

EQUITY NOTE: RÁBA Automotive Holding

Recommendation: HOLD

Target price (12M): HUF 1,475

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Highlights

We maintain our previous HOLD recommendation on Rába Automotive Holding (RABA HB; RABA.BU) with a new 12M target price of 1,475 HUF/share, 5% higher than the HUF 1,405 closing price on February 21. Total return is estimated at 6.4% on a 12-month forecast period. Our new target price reflects the changes in the company's enterprise value, also featuring Rába's real estate expected to be sold in the future. However, our property sale valuation very low probability of concluding such deal in the short run, while in the medium and long term it is surrounded by uncertainty.

Summary

- Net sales increased by almost 3% in 2017, in line with our forecast. Rába benefited from robust growth in the EU, 15% sales increase in the European markets offsets the weakening sales performance in the USA (-11%) and the decline of sales to CIS (-17%). The Q4 sales figures are not that flattering; total sales fell by 6% in the individual fourth quarter, mainly due to dropping domestic and CIS sales.
- Considering the main segments of Rába, the Axle business unit achieved modest 3% sales growth, while the Components Business Unit's sales slightly dropped (-3%). Vehicle sales' decline weighs heavily on Rába Q4 performance, as it fell by 25% in Q4 as the company is running out of public sector orders.
- Although steel raw material prices are yet to stabilise, Rába managed to maintain gross profit margin close to the levels of previous quarters. Passing on the effect of growing raw material prices has not been automatic, Rába declared in its earnings report. We expect steel prices to remain at a high level, adding a downside risk to Rába's profitability.
- Rába also benefited from corporate tax changes; its after-tax profit increased by 14% YoY in 2017 as effective tax rate declined. Its Q4 EPS increased to HUF 63, practically the same level as in Q4 2016. Its 4Q rolling EPS amounts to HUF 116, leaving room to the management for a modest dividend payment, similarly to 2016.
- On the basis of the recently published data we revised our sales forecast slightly up. Strong growth in the European economy (the EC revised its projection to 2.2% in 2018) also fuels the European commercial vehicle market, resulting in higher possible sales potential for automotive suppliers. As a result, we raised our EPS forecast to HUF 119 from 116 HUF/share, while rising wages and raw material costs may weigh on profitability.
- The new target price reflects the changes made in the forecast and the valuation of Rába's immense ground expected to be sold some day in the future. In case

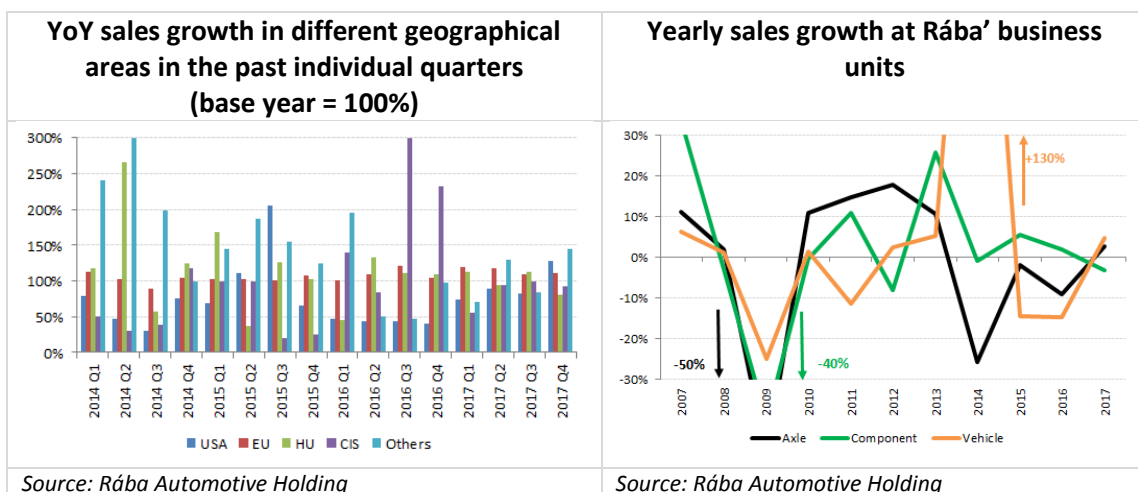
the property is sold this year, though we see the chances for that very slim, it poses an upside risk to our valuation.

- As a result, and due to price movements in the past weeks, Rába shares are now offering a 6% estimated total return on a 12-month horizon. We maintained our HOLD recommendation on Rába.

Financial highlights of Q4 earnings report

Strong EU growth fuels higher export sales to European markets. Rába's total sales revenue increased by 3% in 2017, with exports expanding by 8% YoY, while domestic sales dropped by 6%. Exports' share in total sales increased to 65%, a level not seen in the past three years. However, sales in Q4 were disappointing as domestic sales fell by 21% and total sales declined by 5%. Strong demand in the European market in the individual fourth quarter could not offset the decline of domestic sales revenue and the export to the CIS. Sales to the USA seem to recover as fourth-quarter revenues grew by almost 30%, though the whole-year performance is still weak (-11%).

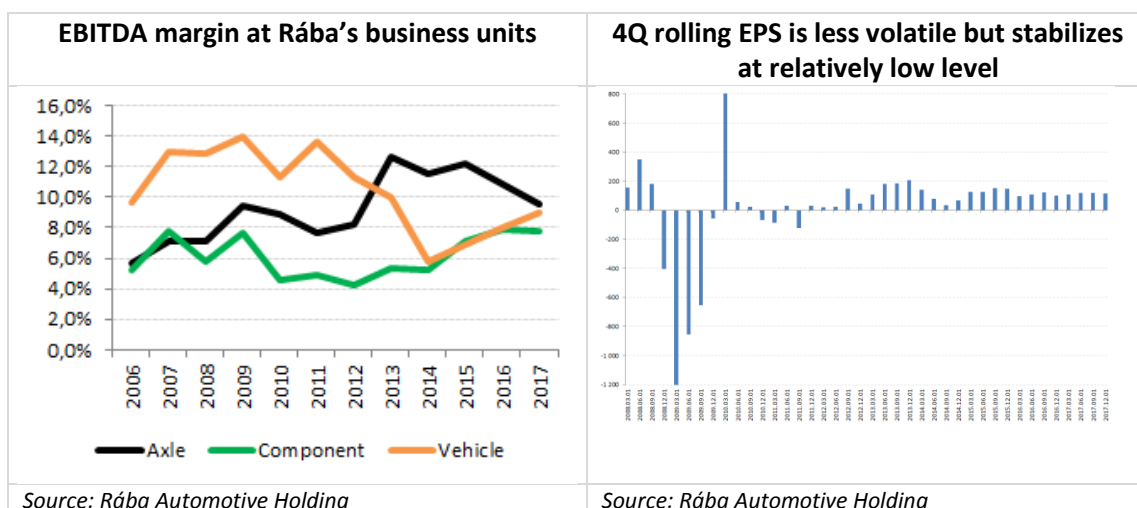
Axle business still fares well, while the components and vehicle business units lag behind. In terms of segmentation, the sales of axles increased both in Q4 and in 2017 as a whole. The market of commercial vehicles in the USA and in the EU are benefiting from strong demand of transportation, resulting in 6% sales growth in 2017 and 12% increase in Q4. Domestic sales of the components business declined 11% last year, while it sees 8% sales growth in Q4 as both exports and more pronounced domestic revenues expanded. The vehicle business unit suffered dramatic domestic sales declines in Q4, presumably due to the running out of the public orders.



Slightly declining margins with counterbalancing effect of corporate tax rate cut. Although Rába still needs to fight high and growing steel raw material prices, profit margins only slightly deteriorated in Q4 and even last year. Rába called the attention to the present situation that the passing on the effect of growing raw material prices has not been automatic along the supply chain and special efforts need be made to maintain the profitability level. We think however that high and even growing raw material prices take a toll on profitability, unless steel prices stabilize at a somewhat lower level. The corporate tax rate cut, effective from January 1, 2017 resulted in

improving after-tax profit margin, but considering future prospects, this advantage may fade away due to growing raw material prices and wage growth.

On the level of business units the components and vehicle business units managed to maintain or improve their profitability level, while the axle unit's profitability has been in a downward trend from 2016, probably due to higher steel content. The axle unit's deteriorating margins add a downside risk to the overall corporate profitability.



Positive outlook as export demand is expected to remain strong in developed markets. In light of the recently released financial data we revised slightly up our sales forecast. Maintaining our profitability expectations, our EPS forecast for 2018 increases to HUF 116. On the basis of the preliminary consolidated financial data we assume that dividend per share may remain at HUF 20, similarly to year 2016.

CONSOLIDATED INCOME STATEMENT	HUFm						
	2014	2015	2016	2017	2018E	2019E	2020E
Domestic sales	19 526	17 838	16 216	15 233	17 177	17 616	18 130
Export sales	28 390	28 315	26 413	28 606	30 012	32 705	34 708
Total sales revenue	47 916	46 154	42 629	43 839	47 189	50 321	52 839
Direct cost of sales	-38 725	-36 317	-33 200	-34 577	-37 751	-39 754	-42 271
Gross profit	9 191	9 837	9 429	9 262	9 438	10 567	10 568
Indirect costs of sales	-7 299	-7 640	-7 429	-7 116	-7 550	-8 454	-8 771
EBIT	1 891	2 196	2 000	2 146	1 888	2 113	1 797
EBITDA	4 122	4 465	4 122	4 097	4 407	4 581	4 421
Net financial profit/loss	-584	-104	-11	-98	189	211	180
Profit before tax	1 308	2 093	1 989	2 048	2 076	2 325	1 976
Tax	-456	-410	-612	-481	-478	-535	-455
After-tax profit	852	1 682	1 378	1 567	1 599	1 790	1 522
Dividend	0	0	271,648	269	543	679	679
EPS	63	125	102	116	119	133	113
DPS			20	20	40	50	50

CONSOLIDATED BALANCE SHEET		HUFm					
	2014	2015	2016	2017	2018E	2019E	2020E
Property, plant, equipment	14 977	14 832	14 410	15 818	16 363	18 581	19 800
Intangible assets	1 071	789	500	282	433	404	389
Non-current assets	17 276	16 723	15 799	16 875	17 471	19 614	20 783
Inventories	6 629	6 211	5 728	7 008	7 588	9 174	9 619
Receivables and other current assets	11 304	8 375	10 075	9 864	9 438	9 261	10 568
Cash and cash equivalents	1 025	3 199	1 900	2 638	1 482	2 323	1 477
Current assets	18 976	17 807	17 703	19 548	18 508	20 758	21 663
TOTAL ASSETS	36 252	34 530	33 502	36 423	35 979	40 371	42 447
Share capital	13 048	13 138	13 473	13 473	13 473	13 473	13 473
Own shares	0		-109	-109	-109	-109	-109
Capital reserve	73	64	0	0	0	0	0
Stock option reserve	97	67	0	0	0	0	0
Retained earnings	1 857	3 837	5 314	6 612	7 263	8 374	9 216
Total Equity	15 075	17 107	18 679	19 976	20 627	21 738	22 581
Long-term loans and other liabilities	6 424	3 006	2 239	4 373	3 567	4 745	5 888
Provisions	315	261	150	163	44	0	0
Non-current liabilities	6 739	3 267	2 434	4 619	3 611	4 745	5 888
Loans and credits	3 185	3 570	746	1 582	1 823	3 667	2 628
Payables and other short-term liabilities	11 252	10 587	11 541	10 127	9 918	10 145	11 274
Current Liabilities	14 438	14 156	12 389	11 828	11 740	13 888	13 978
TOTAL EQUITY AND LIABILITIES	36 252	34 530	33 502	36 423	35 979	40 371	42 447

CONSOLIDATED CASH FLOW		HUFm					
	2014	2015	2016	2017	2018E	2019E	2020E
EBITDA	4 122	4 463	4 122	4 292	4 407	4 581	4 421
Cash flow from operation	3 778	6 641	3 244	2 084	2 806	2 914	3 385
Cash flow from investment	-3 278	-1 790	-1 203	-3 097	-3 455	-4 611	-3 794
FCFF	500	4 851	2 042	-1 014	-649	-1 697	-409
FCFE	1 107	1 924	-1 556	309	477	1 489	-167

Source: OTP Research

Valuation of Rába property for sale

- In our initiation report published in December 2017 we excluded the valuation of Rába's property, expected to be sold for a long while. As we used the cash flow approach when evaluating Rába Automotive Holding, in this point of view we saw no reason to include the value of the property without cash inflows and outflows, while the appraisal of such a transaction is surrounded by a high degree of uncertainty.
- However, this time we make the valuation of the property sale because we think that if the sale is concluded some day in the future, it yields significant one-time revenue of a scale that we cannot ignore.
- The property is located in Győr (northwest Hungary), relatively close to the centre. It is quite large, about 43 hectares, by its size it would be suitable for the construction of a new residential area with about 6,000–10,000 new homes, which is quite a large sum compared to the about 59,000 residential property stock in Győr. However the property is in a non-residential area, with no access to utilities. Furthermore, as an industrial area in the past, the soil is polluted in certain areas and should be replaced. The property was valued at HUF 4.571bn by an official property appraiser, as stated in the 2016 Annual Report of Rába. The management wants to sell the property as a whole, undivided land.

- As the sale of such a large-size property is very uncertain on more scores than one, we follow a conservative although realistic approach when evaluating this asset.
- The Hungarian residential property markets are booming, demand is strong, especially in Budapest and in the main cities, like Győr. But despite the strong demand, given the size of the property, the local market would not be able to absorb the excess supply of thousands of flats that this project could bring to the market, only if the development lasted many years.
- Other main characteristics of the Hungarian residential market are strong capacity bottlenecks, fast rise in costs, and the uncertainty about VAT. VAT on new homes was decreased temporarily to 5% from 27% between 2016 and 2019. Starting a project even right now would bear the risk of not being finished until the end of 2019, which would mean an additional VAT payment of 22 percentage points.
- When evaluating this specific property, we made assumptions on the probability of the settlement of the sale, on the marketability/liquidity of the property and the future price.
- The size of the property in question does not make its sale easier and the local government's reluctance to reconstruct the 'Városrét' area (infrastructure development, building up public services) also questions the marketability of the property in the short to medium term. There are no signs of development in this area in the list of high-priority investments under the 'Program for Modern Cities' scheme either. Therefore, we applied a 50% illiquidity discount in the appraisal.
- Without the cooperation of the local government, no residential or commercial project is likely to be realized on Rába's property, therefore the probability of sale is very low in the short run. In our view, chances are slim even in the medium term. We think such a project can be viable in the long run, particularly at the time of the next real estate cycle.
- In our calculation, the present value of the probable sales income stemming from the property sale is likely to amount to 88 HUF/share. This sum is the average of the different results depending on the time horizon when the deal can be concluded.

The reasons why we think the probability of such a large-scale investment in this real estate cycle is low:

- 1) The management wants to sell the whole property as one, undivided land.
- 2) The property has no access to utilities, and infrastructure development takes time.
- 3) Building up of the infrastructure may take years, beyond 2019, while VAT may be raised back to the original level, starting from 2020.
- 4) The area of Győr is abundant in smaller scale residential investment.

Calculation:

- The property was valued at HUF 4.571bn by an official property appraiser, as stated in the 2016 Annual Report of Rába.
- As a price forecast for the property, we adjusted the officially published property value by the CPI year by year.

- We applied a 50% illiquidity discount, reflecting the limited marketability of the real estate.
- We consider different scenarios depending on the time horizon and the probabilities.
- In our calculation the present value of the probable sales income arising from the property sale is expected to amount to HUF 88/share. This sum is the average of the different results depending on the time horizon when the deal can be concluded.

Calculation of the value of property sale considering different time horizons

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	
Property value (HUFm) as stated in the latest Annual Report of Rába (as of Dec 31, 2016)	4 571												
Property value (adjusted with CPI), HUFbn		4 681	4 802	4 946	5 095	5 248	5 405	5 567	5 734	5 906	6 084	6 266	
Illiquidity discount			50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	
Property value adjusted with illiquidity discount (HUFm)			2 401	2 473	2 547	2 624	2 703	2 784	2 867	2 953	3 042	3 133	
Scenario 1: Sale in 2018													
Probability of Scenario 1													
Revenue/share in Scenario 1 (HUF)			180										
Scenario 2: Sale in 5 years													
Probability of Scenario 2			33%										
Present value of the revenue/share when the property is sold in 5 years (HUF)						51							
Scenario 3: Sale in 7 years													
Probability of Scenario 3			60%										
Present value of the revenue/share when the property is sold in 7 years (HUF)								87					
Scenario 4: Sale in 9 years													
Probability of Scenario 4			80%										
Present value of the revenue/share when the property is sold in 9 years (HUF)										109			
Scenario 5: Sale in 10 years													
Probability of Scenario 5			80%										
Present value of the revenue/share when the property is sold in 10 years (HUF)												106	
Average expected revenue/share deriving from Scenarios 2-5 (HUF)												88	

Source: OTP Bank Research

Change in 12M target price

We raise our 12-month target price to 1,475 HUF/share, from previous 1,380 HUF/share. Our new target price reflects primarily the changes in the company's fair value after incorporating into our valuation the value of Rába's large-sized real estate in Győr, expected to be sold for a long while.

As a result, and due to the price movements in the past weeks, Rába shares are now offering a 6% estimated total return on a 12-month horizon. We maintain our previous HOLD recommendation.

Deduction of 12M target price

Rába's valuation (HUFm)	2017	2018	2019	2020	2021	2022	FCFF in the explicit period
FCFF	-1 951	-649	-1 697	-409	3 588	2 767	
Discount factor		0,92	0,92	0,92	0,91	0,89	
DCF		-600	-1 448	-321	2 572	1 774	1 976
Terminal value (HUFm)							31 348
Net present value (HUFm) of TV							17 922
Enterprise Value (incl. possible future property sale)							21 078
Net debt							3 316
Equity value - Dec 31 2017							17 762
Number of shares							13 352 765
Expected return on equity							9,1%
12M Target price (from Feb 28, 2018 on)							1 475
Current price							1 405
Upside/Downside							5,0%
TR Upside/Downside							6,4%

Source: OTP Research

Risks surrounding Rába's economic activity

FX risk: As export sales have a dominant share in Rába's sales performance, the company is exposed to exchange rate fluctuations. About 60% of the total sales revenue is FX-dominated, which is estimated to grow from 62% in 2016 to 67% in 2022.

Raw material & energy prices: Raw material (steel) prices increased further in the second half of the year, while prices have stabilized at relative high levels in 2018.

Labour supply: The present labour market developments, particularly the prevailing labour shortage may arrive at a point when it may harm the companies' growth potential, and result in higher labour costs, or extra capex need to substitute labour force with robotisation, or may lead to chronic capacity shortage. Rába is located in Western Hungary, where unemployment practically vanished, and the local labour market is supply-driven.

Risks surrounding Rába's property for sale: Although we do not expect that this property to be sold soon, if it happens, the sales revenue add relatively significant value to Rába's enterprise value. Should the property be reclassified as residential area, from the present classification as arable land, that would be a strong value generating factor.

Ownership: Apparently, the state-owned MNV's 75% ownership in Rába made no palpable changes to the company's operation or strategy. A significant part of MNV's asset portfolio consists of companies linked to public services – from this point of view Rába, an industrial manufacturer that operates under market conditions, does not seem to fit the owner's portfolio. MNV has not published a comprehensive strategy or a clear view on its goals with Rába except the declaration at the time of the buyout on the strengthening of the state's presence in strategic sectors like the automotive industry. A further risk is that directives centrally declared on the

operation of state-owned companies make no difference between companies, and do not take into consideration the sector characteristics. Although we consider the dominant state ownership a real risk, this research does not factor it in.

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 Rába Automotive Holding in the past twelve months:

Date	Recommendation	Target price	Publication
15/12/2017	HOLD	HUF 1380	Initiation coverage

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

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