otp Research

EQUITY NOTE: ZWACK UNICUM

Recommendation: HOLD (unchanged)

Target price (12M): HUF 16,056 (revised down)

23 May 2019

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We maintain our **HOLD** recommendation on Zwack Unicum (Zwack HB; ZWCG.BU) with a **new 12M target price of 16,056 HUF/share**, revised down from 16,271 HUF/share. The new target price reflects our slightly modified export sales projection over the forecast horizon of 2019–2024, and changes in the Hungarian risk-free rate. 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 stands 8% below the HUF 17,500 closing price on 23 May, 2019. Even though investors can expect significant dividend payment after the latest business year, offering 7% dividend yield, it cannot fully offset the expected deterioration in the company's valuation. Shares of Zwack Unicum dropped 0.3% on 23 May, 2019, while gained 2.3% in the last 3 months.

Summary/Earnings Highlights

- As it was expected, Zwack Unicum sales revenues dropped significantly YoY in January-March 2019, after heavy stockpiling in the last calendar quarter of 2018.
- Quarterly domestic sales revenues declined 24% YoY, and export sales fell similarly.
- Although the January-March period is usually low season and brings some losses, operating and net loss roughly doubled the one reported in the base period. Employee benefits keep on rising, though at a slower pace than in the previous quarters.
- Considering the past whole business year, Zwack's net sales revenue increased by 13%, to 15.7bn, EBIT gained 20% YoY, and EBITDA added 19% compared to the previous business year. EPS increased to HUF 1,288, from HUF 1,074 one year earlier.
- If the company does not change its dividend payment practice, we assume over 90% dividend payout ratio, and expect Zwack to pay 1,200 HUF/share dividend after the past business year. This equals 7% dividend yield.
- We consider the current and the coming years more challenging. We expect 12% drop in domestic sales income in the current business year, with slow recovery thereafter. EBIT and EBITDA are expected to suffer double-digit decline. We forecast HUF 1.5bn EBIT and HUF 2.1bn EBITDA for this year, while EBIT and EBITDA are expected to increase to HUF 1.6bn and HUF 2.3bn, respectively in the next business year. This year's EPS is expected to plunge to HUF 648, while next year's EPS is forecast to increase to HUF 681.
- In the earnings report, Zwack reiterated the warning issued in February regarding its performance in the coming business years. Due to the tax increase, Zwack expects the sales volume to decline; that would result in a yearly revenue drop of even more than 10%. Zwack also forecasts a significant profit decline for the coming business years. The drop in net profit may even exceed 40% YoY in the current business year.

In the long term, Zwack does not expect the nominal after-tax profit to return the HUF 2bn level earlier than in 2021/2022.

- In February, we revised down our earnings forecast and on the longer run we applied a more conservative scenario, considering profit estimates, than Zwack. In our forecast we expect EBIT to return to HUF 2.0bn in the business year 2022/2023.

Financial Q4 (HUFm)	Jan-Mar 2019	Jan-Mar 2018	YoY Change
Domestic sales	1 118	1 474	-24%
Export sales	263	338	-22%
Net sales income	**1 381**	**1 812**	**-24%**
Material-type costs	619	770	-20%
Gross profit	**762**	**1 042**	**-27%**
Employee benefits	722	666	8%
Depreciation	173	128	35%
Other operating expenses	746	763	-2%
Total operating expenditures	**1 641**	**1 557**	**5%**
Other incomes	79	96	-18%
EBIT	**-800**	**-419**	**91%**
EBITDA	**-627**	**-291**	**115%**
Pre-tax profit	**-797**	**-418**	**91%**
Tax	-80	-88	-9%
After-tax profit	**-717**	**-330**	**117%**

Cumulative quarters (HUFm)	Apr-Mar 2018/2019	Apr-Mar 2017/2018	YoY Change
Domestic sales	14 238	12 418	15%
Export sales	1 501	1 540	-3%
Net sales income	**15 739**	**13 958**	**13%**
Material-type costs	5 723	5 149	11%
Gross profit	**10 016**	**8 809**	**14%**
Employee benefits	2 987	2 734	9%
Depreciation	564	488	16%
Other operating expenses	3 804	3 377	13%
Total operating expenditures	**7 355**	**6 599**	**11%**
Other incomes	418	351	19%
EBIT	**3 079**	**2 561**	**20%**
EBITDA	**3 643**	**3 049**	**19%**
Pre-tax profit	**3 083**	**2 563**	**20%**
Tax	460	377	22%
After-tax profit	**2 623**	**2 186**	**20%**

Financial Q3	Jan-Mar 2019	Jan-Mar 2018	YoY Change
EPS (HUF)	**-352**	**-162**	**117%**
4Q-rolling EPS (HUF)	**1 288**	**1 074**	**20%**
Gross profit rate	**55.2%**	**57.5%**	**-2.3pp**
Operating profit rate	**-57.9%**	**-23.1%**	**-34.8pp**
EBITDA rate	**-45.4%**	**-16.1%**	**-29.3pp**
ROE	**-9.5%**	**-4.8%**	**-4.7pp**
4Q-rolling ROE	**38.5%**	**32.9%**	**5.5pp**
ROA	**-5.4%**	**-2.8%**	**-2.6pp**
4Q-rolling ROA	**24.0%**	**21.1%**	**2.9pp**

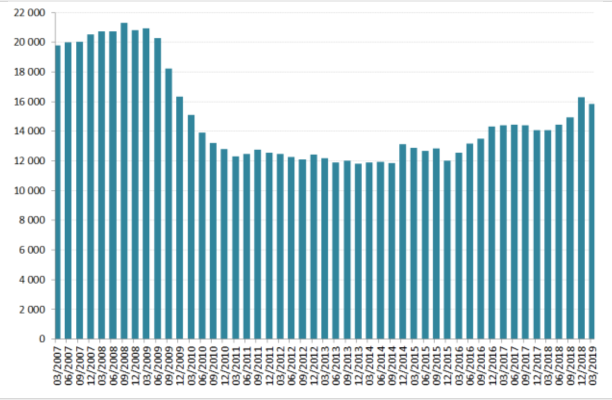
Sources: Zwack Unicum, OTP Research

Heavy stockpiling in the earlier quarters dragged down sales

- Zwack Unicum's extraordinarily weak quarterly sales revenues in the last quarter of the 2018/2019 business year came as no surprise, even if the January-March period is low season anyway. Quarterly domestic sales declined by 24%, as expected, after higher levies on food and beverages deemed unhealthy (the 'NETA' tax) took effect on January 1, 2019. Heavy stockpiling in the second half of 2018, especially in the calendar Q4 dragged down sales in the past quarter.
- Zwack Unicum reported HUF 1.4bn total quarterly sales income, 24% lower than in the corresponding period of 2018. Domestic sales revenues declined 24%, to HUF 1.1bn, a level last seen in 2015 when 'NETA' was first introduced. Low domestic sales performance is the clear consequence of retailers' and wholesalers' bringing forward purchases last year, ahead of this year's tax changes. Due to the recent regulatory changes, 'NETA' increased by 20% as of January 1, 2019 and some kinds of spirits like 'pálinka' and 'herbal liqueurs' or bitters lost their tax exemption under the new regulation.

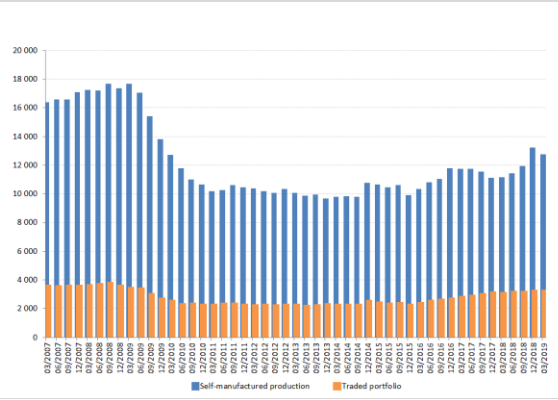
- Exports dropped 22% YoY in the past quarter, to HUF 263m. In Italy, one of Zwack Unicum's main export markets, the change of distributor had a one-off negative effect on sales, the company said. In Germany, the promotional shipments of summer 2018 had been delivered at the end of the previous business year (2017/2018), representing high base value when comparing the January-March periods of 2018 and 2019.
- Quarterly sales revenues of self-manufactured production plunged by 32% YoY, to HUF 1.0bn, a level unmatched in the past six years, when comparing the previous January–March periods. The whole-year sales growth of self-manufactured products slowed to 14% in the past business year, from 19% a year earlier, and further slowdown is expected in the current business year. Zwack reported 16% YoY sales growth in the prime segment, and 21% YoY rate in the quality segment of spirits in the past whole business year, slowing from 20% and 37% cumulative growth rates in the first three quarters.
- In contrast with the self-manufactured segment, the sales growth of distributed products accelerated to 8% YoY in January-March 2019, from the 5% reported in October-December 2018. Zwack reported cumulative 7.9% YoY increase in the sales of Diageo products, while the cumulative sales growth of other traded products slowed to near 2% in the April 2018–March 2019 period.
- Market research data for the period of April 2018 – March 2019 reflected stable consumer demand on Hungary's retail market of spirits (7% nominal YoY growth, and 2% gain in volume). Recently published retail statistics of specialized and non-specialized food shops reflects 3.3% real growth in Q1 2019 YoY (preliminary, seasonally adjusted figure) for the total market, slightly slowing from 3.4% YoY growth rate reported in Q4 by KSH (Hungarian Central Statistics Office).

4Q-rolling sales revenues (total, HUFm)



Sources: Zwack Unicum, OTP Research

4Q-sales of self-manufactured and distributed products (HUFm)



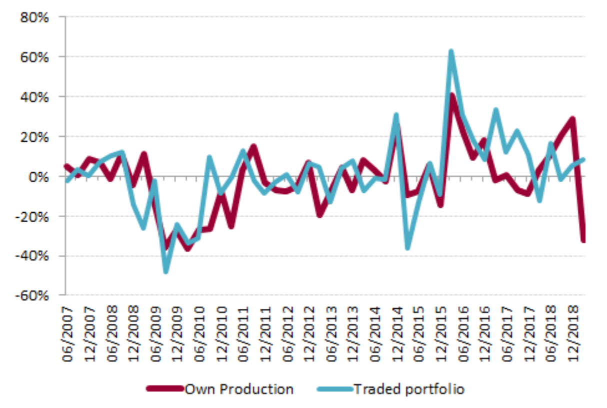
Sources: Zwack Unicum, OTP Research

- Zwack also announced some changes to the accounting policy, which modifications affect mainly the accounting of material-type costs, other incomes and other costs, while some changes in the accounting of certain allowances (employee loyalty bonuses and retirement bonuses) have direct effect on retained earnings. Zwack's financial report is published in accordance with the new accounting rules, but it enables only year/year comparison for the base periods (financial Q4 2017/2018 and the whole business year 2017/2018).
- As a consequence, the recently published profit figures are not comparable with our profit forecasts, and long-term comparisons cannot be made. The accounting changes resulted in 20% gain in gross profit, 5% increase in operating loss, and

6% increase in net loss in FQ4 2017/2018. Quarterly EPS of HUF -153 decreased to HUF -162.

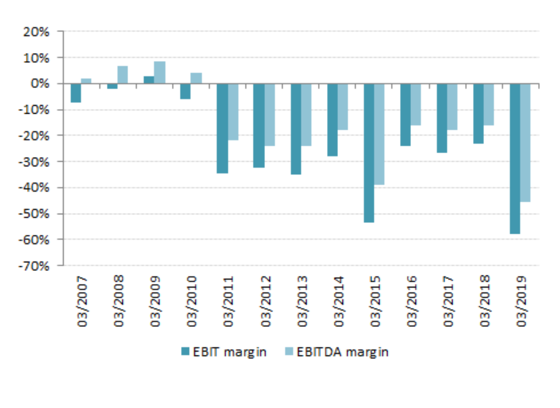
- According to the new methodology, Zwack announced HUF 762m gross profit in January-March 2019, down from the adjusted HUF 1,042m a year before. Operating loss increased to HUF 800m compared to HUF -419m adjusted EBIT in FQ4 2017/2018. The significant decline in the sales of self-manufactured products with higher profit content contributed considerably to the falling profit.
- After-tax loss also more than doubled in a yearly horizon, while quarterly EPS plunged to HUF -352 from HUF -162.
- As a result of changes in the accountancy of material-type costs, gross profit margin decreased to 55% in FQ4 2018/2019, from 58% a year before. Accounting changes resulted in almost 10pp improvement in the base period. However, we have no information how the policy changes affected the latest data. EBIT margin and after-tax profit margin turned negative and fell well below the figures registered in the base period.

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



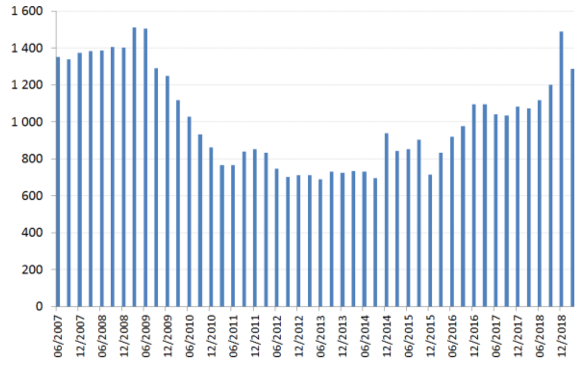
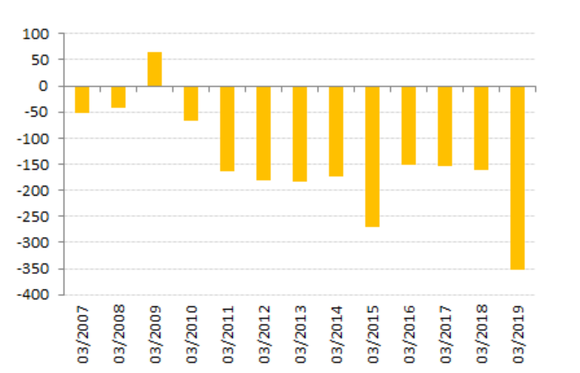
Sources: Zwack Unicum, OTP Research

Profitability ratios in the earlier individual FQ4s



Sources: Zwack Unicum, OTP Research

- For the whole past business year Zwack reported HUF 15.7bn net sales income after gaining 13% YoY. Domestic sales added 15%, while export dropped 3%. Export share declined below 10%, from 11% a year ago. Gross profit increased by 14% YoY to HUF 10.0bn, while EBIT and EBITDA jumped by 20% and 19%, respectively.
- Gross profit margin improved to nearly 64%, from 63% in the previous business year. Due to accounting changes, these figures are higher than the ones published before 2017/2018, so they cannot be applied in a long-term retrospective. EBIT and EBITDA margin also improved, both gaining 1pp, to 20% and 23%, respectively.
- After-tax profit also rose by 20% and amounted to HUF 2.6bn, up from 2.2bn in the business year of 2017/2018. 4Q EPS grew to HUF 1,288 from 1,074 a year earlier. In historical comparison, Zwack ended with the highest yearly net profit since 2009.

4Q-trailing EPS (HUF)	Quarterly EPS in the past individual FQ4s
	
Source: Zwack Unicum	*Source: Zwack Unicum*

Comments

- Zwack's sales figures in the past quarter were in line with our forecast, while we assumed somewhat lower operating costs, even if we were not aware of the accounting changes Zwack introduced.
- As it had been announced, the public health product tax 'NETA' rose by 20% from January 1, 2019 and from that day Unicum, the flagship product of Zwack, and 'pálinka' have been taxed, marking the end of the tax exemption the company benefited from in the past years. As expected, wholesalers and retailers started building inventories in the earlier quarters, while robust consumption also supported strong sales growth.
- Due to the negative effect of higher taxation on demand and as stockpiling stopped, sales income in the last quarter of the 2018/2019 business year declined and it is expected to be much less appealing afterwards.
- In light of stronger-than-expected stockpiling in the last quarter of 2018 (we expected more gradual inventory building in the second half of last year) we had earlier revised our forecast for the last quarter more to the downside. In this case, levelling off may take more time than originally anticipated, and sales revenues can be under pressure for a longer period of time. Zwack's distribution contracts with MHCS and Hennessy was terminated at the end of February 2019, which may also add to concerns about future sales developments.
- Zwack Unicum reiterated the warning issued in February 2019 of less prosperous coming quarters. Due to falling sales volumes – as a consequence of tax-related price increase –, Zwack Unicum expects sales revenues of the next business year decline by more than 10%. Higher expected costs put profitability under pressure; the company plans to offset it by cutting marketing and other operational costs. Total net profit may fall more than 40% in the business year that started on April 1, 2019, Zwack Unicum confirmed in the latest earnings report, adding that it does not expect net profit to return to the HUF 2bn level before 2021/2022.

Conclusion

- After the announcement of the financial figures of the last quarter of 2018, we revised down our short-term and long-term forecasts in February. As declining sales in the January-March period were in line with our estimates, at this time we made only minor changes to the forecast. This is partly due to the changes implemented in Zwack's accounting policy - without knowing the details, we cannot fully apply them in our forecast.

- As a result of the recent modifications, our new 12-month target price declines to 16,056 HUF/share from the previous 16,271 HUF/share, and we still maintain the HOLD recommendation.
- The new target price is 8.0% lower than the HUF 17,500 closing price on May 23, 2019. As dividend is expected to increase to 1,200 HUF/share after the current business year, total return is expected to offset the difference, although the 7% dividend yield does not fully cover it.

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.

Profit & Loss Statement (HUF m)	2016/2017	2017/2018	2018/2019F	2019/2020 F	2020/2021F	2020/2021F
Domestic net sales	12 854	12 418	14 209	12 319	13 658	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	15 250	15 692
Material-type costs	6 044	6 032	6 663	5 552	6 253	6 748
Gross profit	8 237	7 926	9 147	8 328	8 998	8 944
Total operating expenditures	6 021	6 051	6 563	7 246	7 918	7 603
EBIT	2 959	2 580	3 270	1 549	1 628	1 878
Pre-tax profit	2 940	2 582	3 271	1 551	1 630	1 880
Tax	714	378	455	233	244	282
Profit after tax	2 226	2 204	2 816	1 318	1 385	1 598
Dividend	2 137	2 137	2 544	1 221	1 323	1 628
EPS (HUF)	1 094	1 083	1 384	648	681	785
DPS (HUF)	1 050	1 050	1 250	600	650	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	4 163	3 970
Inventories	1 862	2 185	2 386	2 584	2 588	2 818
Recievables and other current assets	2 208	2 275	2 115	2 282	2 340	2 789
Cash and cash equivalents	2 809	2 770	3 064	3 162	2 972	2 681
Current assets	6 879	7 230	7 565	8 028	7 900	8 288
TOTAL ASSETS	**10 036**	**10 677**	**11 147**	**12 078**	**12 063**	**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	3 984	3 676	4 068
TOTAL EQUITY AND LIABILITIES	**10 036**	**10 677**	**11 147**	**12 079**	**12 063**	**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	2 132	2 258	2 504
Cash flow from operation	2 601	2 854	3 754	1 901	1 655	1 928
Cash flow from investment	-371	-765	-927	-1 032	-722	-412
FCFF	2 230	2 089	2 827	2 827	869	932
FCFE	2 232	2 091	2 848	2 848	894	922

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	2 848	894	922	1 526	1 952	1 576	
Discount factor	0,92	0,92	0,92	0,92	0,91	0,91	
DCF	2 620	823	847	1 398	1 784	1 440	6 292
Terminal Value (HUFm)							32 444
Net Present Value - FCFE (HUFm)							26 986
Net debt							-2 750
Equity value (HUFm)							29 737
Number of shares							2 035 000
Expected return on equity							8,7%
12M Target price (DCF)							15 878
12M Target price (DDM)							16 234
12M Weighted Target price (HUF)							**16 056**
Current price							17 500
Upside/Downside							-8,3%
TR Upside/Downside							-1,1%

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 regulatory changes (increase of NETA) which took effect on January 1, 2019, were 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.

Any information relating to the date and time for the price mentioned in this recommendation is revealed in the part of the recommendation where the given price is indicated.

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
20/07/2018	HOLD	HUF 17,046	News Comment
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

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

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

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