

EQUITY NOTE: RÁBA Automotive Holding

Recommendation: BUY (unchanged)

Target price (12M): HUF 1,350 (revised)

14 November 2019

Highlights

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We maintain our previous BUY recommendation on Rába Automotive Holding (RABA HB; RABA.BU) with a new 12M target price of 1,350 HUF/share, up from the previous 12M target price of 1,317 HUF/share. The target price is 23% higher than the HUF 1,095 closing price on 14 November. Total return is estimated at 25% on a 12-month forecast period. Although Q3 earnings report shows disquieting signs of the core business of Rába's axles unit again, we maintain our forecast on balanced sales growth in the short run, while risks surrounding economic growth in the EU and a possible global downturn still linger. Rába also faces challenges on the cost side and while part of the cost increase may affect operation only temporarily, rising energy and labour expenses need to be addressed. The lower-than-earlier-forecast long-term yields also added to factors that led to somewhat higher enterprise value.

Summary

- Rába Automotive Holding announced HUF 10.3bn sales income in Q3 2019, in line with our expectation and slightly higher than a year earlier. Despite reports of strong demand on the key export markets earlier in the year, considerable volatility in demand put the sales performance under pressure in the past quarter.
- Not every business unit managed to maintain the dynamics in its core export market at the levels seen in previous years. The axle business unit's sales declined in YoY comparison in almost every geographical area, though the 2% drop in exports to the EU market in Q3 was a relief after 23% and 6% declines in Q2 and Q1, respectively.
- However, total sales to the EU gained 8% YoY in HUF terms, most of all thanks to the 22% surge in EU exports at the parts business. Another positive development was the rising sales of the axles business in the segment of 'other markets'.
- US sales declined despite the favourable environment in the market of heavy trucks and agricultural machinery, while the decline of sales to the CIS came as no surprise due to the weak demand this year.
- Rába is still struggling with rising energy prices and wages; higher production and general administration costs put profitability under pressure again. Although steel raw material prices have been steadily coming down, the company failed to improve operating profitability in the latest quarter, due to other cost factors. Wage dynamics in the manufacturing sector has slowed lately, but it remains to be seen whether Rába will be able to return to the previous favourable margin levels in the long run.

- As a consequence, quarterly EBIT sank into the red, while EBITDA declined by 16%. Consolidated profitability ratios deteriorated in both yearly and quarterly comparison. The deterioration of profit margins affected the vehicle business most of all.
- Rába ended the past quarter with HUF 429m net loss. Significant financial loss also contributed to the unexpected loss in this past quarter.
- EPS amounted to HUF -32 in Q3 2019, well below our expectation, while 12M-trailing EPS decreased to HUF 73 vs. HUF 110 in Q3 2018.
- One year ago, Rába announced the renewal of the framework contract (Vehicle Procurement Program, VPP) between its subsidiary Rába Vehicle Ltd. ('Rába Jármű') and the Hungarian Ministry of Defence. Sales revenues were not expected to realize in this programme this year, Rába announced recently. In this context, the medium-term outlook also looks quite uncertain.
- We expect this year's EBIT to arrive at HUF 1.7 bn, while net profit is expected at HUF 1.1bn, down from our earlier forecast of HUF 1.3bn. EBITDA may remain at HUF 3.8bn, slightly down from our earlier forecast of HUF 3.9bn. Our 12M EPS forecast for 2019 now stands at HUF 81.
- As no information has been published on the exact size of the above-mentioned public orders, our baseline scenario of HUF sales has not contained expectations linked to the "Zrínyi 2026" programme.
- Robust demand is sustained on Rába's key markets and we do not expect considerable change in that in the short run. However, when considering global growth outlook, we see downside risks. Uncertainty concerning global trade disputes is also a risk factor, and changes in trade policies may strongly affect the European automotive sector and its supply chain.

Financial highlights of Q3 2019 earnings report

HUFm	2019 Q3	2018 Q3	YoY Change
Domestic sales	2 960	3 314	-11%
Export sales	7 324	6 898	6%
Net sales income	10 284	10 212	1%
Direct cost of sales	8 573	8 183	5%
Gross profit	1 712	2 029	-16%
Cost of sales and marketing	199	228	-13%
General managing costs	1 522	1 658	-8%
Other operating expenses	186	163	14%
Total operating expenditures	1 907	2 050	-7%
Other incomes	159	72	120%
EBIT	-37	51	-171%
Net financial profit	-388	14	-
Pre-tax profit	-425	66	-748%
Tax	4	73	-94%
After-tax profit	-429	-7	-

	2019 Q3	2018 Q3	YoY Change
EPS (HUF)	-32	-1	6051%
4Q-rolling EPS (HUF)	73	110	-33%
EBITDA (HUFm)	471	564	-16%
Gross profit rate	16.6%	19.9%	-3.3 pp
EBIT rate	-0.4%	0.5%	-0.9 pp
EBITDA rate	4.6%	5.5%	-0.9 pp
ROE	-2.0%	0.0%	-2.0 pp
4Q-rolling ROE	4.7%	7.4%	-2.7 pp
ROA	-1.0%	0.0%	-1.0 pp
4Q-rolling ROA	2.4%	4.1%	-1.7 pp

Source: Rába Automotive

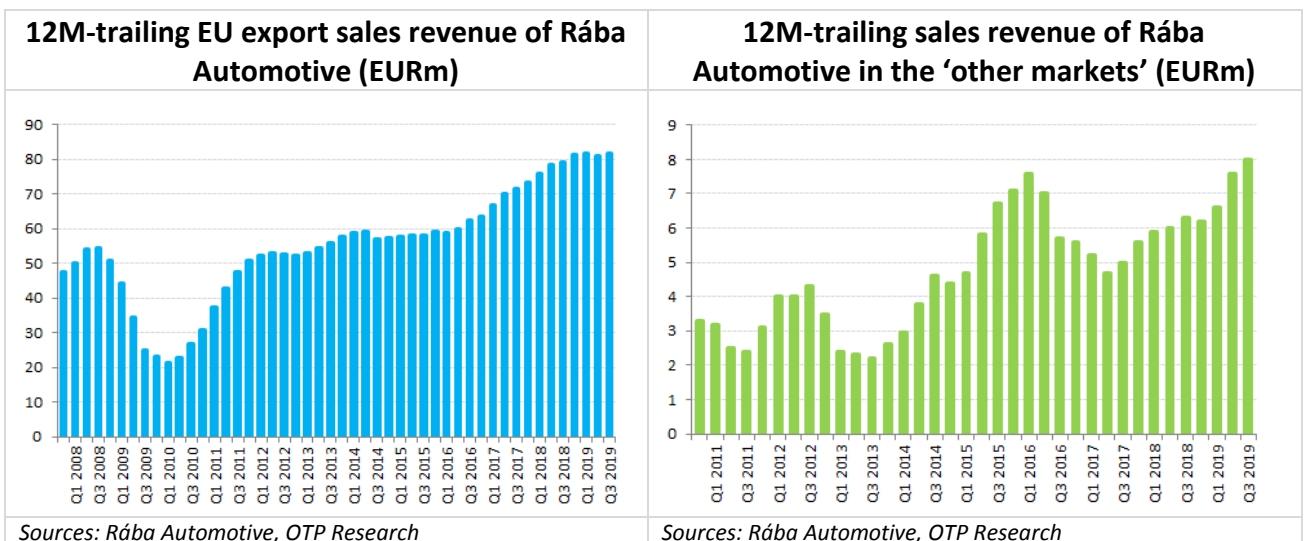
Sales performance keeps on showing worrying signs. Rába recently reported HUF 10.3bn total net sales in Q3 2019, in line with our quarterly forecast. Total sales revenue increased by less than 1% YoY, and has further slowed down compared to the 19% and 7% YoY growth rates witnessed in Q1 and Q2, respectively.

HUF-denominated quarterly export sales have increased by 6% from Q3 2018. Among the main export markets, FX-denominated sales to the USA and the area covering the CIS & Eastern Europe have declined, while sales to the EU and other geographical regions have grown. When comparing the quarterly average FX rates of the corresponding periods, the somewhat weaker HUF also added to sales figures reported in HUF.

After the outstanding performance in the first two quarters of 2019, domestic sales lost momentum, falling by 11% YoY in the July-September period.

Exports' share in total sales revenue climbed, exceeding 71% in the latest quarter – a level much typical for Rába, although the decline of the vehicle segment's domestic sales revenue also had a role in it.

Sales to the EU – representing the biggest share (54% in Q3, up from 52% in Q2 and 47% in Q1 this year) in total sales revenue – rose 8% YoY in HUF terms. In EUR, quarterly sales revenue added 5% YoY, mainly due to the 18% YoY increase in parts' export to the EU. This segment hardly loses momentum in EU sales performance: exports' growth rate averaged over 20% YoY in the past five quarters.



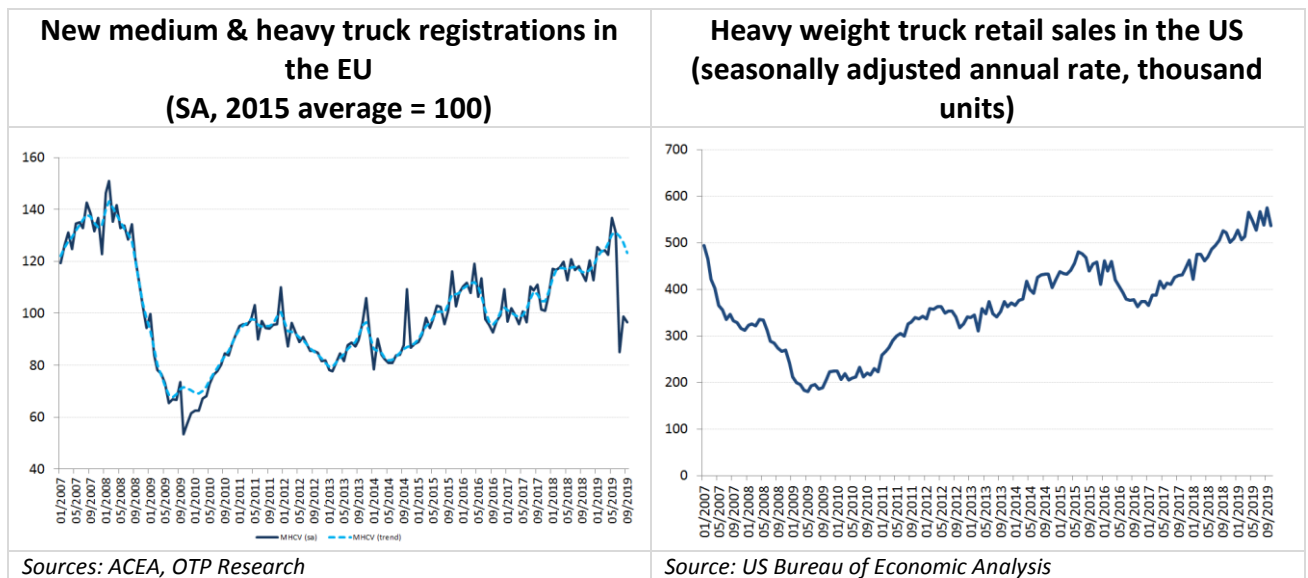
Without the FX effect, quarterly EU sales revenues added 5% YoY as well, making considerable difference compared to the double-digit quarterly growth rates in 2017 and 2018. **Cumulated 3Q sales** to the EU remained practically flat, compared to the corresponding period of 2018. According to the registration figures, heavy truck sales to the EU plunged in Q3 as a result of the market correction after strong demand in H1 due to changing regulations.

Another bright spot in Rába's Q3 earnings report was the segment of 'other markets', where HUF-denominated sales revenues jumped by 26% YoY following skyrocketing growth rates in the first two quarters of this year. Without the FX effect,

sales added 22% YoY in the July-September period. In this latest quarter, the market share of 'other markets' in Rába's total export sales exceeded the one of the US market.

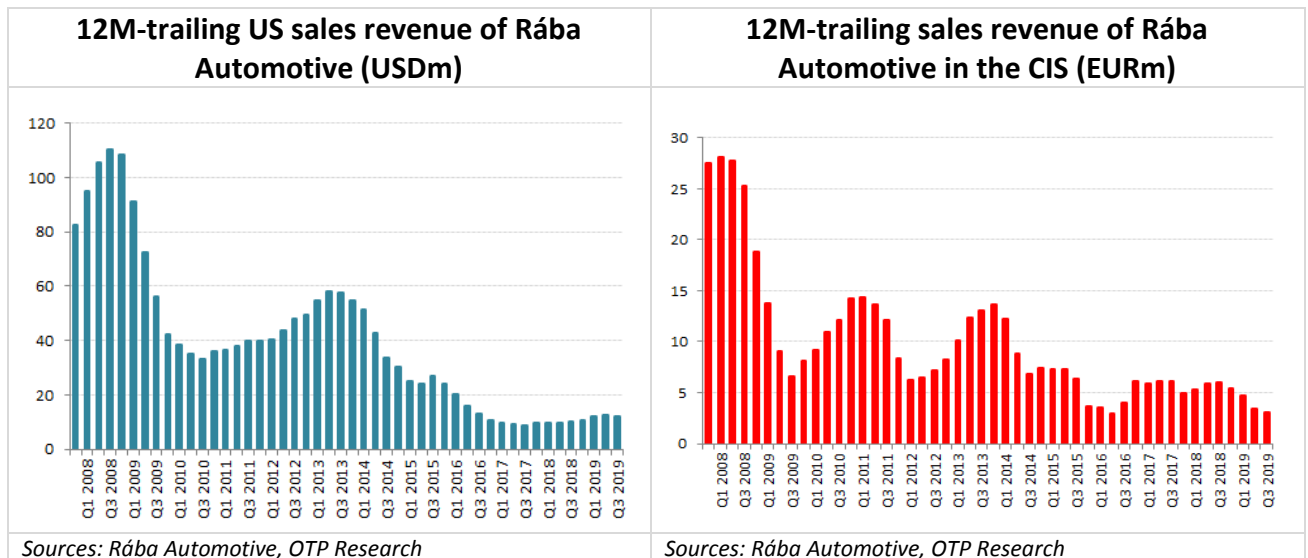
Despite the still strong demand on the US heavy truck and agricultural machinery market, Rába's performance worsened in Q3. USD-denominated sales revenues declined 15% YoY, and the weakening HUF helped smooth the unexpectedly heavy loss that led to 9% drop in HUF-denominated sales.

Demand on the US heavy truck market remained strong, enjoying the still favourable economic conditions: the monthly registration figures of heavy commercial vehicles showed double-digit yearly growth rates in the past nearly two years, as well as in the first seven months of 2019. August showed some slowdown concerning the seasonally adjusted figures, but the momentum returned in September. The July-September period witnessed 10% YoY gain, down from the 13%–17% growth rates registered in the previous three quarters.



The US agricultural machinery market remained in good shape. This year's monthly figures still show strong rise in the retail sales of agricultural machinery, in almost each segment, though some slowdown is undeniable.

Although the CIS has a smaller share in total sales, its decline in the past quarter also contributed to the somewhat weaker export figures of the axle business unit. **Exports to the CIS market plunged 25% YoY in EUR terms,** and without FX effect the decline moderated to 22% YoY. However, the significant drop came as no surprise after the heavy losses of the previous quarters, and the Russian truck market also has been showing signs of weakness this year. Though heavy truck registration figures for July and August were encouraging, registration in September fell again by 5% YoY, resulting in 4% YTD decline.



The axle business unit has the biggest share in Rába's sales revenues, and its performance has deteriorated in all of its geographic segments except 'other markets'. The axle business' exports dropped by 1% YoY in Q3, while domestic sales lost 5%. The second biggest contributor to total sales performance was the parts business, with an unexpected 18% YoY rise in exports to the EU and 9% gain in domestic sales. Rába's vehicle unit also performed well in the EU market, with 20% YoY gain in Q3, but domestic sales income almost halved in the past quarter. The vehicle business has failed to fulfil expectations regarding robust sales growth from this year as the Hungarian Ministry of Defence has not placed any orders, despite the framework contract made earlier.

Base material prices are on a declining path but labour costs still drag down profitability. Market conditions in the international steel market started to change in the second half of 2018. Steel futures in the global commodity market dropped by the middle of summer from the peak reached at the end of June 2018, and aside from some breaks, prices have been steadily coming down since then. By the end of September the benchmark price of hot-rolled coils fell by nearly 40% on a yearly horizon, while Q3 quarterly average price fell 11% from the Q2 quarterly average and it is 37% lower than the average price registered in the third quarter of 2018.

According to the input cost indices reported by Rába, raw material prices are roughly at the same level as a year ago. At the same time, the quarterly energy price index was 4% higher in Q3 2019 than in Q2, but on a yearly horizon the own-calculated index of Rába shows a slight 1% decrease in energy costs.

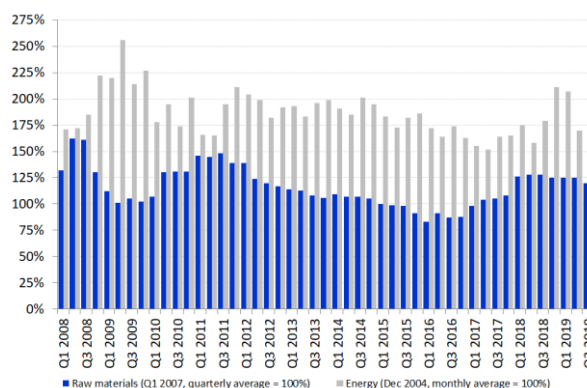
Gross margin deteriorated to 17% in the past quarter from 20% a year earlier, which Rába attributes to direct cost effects, mainly energy and labour costs. Rába's own energy index is below the long-term average, but together with elevated wage costs, it puts profitability under pressure. EBIT declined to below zero and short of our forecast, indicating HUF 37m loss, while EBITDA amounted to HUF 471m, 16% lower than a year before.

Steel market prices further declined in Q3 2019
(hot-rolled coil, USD/metric tonnes)



Source: Bloomberg

Input cost indices of Rába Automotive
(quarterly averages)

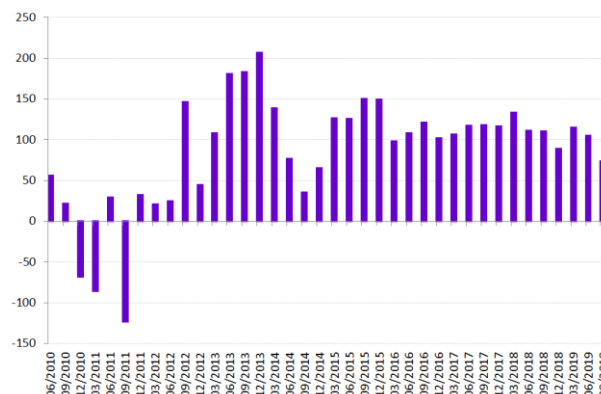


Source: Rába Automotive Holding

Although the company made efforts to control operational costs in Q3 (costs of sales and general administration costs dropped in year/year comparison), not only gross margin, but EBIT and EBITDA margins also deteriorated in year/year terms. EBIT margin fell to below zero from a tiny 0.5% rate a year earlier, while EBITDA margin dropped from 5.5% in Q3 2018 to 4.6% in the latest quarter.

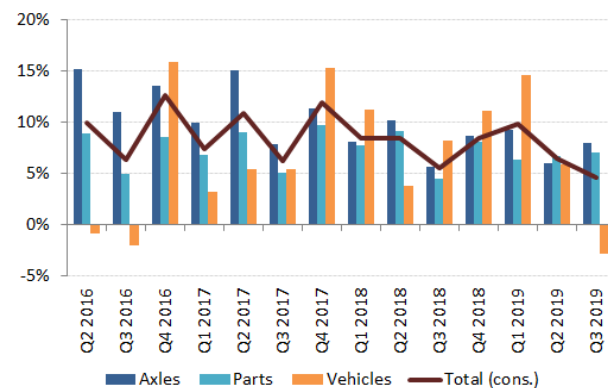
On the level of business units however, the drop in margins was not broad-based: both the axle business and the parts business managed to improve profitability considerably in both yearly and quarterly comparison, while the operation of the vehicle business sank into the red even in the case of EBITDA. The negative profit margins in Rába’s vehicle business are a phenomenon not seen in the past three years, and presumably are related to the unrealized military orders. That is particularly sorrowful, because the vehicle business often operated with the highest profit margins.

The decline of 4Q EPS did not stop in Q3 2019 (HUF)



Source: Rába Automotive Holding, OTP Research

EBITDA-margins at Rába’s business units



Source: Rába Automotive Holding, OTP Research

While the weakening forint added to the HUF-denominated sales revenues on the one hand, on the other hand the volatile FX movements weighed on the financial results. Quarterly net loss on FX transactions amounted to HUF 357m, while other financial transactions resulted in HUF 31m loss in the July-September period.

As a consequence, net income fell to HUF 429m loss from HUF 7m loss in Q3 2018. Quarterly EPS amounted to HUF -32, below our estimate of HUF 1, while 12M-trailing EPS eroded to HUF 73 from HUF 105 in Q2 2019.

Comments

- **The short-term sales outlook remains uncertain**
 - We maintain our expectation of strong demand in the short run, in and We maintain our expectation of strong demand in and outside the EU, in the short run. Under the circumstances, the market loss of Rába's axles business in the EU this year is a disquieting phenomenon. The drop in Q3 sales is in line with the sluggish demand reflected in heavy truck registration during the summer after the regulatory changes. Besides, risks surrounding economic growth in the eurozone and in the global economy are multiplying. In such an environment, economic uncertainties make fleet operators postpone purchases, despite strong land transportation activity.
 - The slowdown in the USA and Russia this year is also part of the baseline scenarios. In the short run, there are no strong signals of losing steam right now. The US agricultural machinery market is expected to stabilize at an elevated level, but the tariffs imposed on steel products and agricultural commodities affect both the supply and the demand sides of the agricultural machinery market. The question still is whether the replacement market may allow modest gains, or farmers postpone their investment.
 - Uncertainty surrounding global trade-related issues still lingers; it remains to be seen how any new measures will affect Europe's commercial vehicle market.
- **Public defence orders are not expected to turn up Rába's domestic vehicle sales in the short run**
 - In November 2018 Rába Automotive announced the renewal of the framework contract (Vehicle Procurement Program, VPP) between its subsidiary Rába Vehicle Ltd. ('Rába Jármű') and the Hungarian Ministry of Defence. While several news reports emerged in the press this year about the high-volume purchases of the Hungarian Ministry of Defence, no announcements were made on the expected public orders under the "Zrínyi 2026" military development programme. As it was suspected, and as Rába admitted recently, sales revenues from this programme were not expected to realize this year and the medium-term outlook is also uncertain.
 - In lack of proper information on the size of the above-mentioned public orders, our baseline scenario of HUF sales does not contain expectations linked to the "Zrínyi 2026" programme.

- **We maintain our expectation of modest revenue gain this year.** Domestic demand seems to be solid, while risks surrounding the core export markets of Rába point to the downside. However, the weakening HUF may cushion the potential decline of sales revenues.

Conclusions

- In light of the recently published data and the cumulated data reported this year, we revised our forecast. This year sales revenues are expected to slightly top our earlier forecast, while EBIT is estimated to decrease compared to the one in 2018.
- In the current environment it remains a question whether profit rates return to the long-term average or they remain at this somewhat lower level in the longer run.
- Our revised forecast on the net balance of the financial transactions in 2019 resulted in HUF 1.4bn pre-tax profit, down from our earlier estimate of HUF 1.7bn. We also applied higher amount of net balance of financial transactions on the whole forecast horizon, which is closer to the long-term average.
- Net profit is expected to amount to HUF 1.1bn, while this year's EPS is revised to HUF 81, down from HUF 96 in our earlier forecast. We expect EPS to increase to 85 HUF/share next year and to 84 EPS/share in 2020.
- As long-term yields came down in the past few months, the discounted values of FCFE have also changed. As a result, enterprise value increased and resulted in a new target price of 1,350 HUF/share, higher than our earlier estimate of 1,317 HUF/share.

Tables

CONSOLIDATED INCOME STATEMENT		HUFm						
	2014	2015	2016	2017	2018	2019E	2020E	2021E
Domestic sales	19 526	17 838	16 216	15 233	15 827	16 105	16 729	16 234
Export sales*	28 390	28 315	26 413	28 609	32 805	33 281	32 549	32 406
Total sales revenue	47 916	46 154	42 629	43 842	48 632	49 386	49 278	48 640
Direct cost of sales	-38 725	-36 317	-33 200	-34 577	-38 262	-39 568	-39 422	-38 912
Gross profit	9 191	9 837	9 429	9 265	10 370	9 818	9 856	9 728
Indirect costs of sales	-7 299	-7 640	-7 429	-7 116	-8 620	-8 110	-8 082	-7 977
EBIT	1 891	2 196	2 000	2 149	1 751	1 708	1 774	1 751
EBITDA	4 122	4 465	4 122	4 100	3 790	4 234	4 433	4 277
Net financial profit/loss	-584	-104	-11	-101	-109	-300	-300	-300
Profit before tax	1 308	2 093	1 989	2 048	1 642	1 408	1 474	1 451
Tax	-456	-410	-612	-479	-445	-324	-339	-334
After-tax profit	852	1 682	1 378	1 569	1 197	1 084	1 135	1 117
Dividend	0	0	271,648	307	238	217	227	224
EPS	66	129	103	117	90	81	85	84
DPS			20	23	18	16	17	17

*Unconfirmed, estimated on the basis of official consolidated total sales and preliminary export sales figures.

CONSOLIDATED BALANCE SHEET		HUFm						
	2014	2015	2016	2017	2018	2019E	2020E	2021E
Property, plant, equipment	14 977	14 832	14 410	15 818	19 145	24 239	24 004	22 804
Intangible assets	1 071	789	500	282	183	185	166	158
Non-current assets	17 276	16 723	15 799	16 876	20 021	25 453	25 106	23 817
Inventories	6 629	6 211	5 728	7 008	9 072	9 877	9 856	8 998
Receivables and other current assets	11 304	8 375	10 075	9 864	12 264	8 267	8 870	11 187
Cash and cash equivalents	1 025	3 199	1 900	2 638	684	2 492	1 390	1 974
Current assets	18 976	17 807	17 703	19 562	22 054	20 376	20 116	22 160
TOTAL ASSETS	36 252	34 530	33 502	36 438	42 075	45 829	44 870	45 626
Share capital	13 048	13 138	13 473	13 473	13 473	13 473	13 473	13 473
Own shares	0		-109	-109	-109	-109	-109	-109
Capital reserve	73	64	0	0	0	0	0	0
Stock option reserve	97	67	0	0	0	0	0	0
Retained earnings	1 857	3 837	5 314	6 613	7 500	8 367	9 275	10 169
Total Equity	15 075	17 107	18 679	19 978	20 865	21 732	22 640	23 533
Long-term loans and other liabilities	6 424	3 006	2 239	4 373	5 916	5 620	4 917	4 215
Provisions	315	261	150	163	245	245	0	0
Non-current liabilities	6 739	3 267	2 434	4 619	6 262	5 715	4 566	3 864
Loans and credits	3 185	3 570	746	1 582	2 186	5 983	6 686	7 402
Payables and other short-term liabilities	11 252	10 587	11 541	10 140	12 489	11 853	10 607	10 530
Current Liabilities	14 438	14 156	12 389	11 841	14 948	18 382	17 664	18 228
TOTAL EQUITY AND LIABILITIES	36 252	34 530	33 502	36 438	42 075	45 829	44 870	45 626
	0	0	0	0	0	0	0	0

CONSOLIDATED CASH FLOW		HUFm						
	2014	2015	2016	2017	2018	2019E	2020E	2021E
EBITDA	4 122	4 463	4 122	4 100	3 790	3 786	4 433	4 277
Cash flow from operation	3 778	6 641	3 244	1 075	1 218	5 957	2 198	2 338
Cash flow from investment	-3 278	-1 790	-1 203	-3 154	-5 184	-7 532	-2 312	-1 237
FCFF	500	4 851	2 041	-2 079	-3 966	-1 575	-113	1 101
FCFE	1 107	1 924	-1 556	813	-1 898	1 695	-344	883

Sources: Rába Automotive, OTP Research

Deduction of 12M target price

Rába's valuation (HUFm)	2018	2019	2020	2021	2022	2023	FCFF in the explicit period
FCFF	-3 971	-1 575	-113	1 101	779	1 345	
Discount factor	0,92	0,94	0,94	0,94	0,94	0,93	
DCF	-3 663	-1 486	-101	924	614	990	940
Terminal value (HUFm)							32 421
Net present value (HUFm) of TV							23 589
Enterprise Value (incl. possible future property sale) HUFm							25 849
Net debt							9 112
Equity value - Dec 31 2019, HUFm							16 737
Number of shares							13 352 765
Expected return on equity							7,7%
12M Target price							1 350
Current price							1 095
Upside/Downside							23,3%
TR Upside/Downside							24,8%

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 60–70% of the total sales revenue is FX-dominated, which climbed from 65% in 2017 to 67% in 2018, and is expected to remain well above 60% in the coming years.

Raw material & energy prices: Raw material (steel) prices stopped increasing last year. Steel prices on the global commodity market started to decline in mid-2018. Since the second half of 2018, benchmark steel prices have been dropping, and by the middle of 2019 prices fell more than 20%, when comparing quarterly averages. In Q3 2019 steel prices remained on the declining path. Q3 quarterly average price fell 11% from the Q2 quarterly average and it is 37% lower than the average price registered in the third quarter of 2018. At the same time energy prices stabilizing at a relatively high level also put Rába's profitability under pressure.

Economic environment: Although the sales performance of Rába shows robust demand, the international economic environment adds downside risk to our forecast. The eurozone is expected to lose momentum, and risks (e.g. trade conflicts, just to name one) surround the global growth outlook. The base scenario our

forecast is built upon bears considerable downside risks. And while the Hungarian monetary and exchange rate policy is also changing, in case of an external shock, the monetary policy will be able to accommodate itself to that situation through exchange rates.

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 very supply-driven. However, wage dynamics in the manufacturing industry have slowed lately; that may ease the pressure on Rába as well.

Risks surrounding Rába's property for sale: Although we do not expect this property to be sold soon, if it happens, the sales revenue adds 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 which 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 strengthening 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's characteristics. Although we consider the dominant state ownership a real risk, this research does not factor it in.

[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 Rába Automotive Holding in the past twelve months:

Period	Recommendations	Percent of Recommendations
Q4 2018	BUY	100%
	HOLD	0%
	SELL	0%
Q1 2019	BUY	100%
	HOLD	0%
	SELL	0%
Q2 2019	BUY	100%
	HOLD	0%
	SELL	0%
Q3 2019	BUY	100%
	HOLD	0%
	SELL	0%

Date	Recommendation	Target Price	Publication
17/05/2018	HOLD	HUF 1469	Quarterly Earnings Update
29/08/2018	BUY	HUF 1427	Quarterly Earnings Update
15/11/2018	BUY	HUF 1412	Quarterly Earnings Update
22/11/2018	BUY	HUF 1412	Equity Note
21/02/2019	BUY	HUF 1502	Quarterly Earnings Update
04/04/2019	BUY	HUF 1403	Equity Note
15/04/2019	BUY	HUF 1403	Equity Note
15/05/2019	BUY	HUF 1403	Quarterly Earnings Update
29/08/2019	BUY	HUF 1317	Quarterly Earnings Update
17/10/2019	BUY	HUF 1317	Equity Note
14/11/2019	BUY	HUF 1350	Quarterly Earnings Update

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

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