otp Research

EQUITY NOTE: ZWACK UNICUM

Recommendation: HOLD (unchanged)

Target price (12M): HUF 15,685 (revised)

8 November 2019

Equity Analyst:
Orsolya Rátkai

Phone:
+36 1 374 7270

Email:
ratkaio@otpbank.hu

We maintain our **HOLD** recommendation on Zwack Unicum (Zwack HB; ZWCG.BU) with a **new 12M target price of 15,685 HUF/share**, revised down from 15,882 HUF/share. Higher taxes, slowing consumption and increasing operational costs also play a role in the somewhat subdued profit outlook in the challenging business environment in the short and medium run. The new target price is 10% below the HUF 17,400 closing price on 7 November, 2019. Due to possibly subdued performance in the coming business years, investors can expect more modest dividend payment compared to the past, unless the profit reserves also got included.

Shares of Zwack Unicum dropped 0.6% on 7 November, 2019 on the day when the earnings report was published while the BUX increased by 0.7%.

Summary/Earnings Highlights

- In line with our expectation, Zwack Unicum remained on the track of subdued sales performance after higher levies on certain food groups and beverages including Zwack's flagship product Unicum (the tax called 'NETA' in Hungarian) took effect on 1 January 2019.
- The decline in the quarterly domestic sales revenues slowed to 11% YoY in the July-September period, after falling 24% in January-March and 18% in April-June. Both self-manufactured production and sales revenues from the distributed portfolio declined by 9% and 8% YoY, respectively. At the same time, exports remained strong, increasing by 7% in the past quarter.
- Falling revenues in the self-manufactured production with higher profit margin hurts profitability, but the company tries to fend off its effects. Quarterly EBIT almost halved in the past quarter, as EBIT and EBITDA margins considerably deteriorated in a yearly horizon.
- Quarterly EPS plunged to HUF 211 from HUF 312 one year before.
- Zwack Unicum maintains its earlier forecast of HUF 1.4bn after-tax profit with net sales drop of over 10% in the current business year. The company expects nominal after-tax profit to return to the HUF 2bn level by 2021/2022, Zwack announced earlier.
- In February, we revised down our earnings forecast and on the longer run we applied a more conservative scenario considering profit estimates, than Zwack. We maintain this earlier forecast for the current business year and expect this year's sales revenue to decrease to HUF 13.9bn, while EBIT may drop to HUF 1.6bn. EPS may decline to HUF 679 in the current business year. In our view, there are still uncertainties as to how long the levelling off may take. According to our model, after-tax profit is expected to return to the level of HUF 2bn after the financial year of 2021/2022.

- We implemented some adjustments in the valuation models both in DCF and DDM. As a result, the new 12-month target price slipped to HUF 15,871 from the earlier 15,882 HUF/share, and we still maintain the HOLD recommendation.

Financial Q2 (HUFm)	2019 July-Sep	2018 July-Sep	YoY Change
Domestic sales	2 966	3 333	-11%
Export sales	431	402	7%
Net sales income	**3 397**	**3 735**	**-9%**
Material-type costs	1 194	1 288	-7%
Gross profit	**2 203**	**2 447**	**-10%**
Personnel costs	691	700	-1%
Depreciation	129	130	-1%
Other operating expenses	1 022	967	6%
Total operating expenditures	**1 842**	**1 797**	**3%**
Other incomes	176	120	47%
EBIT	**537**	**770**	**-30%**
Pre-tax profit	**538**	**770**	**-30%**
Tax	109	134	-19%
After-tax profit	**429**	**636**	**-33%**

Financial Q2 (HUFm)	2019 July-Sep	2018 July-Sep	YoY Change
EPS (HUF)	**211**	**312**	**-32%**
4Q-rolling EPS (HUF)	**1058**	**1193**	**-11%**
EBITDA (HUFm)	**666**	**900**	**-26%**
Gross profit rate	**64.9%**	**65.5%**	**-0.7 pp**
EBIT rate	**15.8%**	**20.6%**	**-4.8 pp**
EBITDA rate	**19.6%**	**24.1%**	**-4.5 pp**
ROE	**8.7%**	**12.1%**	**-3.4 pp**
4Q-rolling ROE	**32.6%**	**37.4%**	**-4.7 pp**
ROA	**3.1%**	**5.6%**	**-2.5 pp**
4Q-rolling ROA	**18.1%**	**20.6%**	**2.4 pp**

Sources: Zwack Unicum, OTP Research

Tax increase is still shaping the domestic sales performance. After strong inventory building at the end of 2018 ahead of major tax increase, domestic sales fell heavily in the periods of January-March and April-July. However, as the huge stocks built up by the end of 2018 are slowly running low and inventory effect is gradually receding. In the latest quarter, domestic sales declined by 11% YoY after plunging 24% in January-March and 18% YoY in April-June. The HUF 3.4bn domestic sales revenue was in line with our expectation.

Revenues from self-manufactured production dropped 9% YoY in the quarter, after falling 32% in Q1 and 17% in Q2.

Sales decline in the prime segment has slowed: the cumulative sales of Zwacks' own prime products dropped 16% after suffering a 21% fall in the April-June period. The segment of 'quality' products kept on shrinking in the latest quarter, although cumulative decline slowed to 17% after experiencing a 26% plunge in April-June, Zwack announced. The company does not provide data on nominal sales volumes, neither at segment nor at product level.

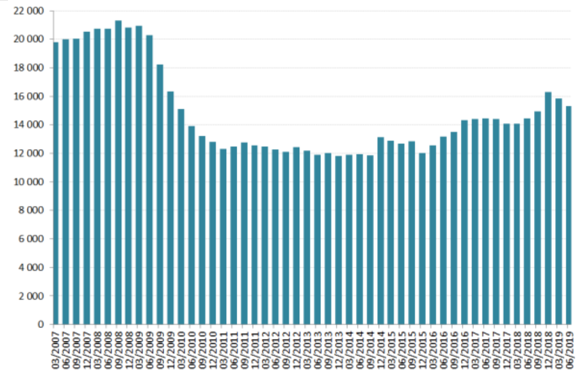
The net sales revenue of the traded products decreased by 8% YoY in July-September, after losing 9% in the April-June period. Revenues from the Diageo portfolio, representing a major part in the total distributed products, surged by 8% compared to the same period a year before. The revenues from other traded products stabilized at a very low level (quarterly sales shows 43% YoY fall, after plunging 45% in April-June) as Zwack stopped trading the products of Moët-Hennessy as of 1 March 2019.

Zwack's sluggish sales performance in the domestic market this year comes as no surprise after higher levies on food and beverages deemed unhealthy (tax called 'NETA') took effect on 1 January 2019. Zwack is not only affected by higher taxes but also its flagship products Unicum and 'pálinka' became taxable. Heavy stockpiling due to the scheduled tax increase in the second half of 2018, especially in the calendar Q4, dragged down sales in the past quarters and sets back this year's sales performance in an otherwise healthy economic environment.

Market research data for the period of April-September 2019 reflected very stable consumer demand on Hungary's retail market of spirits (12% nominal YoY growth, and 2.2% gain in volume) practically the same figures were reported for April-June 2019. This development may have two readings: (1) if sales volumes practically did not change YoY in one of the high seasons of the year (e.g. “festival season” of July-September), that warns us concerning the growth outlook of the whole market; or (2) other producers/sellers/importers suffer from the same market condition (higher taxes) and Zwack has no significant disadvantage just because the Unicum product group became taxable. The second case assumes that the consumers of Zwack’s products may be less price sensitive. On the whole, it remains to be seen whether market growth does slow in the coming quarters.

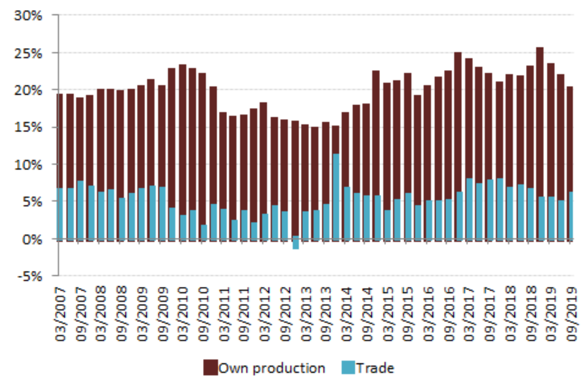
Export growth keeps momentum. Export revenues added 7% YoY in the last quarter after 13% sales growth in the April-June period. Sales performance in Italy and Germany contributed mainly to the growth dynamics, resulting in a combined 10% increase in the past two quarters. Besides, the weakening HUF had a minor role: on average, the EUR/HUF was more than 1% higher in Q3 2019 than a year earlier.

4Q-rolling total net sales revenues (total, HUFm)



Sources: Zwack Unicum, OTP Research

4Q EBIT margin of self-manufactured and distributed products



Sources: Zwack Unicum, OTP Research

Deteriorating sales are also a drag on profitability. Due to the tax changes introduced at the beginning of the year, the sales performance became weaker and since then Zwack has lost volume in the segment with higher profit content. Gross profit declined by 10% YoY.

As a result, this year’s profitability ratios are much lower than the ones in the corresponding periods. In the latest quarter, gross profit rate dropped to 64.9% from 65.5% a year ago, while EBIT rate fell to 15.8% from the 20.6% reported on 30 September 2018. EBITDA rate also plunged from 24.1% a year ago to 19.6% in July-September 2019. However, when comparing profitability ratios with the previous quarter, certain improvement can be observed.

In a yearly comparison, the profitability of the traded portfolio climbed to over 10% from 5% announced last year, while profitability in the self-manufactured segment slid to 17% from 24% in Q3 2018 due to the well-detailed circumstances.

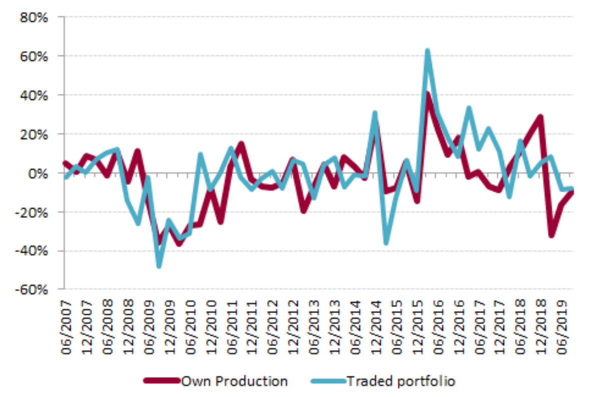
At the same time, **certain cost items developed in a favourable way**. Material-type costs as a flexible item took a dip, along with decreasing sales, though the decline was milder. Certain raw materials are imported, so the weakening HUF makes imports more expensive, preventing material-type costs from bigger dip. Labour costs slightly decreased YoY in an environment afflicted by labour shortage and rising wages.

Net profit declined by 45%, to HUF 348m from HUF 635m in Q3 2018. EPS amounted to HUF 171 in Q3 2019 compared to HUF 312 one year before.

Zwack announced some changes to its accounting policy, effective from the start of 2019. The modifications affect mainly the accounting of material-type costs, other incomes and other costs, while some changes in the accounting of certain allowances (bonuses for long service and retirement bonuses) have direct effect on retained earnings. Zwack publishes the financial report in accordance with the new accounting rules, but only enables YoY comparison for the base periods (financial Q4 2017/2018 and the consecutive quarters). As a consequence, long-term comparisons cannot be made.

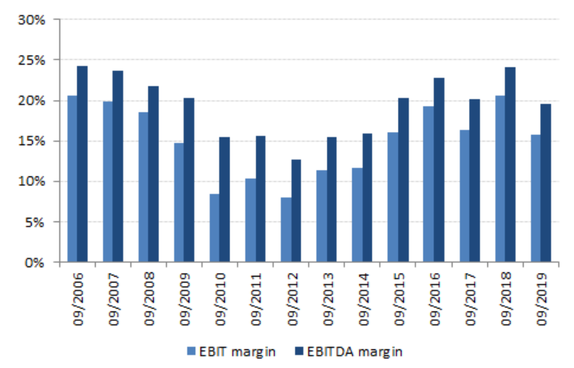
After-tax profit fell by 53% YoY to HUF 231m, while quarterly EPS plunged to HUF 114 from HUF 243, the lowest in the past nine years (without counting the usually loss-making financial last quarters).

Quarterly sales growth of the self-manufactured and the distributed products (YoY change)



Sources: Zwack Unicum, OTP Research

Profitability ratios in the earlier individual FQ2s[1]



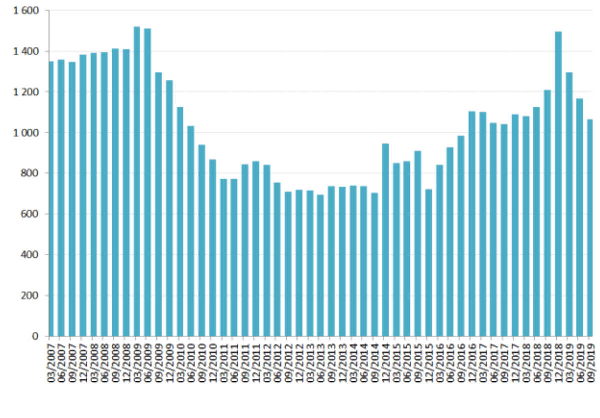
Sources: Zwack Unicum, OTP Research

Sales and profit outlook under pressure in the medium term. Zwack Unicum maintains its earlier forecast of much less prosperous quarters of the current business year as the developments of the past quarters fulfilled this expectation. Due to falling sales volumes – a consequence of tax-related price increase – Zwack Unicum expects sales revenues in the present business year to decline by more than 10%. Higher expected packaging costs put profitability under pressure; the company plans to offset it by cutting marketing and other operational costs. Total net profit may decline by more than 40% in the 2019/2020 business year, Zwack Unicum announced.

According the business plan for the financial year 2019/2020 the management of Zwack Unicum presented earlier this year, the company expects net sales revenues to decline to HUF 14.0bn (-11% YoY), EBIT to fall to HUF 1.8bn (-42%) and after-tax profit drop to HUF 1.4bn (-46%). Zwack Unicum does not expect to achieve HUF 2.0bn after-tax profit before the business year 2021/2022, the company added.

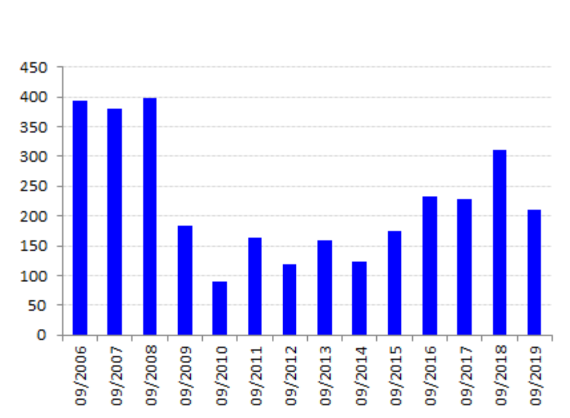
[1] *Financial data for April-June 2017 or earlier are not revised in line with the changes in the accountancy policy implemented as of January 1, 2019*

4Q-trailing EPS is still above the long-term average (HUF)



Source: Zwack Unicum

Quarterly EPS in the past individual FQ2s



Source: Zwack Unicum

Conclusions

- Zwack's sales figures in the July-September period of 2019 (financial 2nd quarter of the 2019/2020 business year) was in line with our quarterly forecast. Quarterly domestic sales figures reflect the gradual shrinking of the inventory piled up ahead of the 20% hike of public health product tax (NETA in Hungarian) from 1 January 2019. As we noted before, from that day 'Unicum' and 'pálinka' also have been taxed, marking the end of the tax exemption the company benefited from in recent years.
- The decline in domestic sales steadily slows but it remains to be seen whether the total downsizing of previous stocks ends with the high season at the end of the year or extends to the next financial year.
- Zwack reported better-than-expected profit figures in this quarter, we had expected somewhat higher material-type and wage costs. Changes to its accounting policy, implemented from the beginning of 2019, also resulted in higher gross margins than what had seen in the pre-changes era and the long-term average. Higher-than-forecasted other incomes lately also contributed to the outperformance of profit figures.
- In our forecast, we apply a more conservative scenario than that of Zwack Unicum. We expect after-tax profit to return the HUF 2bn target after the business year of 2021/2022.
- The reported sales and profit figures of the first two quarters of the current business year (April-June and July-September 2019) are in line with our forecast for the financial year ending on 31 March 2020. However, it still remains to be seen how much time the levelling off may take. We think that the return of net sales revenues to the level seen before 2019 may be more gradual than our previous forecast. In line with that, we changed our sales and profit forecast for FY2020/2021.
- Due to the adjustments implemented in the forecast and the valuation models, our new 12-month target price has also changed. It declined to 15,685 HUF/share from the previous 15,882 HUF/share, and we still maintain the HOLD recommendation.
- The new target price is 9.9% down from the HUF 17,400 closing price on 7 November, 2019. Estimated total return downside is 6.1% on a 12M-horizon due

to the subdued dividend payment in the medium-run unless the management proposes the AGM to tap profit reserves as well. The dividend yield is expected to decrease to 4% from the 6–7% yield paid in the past years.

Risks surrounding our forecast

As Zwack does not publish product level data or data on sold quantities, the uncertainty regarding our sales forecast is moderate to high. When analysing different scenarios, we suppose the demand's price elasticity is near -1 but, due to lack of information, we did not calculate with the probably existing substitution effect among different products or different brands. The substitution effects can play a role as the relative price of Unicum products will be higher after tax changes compared to competitors' products. And in this environment Zwack Unicum even may have to face the possibility of decreasing market share. No information is available, even though there is also a risk: whether the management can assess the danger caused by the persistent decline in the market share, induced by higher prices. In the long run, domestic consumption growth is expected to slow, wage dynamics may falter while the external economic environment is also challenging (global trade war, no-deal Brexit, sluggish economic growth in the eurozone).

A possible excise tax hike from 2020 (published in the media but not officially confirmed) also adds to the risk factors surrounding futures sales performance and our forecasts, but exact information is yet to be announced.

We emphasize that, for the lack of available data, the forecast bears a considerable uncertainty both to the downside and the upside.

Profit & Loss Statement (HUF m)	2016/2017	2017/2018	2018/2019F	2019/2020 F	2020/2021F	2021/2022F
Domestic net sales	12 854	12 418	14 209	12 319	12 935	14 068
Export sales	1 427	1 540	1 602	1 561	1 592	1 624
Net sales income	14 281	13 958	15 810	13 880	14 527	15 692
Material-type costs	6 044	6 032	6 663	5 552	5 811	5 806
Gross profit	8 237	7 926	9 147	8 328	8 716	9 886
Total operating expenditures	6 021	6 051	6 563	7 170	7 409	8 403
EBIT	2 959	2 580	3 270	1 624	1 855	2 076
Pre-tax profit	2 940	2 582	3 271	1 626	1 857	2 078
Tax	714	378	455	244	279	312
Profit after tax	2 226	2 204	2 816	1 382	1 579	1 766
Dividend	2 137	2 137	2 544	1 323	1 475	1 628
EPS (HUF)	1 094	1 083	1 384	679	776	868
DPS (HUF)	1 050	1 050	1 250	650	725	800

Balance sheet (HUFm)	2016/2017	2017/2018	2018/2019	2019/2020F	2020/2021F	2021/2022F
Property, plant, equipment	2 891	3 205	3 330	3 710	3 803	3 613
Intangible assets	106	89	84	103	103	93
Non-current assets	3 157	3 447	3 582	4 051	4 154	3 970
Inventories	1 862	2 185	2 386	2 584	2 466	2 818
Recievables and other current assets	2 208	2 275	2 115	2 282	2 229	2 789
Cash and cash equivalents	2 809	2 770	3 064	3 162	3 214	2 681
Current assets	6 879	7 230	7 565	8 028	7 908	8 288
TOTAL ASSETS	**10 036**	**10 677**	**11 147**	**12 078**	**12 062**	**12 258**
Share capital	2 000	2 000	2 000	2 000	2 000	2 000
Capital reserve	165	165	165	165	165	165
Retained earnings	4 558	4 662	4 915	5 542	5 834	5 636
Total Equity	**6 723**	**6 827**	**7 080**	**7 707**	**7 999**	**7 801**
Long-term loans and other liabilities	427	410	472	389	389	389
Non-current liabilities	427	410	472	389	389	389
Loans and credits	0	0	0	23	11	19
Payables and other short-term liabilities	2 889	3 384	3 567	3 935	3 641	3 993
Current Liabilities	2 886	3 440	3 595	3 983	3 675	4 068
TOTAL EQUITY AND LIABILITIES	**10 036**	**10 677**	**11 147**	**12 078**	**12 062**	**12 258**

CONSOLIDATED CASH FLOW (HUFm)	2016/2017	2017/2018	2018/2019F	2019/2020F	2020/2021F	2021/2022F
EBITDA	3 474	3 049	3 643	2 207	2 466	2 768
Cash flow from operation	2 601	2 854	3 388	1 965	2 061	1 930
Cash flow from investment	-371	-765	-631	-1 032	-693	-488
FCFF	2 230	2 089	2 757	933	1 368	1 442
FCFE	2 232	2 091	2 757	958	1 358	1 452

Sources: Zwack Unicum, OTP Research

Deduction of 12M Target Price

Zwack's valuation (HUFm)	Base Year 2019/2018	2020/2019	2021/2020	2022/2021	2023/2022	2024/2023	FCFE in the explicit period
FCFE	2 757	958	1 358	1 452	2 011	1 637	
Discount factor	0,92	0,92	0,92	0,92	0,91	0,91	
DCF	2 536	879	1 246	1 329	1 835	1 494	6 782
Terminal Value (HUFm)							31 340
Net Present Value - FCFE (HUFm)							26 591
Net debt							-2 750
Equity value (HUFm)							29 342
Number of shares							2 035 000
Expected return on equity							9,1%
12M Target price (DCF)							15 724
12M Target price (DDM)							15 646
12M Weighted Target price (HUF)							**15 685**
Current price							17 400
Upside/Downside							-9,9%
TR Upside/Downside							-6,1%

Source: OTP Research

Risks surrounding Zwack's economic activity

Regulatory risk: In recent years regulatory changes in the industry caused headwinds to the company's profitability. The most notable was the liberalization of spirit distillation at home in small quantities in 2010. The EU lately expressed criticism on discriminative taxing policy of spirits in Hungary and threatened to start infringement process against Hungary. The new regulatory changes (increase of NETA) which took effect on January 1, 2019, are aimed to resolve this conflict with the EU and increase budget revenues at the same time.

Exchange-rate risk: As the company operates in foreign markets as well and the share of export is increasing among the revenues, in case of an appreciating HUF the exchange-rate risk can be an issue, if not managed properly. Weakening HUF poses more risks on the cost side, as most of Zwack's raw materials' price is denominated in EUR, so a significant depreciation of the HUF against the EUR could weigh on the company's profitability. That can be counterbalanced to a certain extent by the higher export revenue in HUF.

Cost-inflation risk: Due to the improving economic conditions and labour shortages in various industries, real wages started to increase significantly in 2016 and kept on rising since then. This landscape is hardly expected to change in the near future. As Zwack's business is somewhat labour-intensive (the share of personnel cost in total costs is around 20%), it will be heavily affected by sustaining high wages denting in profitability.

Notes:

The initiation report, which contains the assumptions of the models used, is available here.

The valuation methodology used in this present equity research note to determine our price targets and recommendations is available here. (Also available in Hungarian)

This investment recommendation has not used proprietary models.

The risk warning, which includes the adequate explanations of the length of time of the investment to which the recommendation relates as well as a sensitivity analysis of the assumptions, is indicated in the part of this recommendation where the length of time and the risks of the investment are presented.

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OTP Bank Plc's recommendations and price targets history for Zwack Unicum in the past twelve months:

Date	Recommendation	Target Price	Publication
03/08/2018	HOLD	HUF 17,046	Earnings Update
13/09/2018	HOLD	HUF 17,046	News Comment
07/11/2018	HOLD	HUF 16,806	Quarterly Earnings Update
06/02/2019	HOLD	HUF 16,271	Quarterly Earnings Update
23/05/2019	HOLD	HUF 16,056	Quarterly Earnings Update
30/05/2019	HOLD	HUF 16,056	Comment
07/08/2019	HOLD	HUF 15,882	Quarterly Earnings Update
08/11/2019	HOLD	HUF 15,685	Quarterly Earnings Update

Period	Recommendation	% of recommendations
Q4 2018	BUY	0
	HOLD	100
	SELL	0
Q1 2019	BUY	0
	HOLD	100
	SELL	0
Q2 2019	BUY	0
	HOLD	100
	SELL	0
Q3 2019	BUY	0
	HOLD	100
	SELL	0

The list of all recommendations made in the past 12 months is available here.

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This document was prepared by:
Orsolya Rátkai
Senior Equity Analyst

OTP Research

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