ECHO loyalty program and the pioneering effort of implementing Click & Brick model speaks volumes of his capability. Barring couple of years when the company made losses, it has been dividend paying for the last 27 years.

Mr. Saboo comes across as a very sincere personality, who is deeply experienced and who is likely to achieve a visionary status in Indian Luxury retail in the long run. The story of how Mr Saboo stuck to his values and principles amidst all challenges has been well documented. One such Link - <http://www.growthinstitute.in/emagazine/jul10/coverstory.html>

**Margin expansion is inevitable –**



	FY 12	FY 15E	FY 20E
Sales	127 Cr	282 Cr	860 Cr
# Of stores	36	46	70
Gross Margin	27.56%	26.82%	26.82%
Rent % of Sales	9.75%	9.14%	7.8%
Employee expense % of Sales	10.85%	6.40%	5%
Operating Margin	3.94%	3.7%	7.95%
PAT margin	.24%	.69%	4.08%

The gross margins that the brand owners provide to the retailers stay almost steady and constant over time. As Ethos grows significantly in scale, while it might be able to negotiate better gross margins from some of the brand owners, on a overall basis, I expect the GMs to stay almost the same at say INR 26.8 on INR 100. Now it all comes down to how Ethos manages its cost, inventory, growth plans and the funding options. Ethos is currently at a point where the focus has shifted from store expansion to catchment area expansion through online channels. The increased investments will be made in online marketing teams and infrastructure than in Store capex. This will all result in margin improvements on rent, employee expense, administrative expenses etc...

***Even with very conservative assumptions, I expect Ethos to reach EBIT margin of around 8% in 4 to 5 year time period from the current 3.7%.*** The assumptions expect only 140 bps saving in rent % of sales and employee cost % of sales over the next 5 years, amidst incremental revenues of INR 600 Cr on INR 280 Cr and decelerating store expansion.

**Overall competitive intensity – Weak to Moderate**

**Supplier’s Bargaining Power – Moderate**

The suppliers (brand owners) are a highly consolidated set. As mentioned above, Rolex Group, Swatch Group, Richemont Group and LVMH Group control the Swiss watch brand portfolio. In addition, the brand owners are the ones to determine the selling price of their goods and they make sure that the retailers do not engage in discounted sales. While these policies seem



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restrictive from a retailer's point of view, it is a very healthy practice to conserve the brand's image and to provide a level playing field to the sales channels.

### **Buyer's Bargaining Power – Weak**

Luxury watch buyers are price insensitive and they would be more interested in seeing a good collection than lower prices. Also, the fact that brand owners determine a unified price across stores, formats, channels and many a times across countries make sure that there is very less room for anybody to bargain on price.

### **Threat of Substitute – Weak**

Watches are the only internationally accepted Jewelry for Men and it is very hard to replace an Omega or Rolex. Apple has recently introduced smart watches at price points of Swiss watches but they are essentially the basic versions glazed with gold or studded with diamonds. ***There isn't much that anybody can do in place of sowing beliefs, history and tradition in a product.***

### **Threat of New entrant – Weak to Moderate**

The market awareness is already built and the buyer today knows to differentiate between brands and between retailers. ***The prime, upmarket real estate locations have all been taken up and the brand owners do not encourage a new player in a location so as to cannibalize the local sales.*** Moreover, the brand identity is exceptionally important for brand owners, since their revenues are all about their reputation and hence they are extremely strict in terms of selecting retailers.

### **Rivalry among existing competitors – Weak to Moderate**

The marketplaces and discounted online models are currently active in the lower end of the price range between INR 500 and INR 5000 and do not pose any competition to Ethos. For various reasons such as ***restriction of online sales by the brand owner, lack of price difference, involvement of the buyer in the purchase process***, marketplaces cannot become a considerable competition in Luxury watch retailing.

With the Brick & Mortar peers, there are some large multi store operators such as Kapoor Watches, Johnson Watches etc.. But they focus on just one city/region and lack the operational or financial leverage that Ethos has. Titan Industries has developed Helios store format over the last 4 years. However, significant portion of the sales are from Titan brands and Helios is almost entirely absent from the Luxury space. Helios is more active in the entry-fashion to premium category and between price points of ***INR 2,000 to INR 25,000, whereas the Average Selling Price of a watch at Ethos is around INR 65,000. Titan no doubt has immense capabilities and resources but will have to come out with an entirely new format than Helios or revamp Helios significantly to capture the Premium & Luxury market.***

## Valuation

### Relative Valuation –

There are several luxury watch retailers such as Hengdeli, The Hour Glass and Oriental Watch listed on the Hong Kong and Singapore exchanges. They trade with Earnings Multiple range of between 13 and 20 on a Trailing Twelve Month basis. While they can be recognized as peers to understand the business in a better fashion, applying the same set of multiples to KDDL is unsuitable.

While the gross margins almost fall in the range of Ethos, other key dynamics such as rental costs, cost of capital and employee cost are significantly different. Most of these peers are also at a very advanced stage of the Market Life cycle while Ethos is still at its nascence. Benchmarking with Hengdeli to derive a valuation for Ethos could have proved useful, but Hengdeli is currently caught under corporate governance issues and the share prices are down significantly.

### Private market valuation –

KDDL as a standalone entity owns 100% of its component manufacturing and precision stamping business and on a fully diluted basis, owns 70.24% in Ethos. Very recently in the month of December 2014, Ethos issues CCCPS to private investors worth INR 7.25 Cr and CCCPS to its Parent KDDL worth .25 Cr. While I am not sure how much the interest was, *Nikhil Vora's Sixth Sense Ventures was a participant and it was his debut deal.*

*This deal valued Ethos at an equity valuation of INR 247 Cr, when the entire KDDL Ltd was available for INR 219 Cr, showing significant interest and the premium that Ethos can attract.*

## Financial Projections

	FY 14	FY 15E	FY 16E	FY 17E	FY 18E	FY 19E	FY 20E
Total Revenue (Cr)	338	409	496	603	735	897	1098
Total expenses (Cr)	312	380	458	555	670	816	987
EBIT (Cr)	25	28	38	48	65	82	111
Finance Cost (Cr)	14	15	18	21	23	25	26
(Loss)/Profit before tax (Cr)	11	13	20	27	42	57	85
Tax (Cr)	2	5	7	9	14	19	28
(Loss)/Profit after tax (Cr)	9	8	13	17	28	38	57
Net Profit after Minority Interest (Cr)	8.5	7.99	12.28	15.51	23.74	31.71	46.33
Fully Diluted EPS after Minority interest (INR)		8.76	13.47	17.00	26.03	34.76	50.78





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## Target & Conclusion –

Globally, Luxury watch retailing has been a ***well-defined business activity that is highly sustainable, perfectly scalable and reasonably profitable***. There are several empirical evidences from listed companies around the world and more particularly from Asian economies. While India differs significantly from say a Singapore, Mainland China or a HK based market on cost of capital, rental cost and operating expenses, the larger picture of Luxury watch retailing in India looks extremely promising at this point of time.

The luxury watch retailing industry is expected to grow at around 18% for the next several years and I believe that KDDL will emerge as the single largest winner from the industry. ***Its scale of operations has reached an inflection point*** where the focus has shifted from expanding store presence & creating awareness to expanding margins & extending the lead.

A majority of the ***qualitative and quantitative factors are supportive of a multi-year growth story*** in KDDL. Especially the qualitative factors such as customer engagement, loyalty program, ecommerce initiatives and the management credentials make KDDL a high-conviction bet.

At the **current market price of INR 308**, India's largest retailer of Luxury watches is today available at an ***equity valuation of less than \$45 Million***. While efforts are on to list the counter on NSE, it is currently traded only on BSE and is undiscovered. Leave out the institutional brokerages; even the retail brokerages do not cover the company currently. Neither has this opportunity been discussed on popular online forums. And to have a mysterious acronym (KDDL) as the company name and to own Ethos through a subsidiary only make this opportunity even more concealed.

**The story is promising, evidences are satisfactory, management passes the test, opportunity is undiscovered and there is a very long platform for growth. Without a price target, I initiate a Strong Buy in KDDL for a 3 to 5 year holding period for Multibagger returns.**