

EQUITY NOTE: ZWACK UNICUM

Recommendation: HOLD (unchanged)

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

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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 Jul-Sep	2017 Jul-Sep	YoY Change	Cumulative quarters (HUFm)	2018 Apr-Sep	2017 Apr-Sep	YoY 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%
Net sales income	3 734	3 221	16%	Net sales income	7 348	6 462	14%
Material-type costs	1 504	1 374	9%	Material-type costs	2 970	2 658	12%
Gross profit	2 230	1 847	21%	Gross profit	4 378	3 804	15%
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%
Total operating expenditures	1 638	1 509	9%	Total operating expenditures	3 314	3 004	10%
Other incomes	177	188	-6%	Other incomes	318	276	15%
EBIT	769	526	46%	EBIT	1 382	1 076	28%
Pre-tax profit	769	526	46%	Pre-tax profit	1 382	1 076	28%
Tax	134	62	116%	Tax	253	191	32%
After-tax profit	635	464	37%	After-tax profit	1 129	885	28%

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

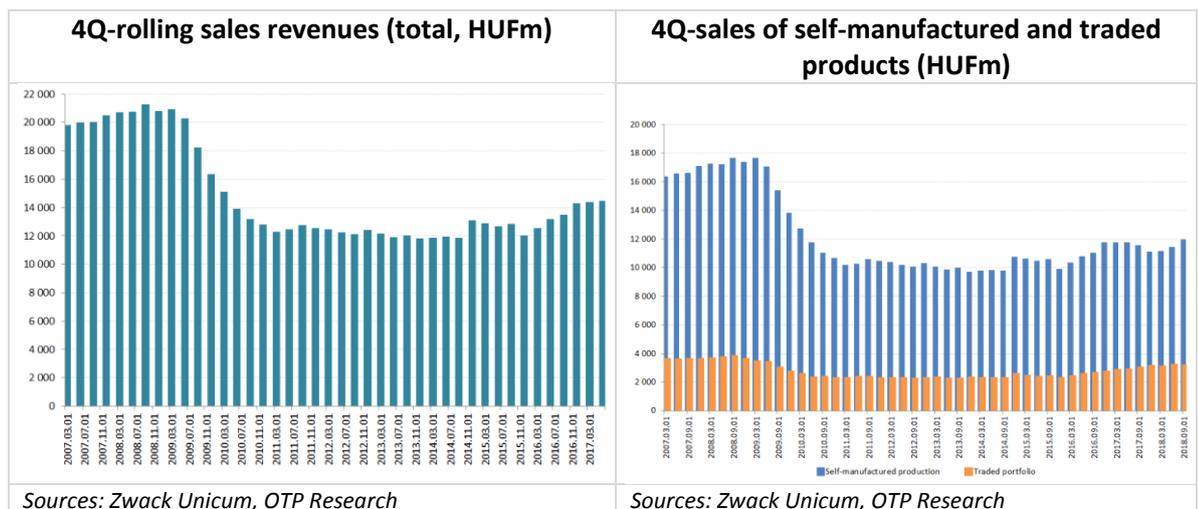
Sources: Zwack Unicum, OTP Research

The details

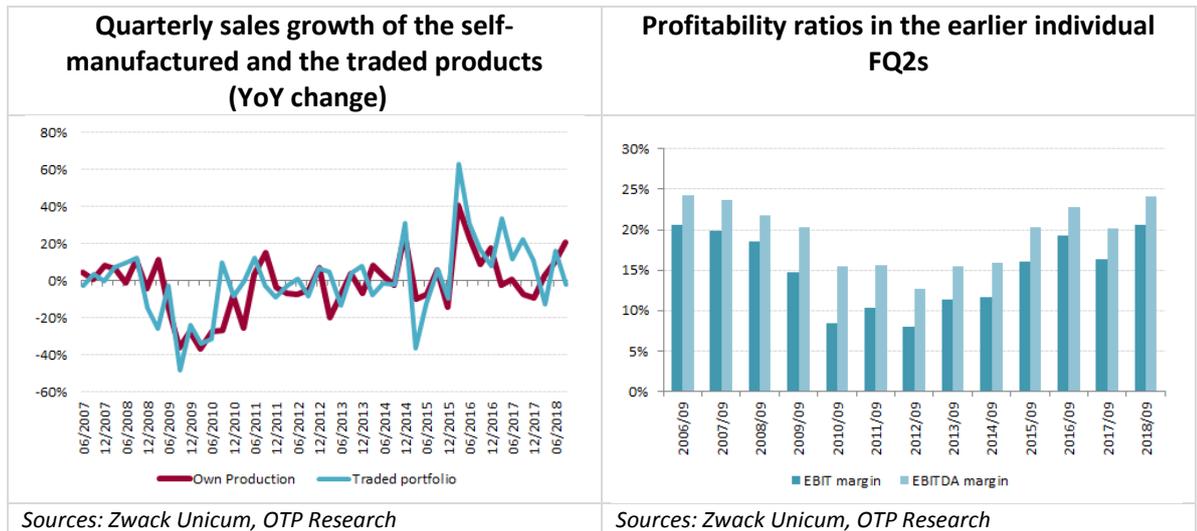
- Market research data for the period September 2017-August 2018, published by Nielsen in October, reflected strong consumer demand on Hungary's retail market of spirits. On the other hand, regulatory changes to take effect at the very beginning of 2019 also supported the expectations of an extraordinary 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.

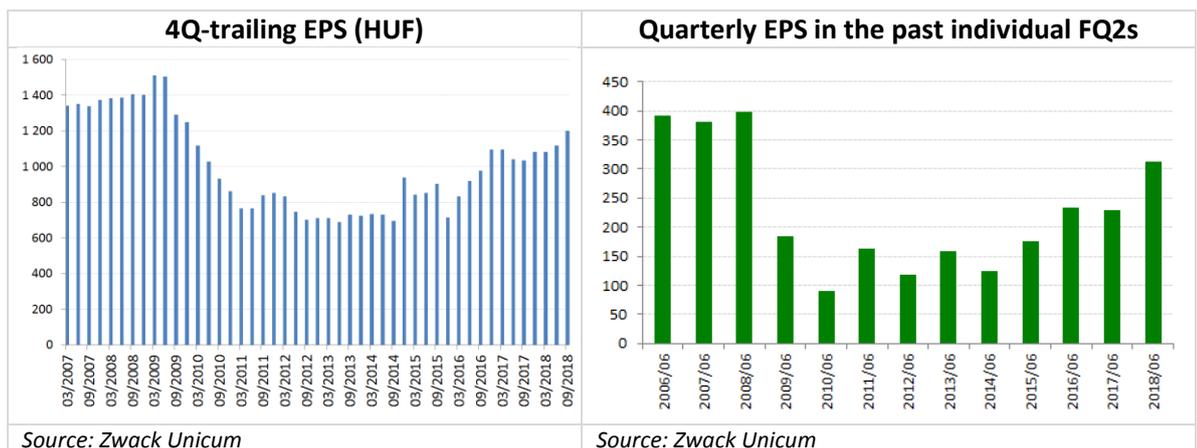
- At the same time, the sales of distributed products slightly decreased in the past quarter (-1.8% YoY). Zwack reported cumulative 7.3% YoY increase in the sales of Diageo products, while the cumulative sales growth of other traded products speeded to 5.7% in July-September. It is noteworthy that Zwack 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.



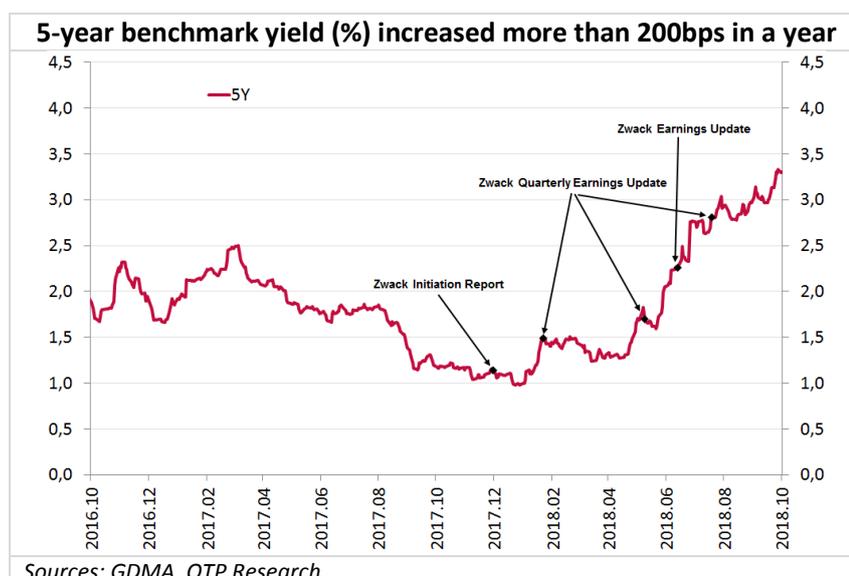
Comments

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

Balance sheet (HUFm)	2015/2016	2016/2017	2017/2018	2018/2019F	2019/2020F	2020/2021F
Property, plant, equipment	2 845	2 891	3 205	3 500	3 710	3 803
Intangible assets	119	106	89	94	103	103
Non-current assets	3 283	3 157	3 447	3 839	4 068	4 168
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
Current assets	6 295	6 879	7 230	7 294	7 442	7 596
TOTAL ASSETS	9 578	10 036	10 677	11 133	11 510	11 764
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
Total Equity	6 210	6 723	6 827	6 476	6 496	6 722
Long-term loans and other liabilities	360	427	410	406	389	389
Non-current liabilities	360	427	410	406	389	389
Loans and credits	0	0	0	20	23	11
Payables and other short-term liabilities	2 310	2 889	3 384	4 156	4 576	4 618
Current Liabilities	3 008	2 886	3 440	4 250	4 625	4 653
TOTAL EQUITY AND LIABILITIES	9 578	10 036	10 677	11 133	11 510	11 764

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)							16 806
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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