EQUITY NOTE: ZWACK UNICUM

Recommendation: HOLD

Target price (12M): HUF 17,891

24 May 2018

Equity Analyst:
Orsolya Rátkai

Phone:
+36 1 374 7270

Email:
ratkaio@otpbank.hu

Highlights

We maintain our HOLD recommendation on Zwack Unicum (Zwack HB; ZWCG.BU) with a new 12M target price of 17,891 HUF/share, 2% higher than the HUF 17,550 closing price on May 24, 2018. Estimated total return is 8% on a 12-month forecast period.

Summary/Earnings Highlights

- Zwack Unicum reported less than 1% net sales decline in January-March 2018, with domestic sales falling 4% and exports jumping 15% YoY. Zwack Unicum's full-year net sales dropped 2% to HUF 14.0bn.
- Gross profit in the January-March period declined by 10% YoY, while other profit figures resulted generally in smaller losses than one year ago in the weakest period of the year. Full-year EBIT and EBITDA suffered double-digit decline. Full-year net profit decreased by only 1% YoY thanks to the corporate tax cut, resulting in HUF 1,083 EPS in FY 2017/2018 compared to HUF 1,094 one year ago.
- Full-year profit margins declined due to changes in the composition of sold products. The share of own production decreased throughout the year owing to earlier heavy stockpiling of 'Kalinka' vodka, while the share of the traded portfolio with lower profit content increased somewhat last year.
- Current macro environment with fast wage growth and low unemployment supports steady and strong consumption growth, providing Zwack with positive sales outlook. Though, Zwack's sales figures still do not reflect the effects of this favourable economic environment. If sales fail to increase in the coming quarters, that adds downside risk to profit expectations and the equity value as well.
- Besides, regulatory changes pose real risk to the positive prospects as the EU expressed criticism on the discriminative taxing policy of spirits in Hungary. Currently, herbal liqueurs and 'pálinka' are exempt from the so called Public Health Tax (NETA), while losing the exemption may result in strong sales decline as demand tightens.
- We revised slightly our sales and earnings forecast. However, due to uncertainties surrounding legal changes, the effect of new taxation is not yet calculated in the forecast. We expect HUF 14.6bn sales income, HUF 3.0bn EBITDA and HUF 1,069 EPS in the present business year.
- Zwack also announced dividend payment of HUF 1,050 per share (93% payout ratio) offering 6% dividend yield. The Management's dividend proposal is expected to be approved by the shareholders on the AGM to be held on June 27, 2018.

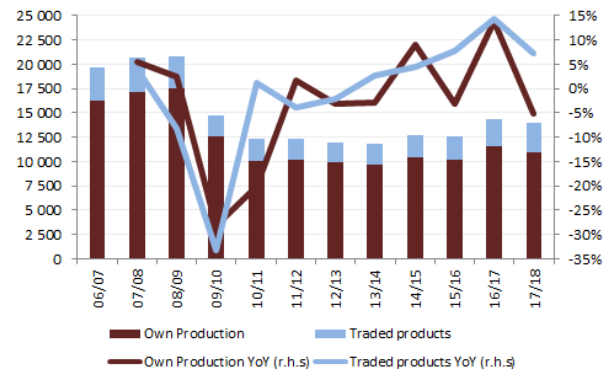
Financial highlights of Q4 earnings report

Sales revenues in January-March slightly fell, despite the low base period. Sales in the January-March period are usually sluggish, but it came as a small surprise that domestic net revenues declined last quarter even compared to the relatively low base period in

2017 (higher taxes on Kalinka vodka took effect on January 1, 2017). Domestic sales fell by 4% YoY, even Easter failed to support growth, but the export sales' 8% surge somewhat offset its negative effect. However, export growth may well be a one-off effect, YoY export sales to Germany increased by a third in January-March, as the delivery of the summer promotional packages has been forwarded to the distributor as early as in March. Sales of own production grew by 3% in January-March, while the sale of traded brands fell 12%.

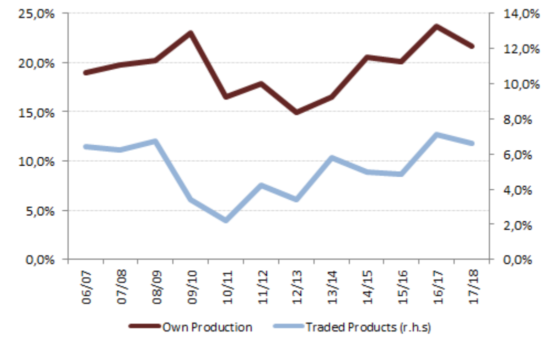
Zwack's full-year net sales income dropped by 2% to HUF 14.0 bn. The decline caused no surprise as due to previous heavy stockpiling, sales shrank throughout the year except one quarter.

Revenue structure and growth (HUFm; %)



Source: Zwack Unicum

EBIT margins slightly declined in FY 2017/2018



Source: Zwack Unicum

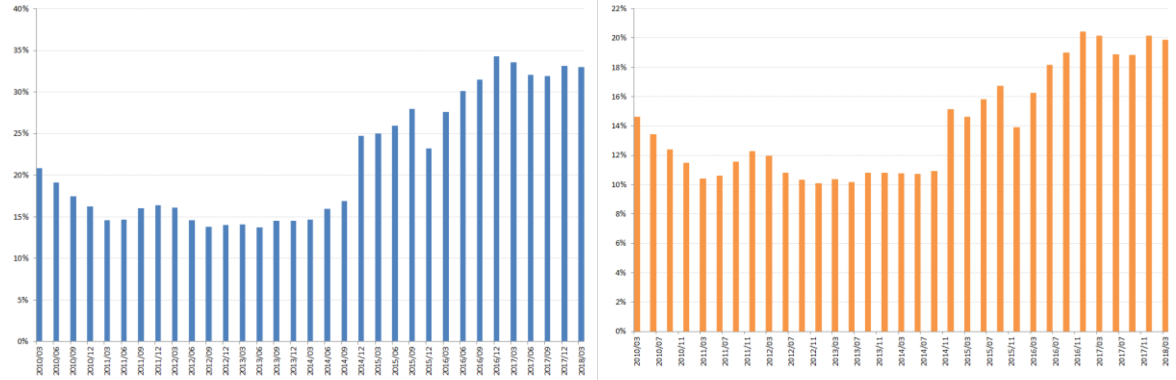
Declining margins with counterbalancing effect of the significant corporate tax rate cut. In the January-March period gross profit fell by 10% YoY, while losses in the level of operating and net income, usual in the last quarter of the financial year shrank. Thanks to the significant corporate tax rate cut (corporate tax rate fell from 19% to 9%, uniformly), Zwack's effective tax rate fell from 24% near 15% in a year, resulting in HUF 312m net loss in the latest quarter, the same amount as one year ago. Gross profit margin in the January-March period fell relatively far from the level Zwack usually performs in this period of the year. Material costs jumped by 10% YoY, the company reported significant price increase of certain herbal ingredients, also adding to higher inventory values.

Zwack Unicum's full-year EBIT sank 13% YoY, while EBITDA fell by 12% and net profit declined by 1%. The full-year EPS amounted to HUF 1,083 slightly lower than the HUF 1,094 level in the previous business year.

With own production falling and the sales of the distributed products increasing YoY, Zwack's profit margins deteriorated in the FY of 2017/2018. Gross profit margin decreased to 56.8% from 57.7% one year earlier, EBIT margin declined to 18.5% from previous 20.7%, and EBITDA-margin shrank to 22% vs. 24% one year ago as payroll costs increased. Net profit margin improved slightly, to 15.8% due to tax changes.

Profitability stabilised in the past four quarters at relatively high level. The 4Q rolling ROE and ROA slightly decreased compared to the previous quarter, but remained close to 33% and 20% respectively, well above the industry average. In terms of historical comparison, the figures of this latest quarter are the fourth best ones in the past seven years beginning from the legalization of home distilleries in 2010.

ROE and ROA stabilise at relatively high level (4Q trailing figures)



Source: Zwack Unicum | *Source: Zwack Unicum*

Economic background – Supporting macro environment, strong competition in the spirits market. The current macro-environment is still expected to be favourable for Zwack, as the ongoing fast wage growth with low unemployment will result in rapid consumption growth and is likely to positively affect demand for its products. Monetary policy is also supportive, as not only euro, but also HUF interest rates could remain low for an extended period, while the National Bank is expected to keep the HUF at current levels, but an appreciation would result in stronger price competition through imported spirits. However, Zwack's sales figures fail to reflect the positive effects of the favourable economic environment. Although the January-March period is the weakest quarter, this was the first one free from the "Kalinka" stockpiling effect. Despite the low base period, domestic sales did not show new strength. If the sales income fails to gather momentum in the coming quarters, it adds a downside risk to our forecasts and valuation.

Regulatory changes add to concerns. The EU expressed criticism on the currently effective discriminatory taxing policy of spirits in Hungary. The European Commission lately sent Hungary a reasoned opinion for granting an exemption from the public health tax to fruit distillates, such as 'pálinka', as well as to herbal liqueur which are mostly produced domestically.
According to the regulation in effect sales of bitters and 'pálinka' are exempted from paying the so-called Public Health Tax (NETA in Hungarian), while other spirits between 35 and 45 degrees of alcohol are subject to HUF 700 tax per litre. Calculating with about 3 million litres yearly consumption of Unicum, it means more than HUF 2bn increase in tax payment only in terms of Zwack's Unicum product line. Zwack may decide to fully pass higher taxes on to customers by raising the selling price by the same amount, but it would risk significant decline in demand and its market position in a very price sensitive market. As forecasting legal outcomes goes beyond the capacity of this present equity research, our earnings forecast for the present does not calculate with tax changes. Regulatory changes pose real downside risk to our sales forecast.

Revision of our forecast. In light of the developments of the January-March period, we revised our sales, cost and profit forecasts. In the present financial year (April 01, 2018 – March 31, 2019) we expect HUF 14.6bn net sales income, HUF 2.5bn EBIT and HUF 1,069 full-year EPS, slightly down from the earlier sales forecast of HUF 14.9bn, while EBIT and EPS forecasts have been decreased by 7% each. Next year dividend per share is expected to remain at the present level of HUF 1,050.

Valuation. We raise our 12-month target price to HUF 17,891/share from the previous HUF 17,781/share. We revised our sales and earnings forecast slightly down but possible tax changes are not yet implemented due to lack of information. Changes in net debt due to higher cash and smaller debt liabilities compared to the previous forecast explain changes in equity value.

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	13 039	13 626	14 171
Export sales	1 425	1 427	1 540	1 532	1 563	1 594
Net sales income	12 458	14 281	13 958	14 571	15 188	15 765
Material-type costs	5 306	6 044	6 032	6 266	6 531	6 779
Gross profit	7 152	8 237	7 926	8 305	8 657	8 986
Total operating expenditures	5 781	6 021	6 051	6 354	6 796	6 964
EBIT	2 160	2 959	2 580	2 535	2 469	2 652
Pre-tax profit	2 177	2 940	2 582	2 530	2 459	2 637
Tax	483	714	378	354	295	316
Profit after tax	1 694	2 226	2 204	2 175	2 164	2 321
Dividend	1 725	2 137	2 137	2 137	2 035	2 137
EPS (HUF)	832	1 094	1 083	1 069	1 063	1 141
DPS (HUF)	850	1 050	1 050	1 050	1 000	1 050

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	3 840	4 069	4 168
Inventories	1 876	1 862	2 185	2 496	2 321	2 289
Recievables and other current assets	2 162	2 208	2 275	2 395	2 604	2 549
Cash and cash equivalents	2 257	2 809	2 770	2 768	2 886	2 995
Current assets	6 295	6 879	7 230	7 660	7 811	7 834
TOTAL ASSETS	9 578	10 036	10 677	11 500	11 879	12 001
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	4 701	4 729	5 014
Total Equity	6 210	6 723	6 827	6 866	6 894	7 179
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	4 136	4 545	4 397
Current Liabilities	3 008	2 886	3 440	4 228	4 597	4 433
TOTAL EQUITY AND LIABILITIES	9 578	10 036	10 677	11 500	11 879	12 001

CONSOLIDATED CASH FLOW (HUFm)	2015/2016	2016/2017	2017/2018	2018/2019F	2019/2020F	2020/2021F
EBITDA	2 674	3 474	3 068	3 033	3 161	3 281
Cash flow from operation	2 132	2 601	2 854	3 014	3 198	2 898
Cash flow from investment	-698	-371	-765	-871	-901	-708
FCFF	1 434	2 230	2 089	2 143	2 297	2 190
FCFE	1 445	2 232	2 091	2 159	2 291	2 165

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	2 159	2 291	2 165	2 241	2 256	
Discount factor	0,91	0,92	0,92	0,91	0,91	0,91	
DCF	1 913	1 979	2 098	1 977	2 045	2 051	10 151
Terminal Value (HUFm)							33 007
Present Value (HUFm)							31 034
Net debt							-2 342
Equity value (HUFm) - March 31, 2019							33 376
Number of shares							2 035 000
Expected return on equity							9,1%
12M Target price							**17 891**
Current price							17 550
Upside/Downside							2%
TR Upside/Downside							8%

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 starts infringement process against Hungary (see above).

Exchange-rate risk: As the company operates in foreign markets as well and the share of export is increasing among the revenues, exchange-rate risk could be an issue in the future, if not managed properly. Moreover the price of most of its new raw materials is denominated in EUR, so a significant depreciation of the HUF against the EUR could decrease the company's profitability. But in the short run, the fundamentals of the Hungarian economy are strong, so the risk of sharp HUF depreciation is low. Moreover the loss on exchange rates could be somewhat offset by the higher export revenue.

Cost-inflation risk: Due to the improving economic conditions and labour shortages in various industries, real wages started to increase significantly in 2016 and they are expected to do so in the near future. As Zwack's business is labour-intensive (the share of personnel cost is almost 45%), it will be heavily affected by future wage increases which could erode margins.

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

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

Disclaimer 1

This research/commentary was prepared by the assignment of the Budapest Stock Exchange Ltd. (registered seat: 1054 Budapest, Szabadság tér 7. Platina torony I. ép. IV. emelet; company registration number: 01-10-044764, hereinafter: BSE) under the agreement that was concluded by and between BSE and OTP Bank Plc (registered seat: H-1051 Budapest, Nádor utca 16., Hungary, company registration number: 01-10-041585, hereinafter: OTP Bank or Investment Service Provider).

The BSE shall not be liable for the content of this research/commentary, especially for the accuracy and completeness of the information therein and for the forecasts and conclusions. The Service Provider is entitled to all copyrights regarding this research/commentary however BSE is entitled to use and advertise/disseminate it without amending its content.

This research/commentary shall not be qualified as investment advice specified in Point 9 Section 4 (2) of Act No. CXXXVIII of 2007 on Investment Firms and Commodity Dealers and on the Regulations Governing their Activities. Furthermore, this document shall not be qualified as an offer or call to tenders for the purchase, sale or hold of the financial instrument(s) concerned by the research/commentary.

Disclaimer 2

1. Pursuant to the Commission-delegated regulation 2017/565/EU of the European Parliament, the content of this document shall be considered as an investment research, which recommends or suggests an investment strategy, explicitly or implicitly concerning one or more financial instruments or the issuers of financial instruments, including any opinion as to the present or future value or price of such instruments. The statements in this investment research contain objective or independent explanation. Furthermore, pursuant to Directive 2014/65/EU of the European Parliament and of the Council, this document shall be considered as investment recommendation. This document does not take into account investors' individual interests, circumstances, or objectives; therefore, in the absence of personal recommendation, it shall not be considered as an investment advice.
   OTP Bank intends to make this document available to its clients or to the public, or to make it accessible to other persons in a way that allows this document to be disseminated to the public.

2. Information herein reflects the market situation at the time of writing. It provides only momentary information and may change as market conditions and circumstances develop. Additional information may be available on request. Where a figure relates to a period on or before the date of communication, the figure relates to the past and indicates a historic data. Past performance is not a reliable indicator of future results and shall be not treated as such. OTP Bank makes no representation or warranty, express or implied, is made regarding future performance of any financial instrument mentioned in this communication. OTP Bank shall have no liability for the information contained in this for any loss or damage whether direct, indirect, financial, economic, or consequential, whether or not caused by the negligent act or omission of OTP Bank, provided that such limitation of liability shall not apply to any liability which cannot be excluded or limited under the applicable law.

3. The issuer of this report does not claim that the information presented herein is perfectly accurate or complete. However it is based on sources available to the public and widely believed to be reliable. Also the opinions and estimates presented herein reflect a professional subjective judgment at the original date of publication and are therefore subject to change thereafter without notice. Furthermore there can be no guarantees that any market developments will unfold as forecasted. Opinions and estimates constitute our judgment and are subject to change without notice.

4. The issuer(s) of the product(s) mentioned in this document do not hold more than 5% of OTP Bank's registered capital. OTP Bank is a market maker of the financial instrument that is discussed in this document. Neither was OTP Bank a lead-manager (organizer) or joint lead manager (organizer) of any public placement of the issuer's financial instruments (e.g. securities) in the previous 12 months. Regarding investment services defined in Sections A and B of Annex 1 of Directive 2014/65/EU, OTP Bank is not a party of the agreement with the issuer. OTP Bank maintains a conflict of interest policy and it keeps such records, and is has requirements that regulate the transmission of bank secrets and securities secrets, which requirements shall be considered as the effective internal organizational and management solutions as well as information barriers to prevent or manage conflicts of interest. The remuneration of the person(s) participating in preparing the recommendation is not directly related to the transactions carried out as part of the investment services specified in Sections A and B of Annex 1 of Directive 2014/65/EU, or to transactions carried out by them or by other legal entities of the same group or to trading fees that they or another legal person of the same group receive. OTP Bank does not hold net long or short positions that exceed 0.5% threshold of the issuer's total registered capital.

5. OTP Bank has developed appropriate internal procedures for (i) the personal transactions and tradings of financial analysts and other relevant persons, (ii) the physical separation of the financial analysts involved in the production of investment research and other relevant persons; moreover, information barriers have been implemented, (iii) for accepting and managing incentives and remuneration.

6. This communication does not contain a comprehensive analysis of the described issues; it is only for information purposes. No part, chapter, or the entirety of this information shall be considered as investment advice, not even if any part of this document contains a description of a certain financial instrument in terms of its possible price or yield development, and the related investment options. This information shall not be considered as legal, tax or accounting advice.

7. This information reflects the market situation at the time when the document was prepared. You may request more information from OTP Bank. This document was prepared based on publicly accessible information made available to OTP Bank from one or more sources. This document was prepared using data, facts and information from the following essential sources: Bloomberg, Reuters, Hungarian Central Statistical Office, Eurostat, Magyar Nemzeti Bank (Hungary's central bank), and European Central Bank (ECB). Although the information in this document has been prepared in good faith from sources that OTP Bank believes to be reliable, we do not represent or warrant its accuracy or completeness. This document represents the opinion and estimations of analysts at OTP Research, based on publicly available data. You may receive different recommendation from the staff of OTP Bank, in particular if you are provided investment advice based on an investment advice agreement. The content of this document is based on the opinion of OTP Research's analyst at the time when the document was prepared, and they may be subject to change at any time in the future without further notice.

8. Please be informed that, irrespective of the statements of this investment research, OTP Bank is entitled to deal or trade as market maker, acting in good faith and in accordance with the usual way of market-making, with the financial instruments distributed by the issuer(s) specified in this document, as well as to provide other investment activities or ancillary (investment) services, and/or other financial or ancillary financial services to the issuer and other persons.

9. This document shall not be a basis for any further analysis in relation to the financial instruments contained therein. Any reference in this document to the future distribution of a financial instrument shall be construed as indicative, preliminary and informative, and any analysis of such financial instrument is exclusively based on publicly available information listed in the respective prospectus or announcement. The content of this document shall not imply that OTP Bank acts as an agent, a fiduciary, or an advisor to, or on behalf on, any prospective purchaser of the financial instruments discussed herein.

10. For certain persons, access to the products and/or services discussed in this document may not be granted, or it may be limited. The act of preparing this document by OTP Bank, its uploading to the website, its publication may under no circumstances be considered as OTP Bank's intention to make available product and/or service information in the prospectus to persons whom any country or state prohibits from having or obtaining the given product and/or service, including the promotion and the advertisement thereof. This communication and any of the financial instruments and information contained herein are not intended for the use of private investors in the UK and US. OTP Bank is not allowed to provide direct investment services to US investors. Any individual decision or investment made based on this publication is made solely at the risk of the client and OTP Bank shall not be held responsible for the success of the investment decisions or for attaining the Client's target.

11. This publication contains generic presentation of information and knowledge, thus it does not take into account the individual clients' unique and special interests, financial condition, or their ability and willingness to take risks. Therefore please contact our staff or contact your banking consultant for advice before you make an investment decision. The assessment and the consideration of the individual circumstances is provided by the suitability and compliance tests that assess clients' financial knowledge, experience, risk-taking abilities, as well as the examination of the target market.

12. Before making an informed decision to invest and to use the services, please carefully read through all documents, including the documentation, prospectus, regulations, terms and conditions, announcements and key information documents for that product/service, and carefully consider the subject, the risk, the fees and costs of your investment, the possibility of any loss, and seek information about the tax regulations regarding the product and the investment. The prices of financial instruments and securities are changing, outrights sales are realized at then current market prices, which may involve losses.
    The information and opinions in this document do not substitute or take the place of the issuance documentation for the given financial assets (e.g. prospectus, fund management rules), or their brochures or announcements.

13. You assume total responsibility and risk for any specific decision or investment; OTP Bank shall not be held responsible for the effectiveness of investment decisions or for reaching your purpose, nor for the individual investment decision made based on this document or any part thereof, or for their consequences.
    Investments in financial instruments carry a certain degree of risk, which may affect the effectiveness of the investment decision, and investors may not receive the whole amount they had expected the investment to yield in their investment targets; they may not preserve even the invested amount, therefore the invested capital might even decrease, be wholly lost, or even lead to additional payment obligation.

14. Trading with leveraged products (such as foreign exchange contracts, or shares and indices that have underlying products) carries a considerable amount of risk, and these products are not suitable for all investors. Trading with leveraged products carries the risk of losing all capital, and it may incur losses that exceed the amount invested.

15. **The figures and information described herein refer to the past, and past performance is not a reliable indicator of future yields, changes, or performance.**

The changes on money and capital markets, the fluctuation of prices, the development of investments and their yields are influenced by the combined effect of multiple factors; one important factor of them is the change in investors' expectations. **The development of prices, the future yield of financial assets, indices or indicators, the examination of their changes, trends, and future performance is based on estimations and forecasts, which forecasts do not allow reliable conclusions to be drawn about the future moves of prices, real future yields, changes, or performance.** For each product and service, please assess their tax accounting implications, and other tax consequences, taking into account that they cannot be precisely assessed without knowing the effective tax regulations of the client's individual circumstances; and these legislative provisions as well as the circumstances may change over time.

16. OTP Bank reserves the right to modify this document in the future, without prior notice.
    The planned frequency of updates to the recommendation is quarterly. The initiation report preceding this research was published on 18 December 2017.

17. OTP Bank (business registration number: 01-10-041-585; registered seat: Nádor utca 16., Budapest H-1051, Hungary; authorised by Magyar Nemzeti Bank (former supervisory authority: Hungarian Financial Supervisory Authority, 'PSZÁF'). Supervisory authority: Magyar Nemzeti Bank (National Bank of Hungary – H-1054 Budapest, Szabadság tér 9); financial customer services: H-1013 Budapest, Krisztina krt. 39. The terms and conditions of this equity research and disclaimer shall be governed by and construed in accordance with Hungarian law.

18. Please note that the Internet is not a secure environment and OTP Bank does not accept any liability for any loss caused by the result of using this report in a form altered or delayed by the wilful or accidental interception, corruption or virus infection.

19. OTP Bank, in compliance with the applicable law, assumes no responsibility, obligation, warranty or guarantee whatsoever for any direct or indirect damage (including losses arising from investments), or for the costs or expenses, detrimental legal consequences or other sanctions (including punitive and consequential damage) sustained by any natural or legal person as a result of the purchase or sale of financial instruments or engaging investment services described herein, even if OTP Bank was warned of the possibility of such occurrences.

20. If you received this document from OTP Bank Plc, then it was sent to you with your previous consent. You may withdraw this permission by sending an e-mail to research@otpbank.hu or writing a letter addressed to 'Research Center', Hungary H-1051, Budapest, Nádor utca 21. Please refer to your name and e-mail address in both cases.

This document was prepared by:
Orsolya Rátkai
Senior Equity Analyst
OTP Research

This document was finalized at 10:04:37 PM on 24 May 2018