

# EQUITY NOTE: ZWACK UNICUM

**Recommendation: HOLD (unchanged)**

**Target price (12M): HUF 16,806 (revised down)**

**07 Nov 2018**

**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 12M target price of 16,806 HUF/share, revised down from 17,046 HUF/share. The new target price reflects our updated forecast and the bigger-than-expected changes in the risk-free interest rates. The new target price stands 1% higher than the HUF 16,600 closing price on 7 Nov 2018. Estimated total return is 5% on a 12-month forecast period.

## **Summary/Earnings Highlights**

- The public health product tax (NETA in Hungarian) will rise by 20% from 1 January 1 2019 and from that day Unicum and 'pálinka' will also be taxed, marking the end of the tax exemption they currently benefit from. As it was expected, wholesalers and retailers have started building inventories, which resulted in robust domestic sales growth in the current quarter.
- As a result, Zwack reported a stupendous HUF 3.7bn total net sales income in July-September 2018, surpassing our expectation. Quarterly net sales revenues were 16% higher than one year earlier, due to a 17% increase in domestic sales. Quarterly domestic sales of self-manufactured products gained 23% in year.
- At the same time, market research data reflect strong retail consumption growth in the market of spirits. According to the latest Nielsen survey, the market of spirits increased by 13% in nominal terms between September 2017 and August 2018, while the total market grew by 11%.
- Although raw material prices and other operation-related costs also grew year over year, profitability improved due to favourable product mix (higher share of self-manufactured products in the sales revenue). EBIT increased by an astonishing 46%, to HUF 769m. EBIT and EBITDA rates improved to 20% and 24% respectively, the highest in a decade.
- Net profit jumped by 37% to HUF 635m, resulting in HUF 312 EPS vs. HUF 229 in the July-September period of 2017.
- Due to the noticeably strong stockpiling and its effect on the current business year and the coming one, we revised our sales and profit forecasts, even though the effect of inventory building and the underlying consumption growth cannot be easily uncoupled at the moment. We raised the sales and profit forecasts for 2018/2019, but in return, sales in the coming business years may get under pressure. But we maintain that risks are tilted to the upside concerning our sales forecasts for the coming business years.
- A somewhat higher discount ratio due to rising interest rate environment also added to the decreasing enterprise value.
- We expect EPS for the current business year to increase to HUF 1,194, up from HUF 1,083 last year, while EPS is expected to fall considerably next year. If Zwack

maintains its usual dividend payout ratio, dividend per share may reach 1,100 HUF/share after the current business year, up from 1,050 HUF/share in 2017.

- Six weeks after Zwack was removed from Hungarian benchmark index BUX, the traded volume of Zwack shares in the Budapest Stock Exchange has not shown significant change. Its market turnover remained at the usual, relatively low level. In the light of trading volume data, we might need to revise our calculation in the coming months and to apply higher small-company discount ratio when evaluating the company.

| Financial Q2 (HUFm)                 | 2018<br>Jul-Sep | 2017<br>Jul-Sep | YoY<br>Change | Cumulative quarters<br>(HUFm)       | 2018<br>Apr-Sep | 2017<br>Apr-Sep | YoY<br>Change |
|-------------------------------------|-----------------|-----------------|---------------|-------------------------------------|-----------------|-----------------|---------------|
| Domestic sales                      | 3 332           | 2 854           | 17%           | Domestic sales                      | 6 583           | 5 738           | 15%           |
| Export sales                        | 402             | 367             | 10%           | Export sales                        | 765             | 724             | 6%            |
| <b>Net sales income</b>             | <b>3 734</b>    | <b>3 221</b>    | <b>16%</b>    | <b>Net sales income</b>             | <b>7 348</b>    | <b>6 462</b>    | <b>14%</b>    |
| Material-type costs                 | 1 504           | 1 374           | 9%            | Material-type costs                 | 2 970           | 2 658           | 12%           |
| <b>Gross profit</b>                 | <b>2 230</b>    | <b>1 847</b>    | <b>21%</b>    | <b>Gross profit</b>                 | <b>4 378</b>    | <b>3 804</b>    | <b>15%</b>    |
| Employee benefits                   | 700             | 619             | 13%           | Employee benefits                   | 1 421           | 1 332           | 7%            |
| Depreciation                        | 130             | 122             | 7%            | Depreciation                        | 264             | 236             | 12%           |
| Other operating expenses            | 808             | 768             | 5%            | Other operating expenses            | 1 629           | 1 436           | 13%           |
| <b>Total operating expenditures</b> | <b>1 638</b>    | <b>1 509</b>    | <b>9%</b>     | <b>Total operating expenditures</b> | <b>3 314</b>    | <b>3 004</b>    | <b>10%</b>    |
| Other incomes                       | 177             | 188             | -6%           | Other incomes                       | 318             | 276             | 15%           |
| <b>EBIT</b>                         | <b>769</b>      | <b>526</b>      | <b>46%</b>    | <b>EBIT</b>                         | <b>1 382</b>    | <b>1 076</b>    | <b>28%</b>    |
| Pre-tax profit                      | 769             | 526             | 46%           | Pre-tax profit                      | 1 382           | 1 076           | 28%           |
| Tax                                 | 134             | 62              | 116%          | Tax                                 | 253             | 191             | 32%           |
| <b>After-tax profit</b>             | <b>635</b>      | <b>464</b>      | <b>37%</b>    | <b>After-tax profit</b>             | <b>1 129</b>    | <b>885</b>      | <b>28%</b>    |

| Financial Q2                | 2018<br>Jul-Sep | 2017<br>Jul-Sep | YoY<br>Change |
|-----------------------------|-----------------|-----------------|---------------|
| <b>EPS (HUF)</b>            | <b>312</b>      | <b>229</b>      | <b>36%</b>    |
| <b>4Q-rolling EPS (HUF)</b> | <b>1 202</b>    | <b>1 035</b>    | <b>16%</b>    |
| <b>EBITDA (HUFm)</b>        | <b>899</b>      | <b>648</b>      | <b>39%</b>    |
| <b>Gross profit rate</b>    | <b>59.7%</b>    | <b>57.3%</b>    | <b>2.4pp</b>  |
| <b>EBITDA rate</b>          | <b>24.1%</b>    | <b>20.1%</b>    | <b>4.0pp</b>  |
| <b>ROE</b>                  | <b>10.8%</b>    | <b>8.4%</b>     | <b>2.4pp</b>  |
| <b>4Q-rolling ROE</b>       | <b>39.1%</b>    | <b>34.7%</b>    | <b>4.4pp</b>  |
| <b>ROA</b>                  | <b>5.8%</b>     | <b>4.6%</b>     | <b>1.2pp</b>  |
| <b>4Q-rolling ROA</b>       | <b>21.3%</b>    | <b>18.8%</b>    | <b>2.4pp</b>  |

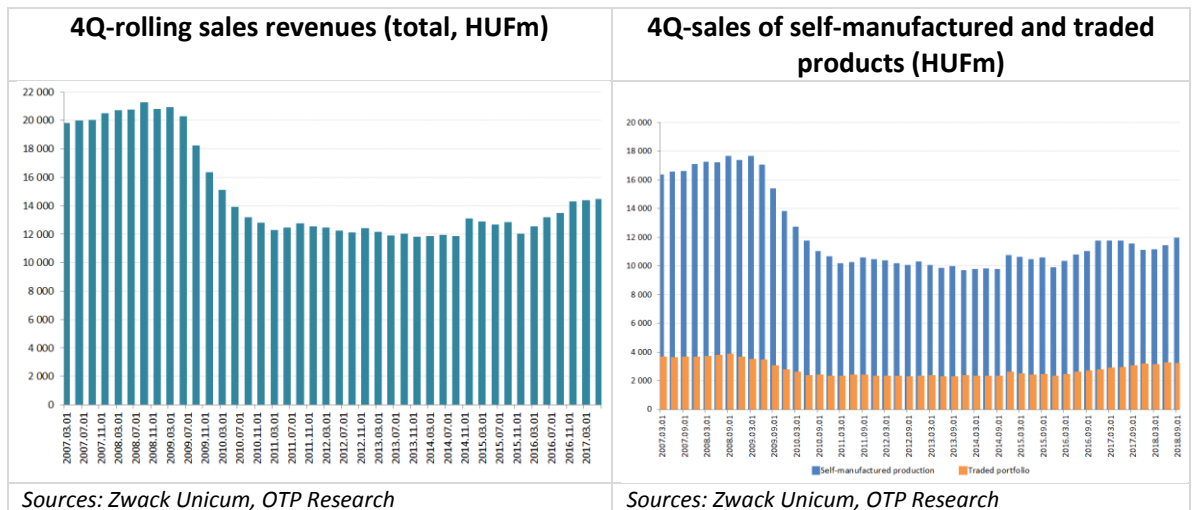
Sources: Zwack Unicum, OTP Research

## The details

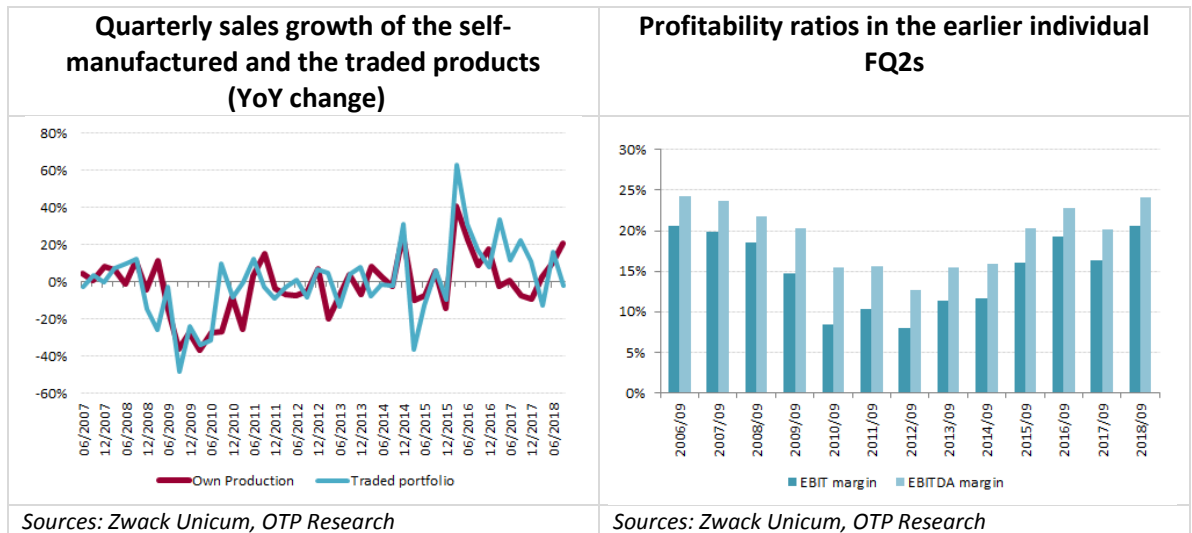
- Market research data for the period September 2017-August 2018, published by Nielsen in October, reflected strong consumer demand on Hungary's retail market of spirits. On the other hand, regulatory changes to take effect at the very beginning of 2019 also supported the expectations of an extraordinary strong quarter for Zwack Unicum. Robust demand growth due to heavy stockpiling resulted in HUF 3.7bn sales income in the July-September period, surpassing our expectation of HUF 3.5bn.
- Sales revenues of self-manufactured production jumped by 21% YoY to HUF 3.1bn, a level not seen in the past ten years when comparing the previous July-September periods. The relatively low basis also supported the strong growth in figures primarily in the “quality” segment while sales growth in the “prime”

segment accelerated. Unicum sales increased by more than the 13.7% cumulative growth rate in the prime segment, while the off-trade introduction of Unicum Riserva also supported the positive developments.

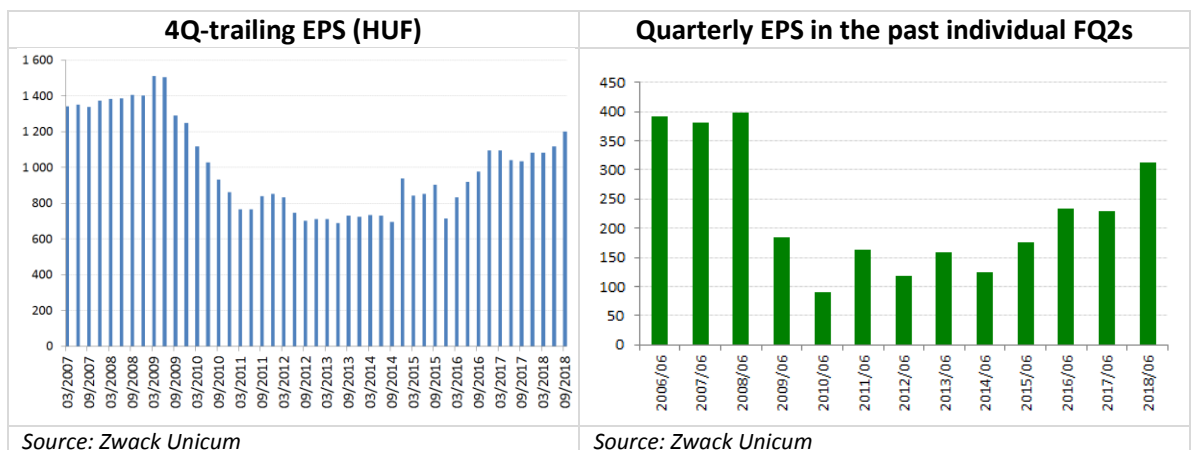
- At the same time, the sales of distributed products slightly decreased in the past quarter (-1.8% YoY). Zwack reported cumulative 7.3% YoY increase in the sales of Diageo products, while the cumulative sales growth of other traded products speeded to 5.7% in July-September. It is noteworthy that Zwack reported nearly 24% increase in Diageo sales in the financial first quarter (April-June), which slowed to 7% in the first two financial quarters. That implies that the sales of Diageo products distributed by Zwack suffered a considerable decline in July-September.



- Material costs increased by 9% YoY in July-September and slowed compared to the April-June period, when Zwack announced that significantly higher herbal base material prices, the weakening HUF, and higher freight costs all dented profitability.
- Quarterly gross profit increased to HUF 2.2bn (+21% YoY), while EBIT jumped to HUF 769m (+46% YoY), and EBITDA rose to HUF 899m (+39% YoY). As quarterly sales growth came from the self-manufactured products with much higher profit content than the distributed portfolio (24.1% vs. 5.0% EBIT ratio), overall quarterly profit margins improved. Gross margin jumped to 59.7%, a multi-year peak, compared to earlier July-September periods. EBIT ratio exceeded 20%, an unusually high level in this period of the year. Zwack’s profitability ratio improved despite rising wage costs (due to overall wage increase at the beginning of 2018 and a slight rise in headcount). Zwack keeps spending more on product marketing, to support sales.



- Quarterly pre-tax profit grew by 46% YoY, while after-tax profit rose only by 39% YoY due to higher tax payment, to HUF 635m. Effective tax rate fell to 17% in the July-September, down from 19% in April-June and 22% in January-March. After-tax profit margin improved to 17.0% from 14.4% a year earlier, well above the long-term average when comparing the same period of previous years.
- Zwack reported a quarterly EPS of HUF 312, up from HUF 229 a year earlier. In historical comparison, EPS of July-September 2018 is at ten-year high, when comparing EPS figures of the same period (financial Q2s). Cumulative four-quarter EPS leapt to HUF 1,202, the biggest value in the past decade. The company’s announcement suggests that this unusually high profitability may continue in the next quarter, but the subsequent one, starting at the beginning of 2019, looks less promising. Due to the negative effect of higher taxation on demand and as stockpiling fades away, sales income in the last quarter of the 2018/2019 business year is expected to be much less appealing.



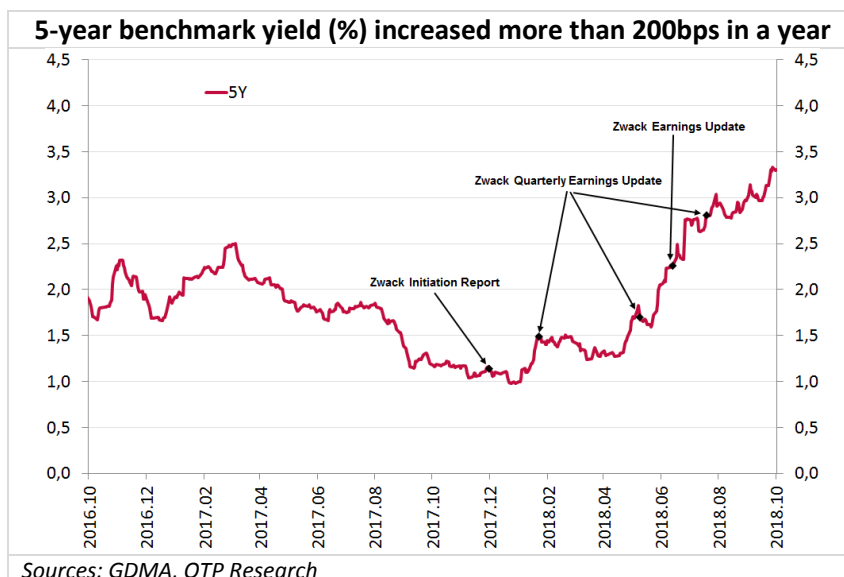
## Comments

- Zwack’s sales and profit figures in the July-September period exceeded our quarterly forecast. As it has been announced, the public health product tax (NETA in Hungarian) will rise by 20% from January 1, 2019 and from that day Unicum and ‘pálinka’ will also be taxed, marking the end of the tax exemption they currently benefit from. As it was expected, wholesalers and retailers have started building inventories while strong consumption also supported strong sales growth.

- Higher NETA payment will affect sales volume from 2019 and onward. Therefore we earlier revised down our forecast slightly for the current business year and by more for the coming years, as detailed in our equity note of June 28, 2018.
- As we wrote before, concerning our sales forecasts for the whole business year of 2019/2018, risks are tilted to the upside as the volume of stockpiling is not easy to predict.
- As the current growth drivers (heavy stockpiling coupled with general strong retail demand) will remain prevailing in the rest of the year, Zwack's sales performance in financial Q3, in a traditionally high season can be overwhelming.
- Retail spending on spirits in Hungary increased by 11% YoY in value between September 2017 and August 2018, market research company Nielsen reported recently. Total spending growth accelerated, and retail spending amounted to HUF 89bn in that period. Bitters maintain the market leading position with 27% share and tiny increase YoY, while the market share of 'vodka' slightly decreased (24% vs. 24.6%). According to the Nielsen survey, the retail consumption of bitters was around 4.8m litres in the Sept-Aug period compared to 4.4m one year before. Nielsen's market data also confirms our expectation of strong holiday-season sales.
- At the same time, we have to consider, that stronger-than-expected stockpiling in the current quarter affects sales revenues more to the downside in the coming quarters starting on January 1, 2019. In this case, level-off may take more time than originally anticipated and sales revenues can be under pressure for a longer period of time. The distribution contract between Zwack and LVMH will be terminated by February 2019, which may also add to concerns about future sales developments.

## Conclusion

- After recently announced financial figures of the July-September period we revise our short-term forecast and long-term forecast. As demand (both from retailers and consumers) on the short run seems stronger than anticipated we raised our sales and profit forecast for the current business year (ending on March 31, 2019). In return, we revised slightly down our forecast for the next business year. However, in lack of product-level data, the stockpiling effect can hardly be quantified. Even if we ignore the effect of stockpiling, the coming years will be characterized by steady but slowing consumption growth.
- Rising risk-free rates also have a negative effect on enterprise value, while thanks to higher profitability in the current business year we raised slightly our short-term dividend forecast. Due to the forecast changes we cut our 12-month target price to HUF 16,806/share from previous HUF 17,046/share and maintain the HOLD recommendation.
- The new target price is 1.2% up from HUF 16,600 closing price as of Nov 7, 2018 and equals 5.0% 1Y expected total return.



### 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        | 13 844        | 12 897        | 13 424        |
| Export sales                        | 1 425         | 1 427         | 1 540         | 1 602         | 1 666         | 1 732         |
| <b>Net sales income</b>             | <b>12 458</b> | <b>14 281</b> | <b>13 958</b> | <b>15 445</b> | <b>14 563</b> | <b>15 156</b> |
| Material-type costs                 | 5 306         | 6 044         | 6 032         | 6 969         | 6 646         | 6 582         |
| <b>Gross profit</b>                 | <b>7 152</b>  | <b>8 237</b>  | <b>7 926</b>  | <b>8 477</b>  | <b>7 917</b>  | <b>8 574</b>  |
| <b>Total operating expenditures</b> | <b>5 781</b>  | <b>6 021</b>  | <b>6 051</b>  | <b>6 234</b>  | <b>6 496</b>  | <b>7 109</b>  |
| <b>EBIT</b>                         | <b>2 160</b>  | <b>2 959</b>  | <b>2 580</b>  | <b>2 825</b>  | <b>2 026</b>  | <b>2 100</b>  |
| <b>Pre-tax profit</b>               | <b>2 177</b>  | <b>2 940</b>  | <b>2 582</b>  | <b>2 825</b>  | <b>2 026</b>  | <b>2 100</b>  |
| Tax                                 | 483           | 714           | 378           | 395           | 284           | 294           |
| <b>Profit after tax</b>             | <b>1 694</b>  | <b>2 226</b>  | <b>2 204</b>  | <b>2 429</b>  | <b>1 742</b>  | <b>1 806</b>  |
| Dividend                            | 1 725         | 2 137         | 2 137         | 2 239         | 1 730         | 1 730         |
| <b>EPS (HUF)</b>                    | <b>832</b>    | <b>1 094</b>  | <b>1 083</b>  | <b>1 194</b>  | <b>856</b>    | <b>888</b>    |
| <b>DPS (HUF)</b>                    | <b>850</b>    | <b>1 050</b>  | <b>1 050</b>  | <b>1 100</b>  | <b>850</b>    | <b>900</b>    |



| 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           |
| <b>Non-current assets</b>                 | <b>3 283</b> | <b>3 157</b>  | <b>3 447</b>  | <b>3 839</b>  | <b>4 068</b>  | <b>4 168</b>  |
| Inventories                               | 1 876        | 1 862         | 2 185         | 2 166         | 2 178         | 2 266         |
| Receivables and other current assets      | 2 162        | 2 208         | 2 275         | 2 347         | 2 298         | 2 441         |
| Cash and cash equivalents                 | 2 257        | 2 809         | 2 770         | 2 782         | 2 965         | 2 890         |
| <b>Current assets</b>                     | <b>6 295</b> | <b>6 879</b>  | <b>7 230</b>  | <b>7 294</b>  | <b>7 442</b>  | <b>7 596</b>  |
| <b>TOTAL ASSETS</b>                       | <b>9 578</b> | <b>10 036</b> | <b>10 677</b> | <b>11 133</b> | <b>11 510</b> | <b>11 764</b> |
| 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         | 4 311         | 4 331         | 4 557         |
| <b>Total Equity</b>                       | <b>6 210</b> | <b>6 723</b>  | <b>6 827</b>  | <b>6 476</b>  | <b>6 496</b>  | <b>6 722</b>  |
| Long-term loans and other liabilities     | 360          | 427           | 410           | 406           | 389           | 389           |
| <b>Non-current liabilities</b>            | <b>360</b>   | <b>427</b>    | <b>410</b>    | <b>406</b>    | <b>389</b>    | <b>389</b>    |
| Loans and credits                         | 0            | 0             | 0             | 20            | 23            | 11            |
| Payables and other short-term liabilities | 2 310        | 2 889         | 3 384         | 4 156         | 4 576         | 4 618         |
| <b>Current Liabilities</b>                | <b>3 008</b> | <b>2 886</b>  | <b>3 440</b>  | <b>4 250</b>  | <b>4 625</b>  | <b>4 653</b>  |
| <b>TOTAL EQUITY AND LIABILITIES</b>       | <b>9 578</b> | <b>10 036</b> | <b>10 677</b> | <b>11 133</b> | <b>11 510</b> | <b>11 764</b> |

#### CONSOLIDATED CASH FLOW (HUFm)

|                           | 2015/2016 | 2016/2017 | 2017/2018 | 2018/2019F | 2019/2020F | 2020/2021F |
|---------------------------|-----------|-----------|-----------|------------|------------|------------|
| EBITDA                    | 2 674     | 3 474     | 3 068     | 3 376      | 2 606      | 2 735      |
| Cash flow from operation  | 2 132     | 2 601     | 2 854     | 3 718      | 2 731      | 2 250      |
| Cash flow from investment | -698      | -371      | -765      | -923       | -790       | -714       |
| FCFF                      | 1 434     | 2 230     | 2 089     | 2 795      | 1 941      | 1 536      |
| FCFE                      | 1 445     | 2 232     | 2 091     | 2 815      | 1 944      | 1 511      |

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     | 2 815     | 1 944     | 1 511     | 2 177     | 1 985     |                             |
| Discount factor                     | 0,92      | 0,91      | 0,91      | 0,91      | 0,91      | 0,90      |                             |
| DCF                                 | 1 916     | 2 575     | 1 772     | 1 373     | 1 973     | 1 789     | 9 481                       |
| Terminal value (HUFm)               |           |           |           |           |           |           | 31 421                      |
| Net present value (HUFm)            |           |           |           |           |           |           | 28 131                      |
| Net debt                            |           |           |           |           |           |           | -2 356                      |
| Equity value (HUFm) - June 30, 2019 |           |           |           |           |           |           | 30 487                      |
| Number of shares (pcs)              |           |           |           |           |           |           | 2 035 000                   |
| Expected return on equity           |           |           |           |           |           |           | 9,3%                        |
| 12M Target price (DCF)              |           |           |           |           |           |           | 16 381                      |
| 12M Target price (DDM)              |           |           |           |           |           |           | 17 232                      |
| 12M Weighted Target price (HUF)     |           |           |           |           |           |           | <b>16 806</b>               |
| Current price                       |           |           |           |           |           |           | 16 600                      |
| Upside/Downside                     |           |           |           |           |           |           | 1,2%                        |
| TR Upside/Downside                  |           |           |           |           |           |           | 5,0%                        |

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) 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. 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 somewhat 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.

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 |

| Period | Recommendations | Percent of recommendation |
|--------|-----------------|---------------------------|
| 2017Q4 | BUY             | 100%                      |
|        | HOLD            | 0%                        |
|        | SELL            | 0%                        |
| 2018Q1 | BUY             | 0%                        |
|        | HOLD            | 100%                      |
|        | SELL            | 0%                        |
| 2018Q2 | BUY             | 0%                        |
|        | HOLD            | 100%                      |
|        | SELL            | 0%                        |
| 2018Q3 | 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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