

EQUITY NOTE: ZWACK UNICUM

Recommendation: HOLD (unchanged)

Target price (12M): HUF 17,046 (revised down from HUF 17,891)

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News

News No. 1: The Ministry of Finance published the proposal of the law amendment on certain taxes (Act No. 625) also including the so-called Public Health Tax (NETA) on June 19, 2018. The new bill when passed (final vote on 20 July) abolishes the exemption from NETA to herbal liqueurs and fruit distillates, such as 'pálinka' and at the same time increases the current HUF 700/litre health tax to HUF 850/litre for all the spirits with alcohol content between 35 and 45 degrees.

News No. 2: Zwack's shareholders approved the management's dividend proposal of HUF 1,050/share on the AGM held on June 27, 2018.

Comments

- The new legislation affects the Hungarian spirit producers/market by two ways: (1) every litres of spirits with 35–45% alcohol degree currently subject to HUF 700/litre health tax payment will tax HUF 850 (**increase of HUF 150/litre**); (2) every litres of herbal liqueurs or 'bitters' and fruit distillates with 35–45% alcohol degree will be subject to HUF 850 tax payment **instead of current zero tax payment (HUF 850 increase per litre)**.
- While in the first case additional tax payment only slightly increases sales price if producers decide to fully pass higher taxes on to customers and thus its effect is expected to be limited on the demand, in the second case, taxing bitters and 'pálinka' puts a relative high additional tax burden on these kinds of spirits. Depending on the type of spirits, the size and the price applied, the abolition of NETA exemption may add even 14–20% to the sales price if it's fully passed on to customers.
- Zwack's flagship Unicum product line and fruit distillates until now enjoyed the tax exemption the new regulation is expected to abolish. Although 'NETA' is a tax item that practically flows through the companies once they sell their products and it doesn't affect profitability directly, in price-sensitive markets like Hungary, such taxes do harm the demand and so the sales revenues when fully or partially built in the sales price. We have to add, that competitors in the market of 'pálinka' face the same challenges, while in the market of bitters only Zwack benefited from the tax exemption due to Unicum's high herbal content, and this advantage will come to an end.
- Producers' options are to keep gross sales price (net sales price + duties & taxes) constant or partially or fully passing higher taxes on to customers by raising the sales price by the newly increased tax amount or a part of it, depending on the producers' market position, the market demand, the price elasticity of the consumption, the consumption patterns, etc.
- Historical data show that both net and gross sales revenues are sensitive to regulatory changes but this sensitivity is stronger in case of net sales. When tax burden increased, net sales declined more than gross sales. Regulatory changes in the

Hungarian spirit markets are not without example, additionally it is hard to calculate their direct effect as stockpiling also plays a role on the short run.

Conclusions

- As in one way or other, addition taxes will affect sales volume in the short and middle run we revised our revenues forecast down to HUF 14.5bn from HUF 14.6bn in the current financial year and to HUF 14.7bn from HUF 15.2bn for the business year 2019/2020. As part of the costs are not flexible or it requires more time to adjust, our profit forecasts are also revised down: after-tax profit is expected to decrease to HUF 2.0bn from previously forecast 2.2bn this year and to HUF 1.8bn from 2.1bn next year. Our new EPS forecasts are HUF 982 and HUF 873 for this financial year and the next, respectively.
- With net profit decreasing we revised down also our dividend forecast: we expect HUF 950 and 850/per share for the current and the next business year. On the basis of the updated cash flow and dividend forecasts, our discounted cash flow model results in a target price of 16,818/per share, while a target price of HUF 17,275/share derives from our dividend discount model. We give equal weight to both results.
- All in all, **we decrease our 12-month target price to HUF 17,046/share from the previous HUF 17,891/share and maintain our *HOLD* recommendation.** Our sales and earnings forecasts have been revised due to the expected regulatory changes, while the weakening HUF against the euro is also expected to affect the operation both on the revenue and the cost side. The new valuation also includes our updated interest rate forecast reflecting the possible future changes in the interest rate environment. The new target price is 2% down from HUF 17,400 yesterday's closing price and equals 3.4% 1Y total return.
- The HUF 1,050 dividend per share approved yesterday by the AGM offers 6% dividend yield when calculated with the latest closing price.

Risks surrounding our forecast

As Zwack does not publish either 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. We emphasize, for lack of available data the forecast bears a considerable uncertainty both to the downside and the upside. When new information emerges, we will update our forecast.

Profit & Loss Statement (HUF m)	2015/2016	2016/2017	2017/2018	2018/2019F	2019/2020 F	2020/2021F
Domestic net sales	11 033	12 854	12 418	12 962	13 161	13 424
Export sales	1 425	1 427	1 540	1 570	1 585	1 610
Net sales income	12 458	14 281	13 958	14 533	14 746	15 034
Material-type costs	5 306	6 044	6 032	6 557	6 730	6 529
Gross profit	7 152	8 237	7 926	7 976	8 016	8 505
Total operating expenditures	5 781	6 021	6 051	6 234	6 558	7 054
EBIT	2 160	2 959	2 580	2 325	2 066	2 081
Pre-tax profit	2 177	2 940	2 582	2 325	2 066	2 081
Tax	483	714	378	325	289	291
Profit after tax	1 694	2 226	2 204	1 999	1 777	1 790
Dividend	1 725	2 137	2 137	1 933	1 730	1 730
EPS (HUF)	832	1 094	1 083	982	873	880
DPS (HUF)	850	1 050	1 050	950	850	850

Balance sheet (HUFm)	2015/2016	2016/2017	2017/2018	2018/2019F	2019/2020F	2020/2021F
Property, plant, equipment	2 845	2 891	3 205	3 500	3 710	3 803
Intangible assets	119	106	89	94	103	103
Non-current assets	3 283	3 157	3 447	3 838	4 067	4 166
Inventories	1 876	1 862	2 185	2 496	2 321	2 289
Receivables and other current assets	2 162	2 208	2 275	2 395	2 604	2 549
Cash and cash equivalents	2 257	2 809	2 770	2 785	2 804	2 835
Current assets	6 295	6 879	7 230	7 677	7 729	7 674
TOTAL ASSETS	9 578	10 036	10 677	11 515	11 796	11 840
Share capital	2 000	2 000	2 000	2 000	2 000	2 000
Capital reserve	165	165	165	165	165	165
Retained earnings	4 045	4 558	4 662	4 716	4 646	4 853
Total Equity	6 210	6 723	6 827	6 881	6 811	7 018
Long-term loans and other liabilities	360	427	410	406	389	389
Non-current liabilities	360	427	410	406	389	389
Loans and credits	0	0	0	20	23	11
Payables and other short-term liabilities	2 310	2 889	3 384	4 136	4 545	4 397
Current Liabilities	3 008	2 886	3 440	4 228	4 597	4 433
TOTAL EQUITY AND LIABILITIES	9 578	10 036	10 677	11 515	11 797	11 840

CONSOLIDATED CASH FLOW (HUFm)						
	2015/2016	2016/2017	2017/2018	2018/2019F	2019/2020F	2020/2021F
EBITDA	2 674	3 474	3 068	2 806	2 734	2 710
Cash flow from operation	2 132	2 601	2 854	2 816	2 777	2 354
Cash flow from investment	-698	-371	-765	-852	-878	-708
FCFF	1 434	2 230	2 089	1 965	1 900	1 646
FCFE	1 445	2 232	2 091	1 985	1 903	1 621

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	FCFE in the explicit period
FCFE	2 091	1 985	1 903	1 621	2 022	2 120	
Discount factor	0,91	0,91	0,91	0,91	0,91	0,90	
DCF	1 913	1 812	1 731	1 470	1 830	1 912	8 755
Terminal Value (HUFm)							33 143
Net Present Value - FCFE (HUFm)							28 889
Net debt							-2 359
Equity value (HUFm)							31 248
Number of shares							2 035 000
Expected return on equity							9,5%
12M Target price (DCF)							16 818
12M Target price (DDM)							17 275
12M Weighted Target price (HUF)							17 046
Current price							17 400
Upside/Downside							-2%
TR Upside/Downside							3,4%

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 are aimed to resolve this conflict with the EU and to 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. At the moment, the 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 last year. This landscape is hardly expected to change in the near future. As Zwack's business is labour-intensive (the share of personnel cost is around 30%), 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.

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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
15/12/2017	BUY	HUF 17,668	Initiation Coverage
06/02/2018	HOLD	HUF 17,781	Quarterly Earnings Update
24/05/2018	HOLD	HUF 17,891	Quarterly Earnings Update
28/06/2018	HOLD	HUF 17,046	Earnings Update

[The list of all recommendations made in the past 12 months is available here.](#)

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