EQUITY NOTE: ZWACK UNICUM

Recommendation: HOLD (unchanged)

Target price (12M): HUF 16,271 (revised down)

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We maintain our **HOLD** recommendation on Zwack Unicum (Zwack HB; ZWCG.BU) with a **new 12M target price of 16,271 HUF/share**, revised down from 16,806 HUF/share. The new target price reflects our updated forecast including the new forecast horizon of 2019–2024. Higher taxes, slowing consumption and increasing operational costs also play a role in somewhat deteriorating profit outlook in the long run. The new target price stands 5% below the HUF 17,100 closing price on 6 Feb 2019. As investors can expect significant dividend payment after the current business year offering 7% dividend yield, the estimated total return improves to 2% on a 12-month forecast period. Shares of Zwack Unicum dropped 1.2 on 6 Feb, 2019.

Summary/Earnings Highlights

- In the last quarter of 2018 wholesalers and retailers – as it was expected – continued building inventory ahead of the 20% rise of the public health product tax (NETA in Hungarian) from 1 January, 2019. From that day Unicum and 'pálinka' have also been taxed, marking the end of the tax exemption the producers benefited from in the past.
- As a result of the year-end rush, Zwack reported a stupendous HUF 7.0bn total net sales income in October–December 2018, surpassing our expectation. Quarterly net sales revenues were 23% higher than one year earlier, due to the spectacular 26% increase in domestic sales. Quarterly domestic sales of self-manufactured products gained 29% in a year.
- Although the 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). Quarterly EBIT increased by 31%, to HUF 2.5bn. EBIT and EBITDA rates improved to 36% and 37% respectively. Quarterly net profit jumped by 36% to HUF 2.2bn, resulting in HUF 1,086 EPS vs. HUF 800 a year earlier.
- However, the extraordinary performance of the past quarter is the result of the one-off effect of early stockpiling in the wake of tax increases. The early purchases of wholesalers and retailers in Q4 will be a drag on Zwack's sales performance in the next business year, while our view on the underlying developments has not changed. In our expectations, the coming years will be characterized by steady but slowing consumption growth.
- As part of the earnings report, Zwack also shared a warning regarding its performance of the next business year. Due to the tax increase, Zwack expects the sales volume decline, resulting in a yearly revenue drop even more than 10%. Zwack also forecasts a significant profit decline for the coming business year, which may even exceed 40%.

- 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 our sales and profit forecasts for 2018/2019, but in return, sales in the coming business years may get under pressure.
- We also shifted by one year the forecast horizon of our valuation models. As a consequence, the very successful current business year drops out, resulting in falling FCFE values in the cash-flow valuation, and the changes also affect our DDM-model. As a result of the recent modifications, our new 12-month target price declines to HUF 16,271/share from previous HUF 16,806/share and we still maintain the HOLD recommendation.
- We expect EPS for the current business year to increase to HUF 1,384, up from HUF 1,083 last year, while EPS is expected to fall considerably in the next business year. If Zwack maintains its usual dividend payout ratio, dividend per share may reach HUF 1,250 after the current business year, up from HUF 1,050 in 2017 providing 7% expected dividend yield.

Financial Q3 (HUFm)	2018 Sep-Dec	2017 Sep-Dec	YoY Change
Domestic sales	6 536	5 206	26%
Export sales	473	478	-1%
Net sales income	**7 010**	**5 684**	**23%**
Material-type costs	2 894	2 427	19%
Gross profit	**4 116**	**3 257**	**26%**
Employee benefits	844	736	15%
Depreciation	127	124	2%
Other operating expenses	958	787	22%
Total operating expenditures	**1 929**	**1 647**	**17%**
Other incomes	310	293	6%
EBIT	**2 497**	**1 903**	**31%**
EBITDA	**2624**	**2027**	**29%**
Pre-tax profit	2 497	1 903	31%
Tax	287	274	5%
After-tax profit	**2 210**	**1 629**	**36%**

Cumulative quarters (HUFm)	2018 Apr-Dec	2017 Apr-Dec	YoY Change
Domestic sales	13 120	10 944	20%
Export sales	1 238	1 202	3%
Net sales income	**14 358**	**12 146**	**18%**
Material-type costs	5 864	5 085	15%
Gross profit	**8 494**	**7 061**	**20%**
Employee benefits	2 265	2 068	10%
Depreciation	391	360	9%
Other operating expenses	2 587	2 222	16%
Total operating expenditures	**5 243**	**4 650**	**13%**
Other incomes	628	569	10%
EBIT	**3 879**	**2 980**	**30%**
EBITDA	**4 270**	**3 340**	**28%**
Pre-tax profit	3 880	2 981	30%
Tax	540	465	16%
After-tax profit	**3 340**	**2 516**	**33%**

Financial Q3	2018 Sep-Dec	2017 Sep-Dec	YoY Change
EPS (HUF)	**1086**	**800**	**36%**
4Q-rolling EPS (HUF)	**1 488**	**1 083**	**37%**
Gross profit rate	**58.7%**	**57.3%**	**1.4pp**
Operating profit rate	**35.6%**	**33.5%**	**2.1pp**
EBITDA rate	**37.4%**	**35.7%**	**1.7pp**
ROE	**27.4%**	**22.8%**	**4.6pp**
4Q-rolling ROE	**46.6%**	**36.1%**	**10.5pp**
ROA	**14.4%**	**12.8%**	**1.6pp**
4Q-rolling ROA	**24.9%**	**20.2%**	**4.7pp**

Sources: Zwack Unicum, OTP Research

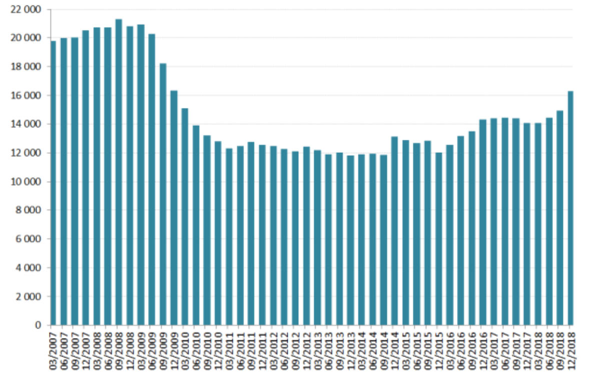
The details

- Zwack Unicum reported extraordinary strong quarterly sales revenue in the last quarter of 2018 in the wake of the earlier announced regulatory changes. Inventory building that had already started in the previous quarter (July–

September) accelerated, providing spectacular domestic sales growth in the October–December period. The last quarter of the year is otherwise regarded as high season, while favourable economic conditions and still strong domestic consumption also might have supported the company's robust performance.

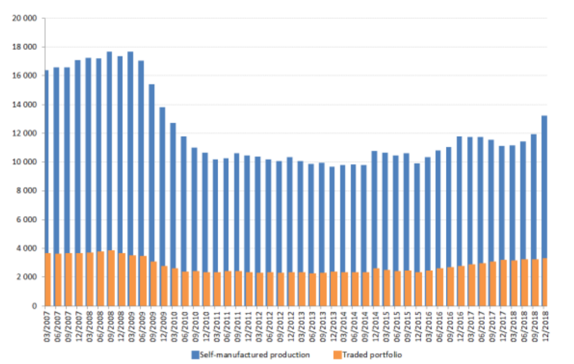
- Market research data for the period of September 2017– August 2018, published by Nielsen in October, reflected strong consumer demand on Hungary's retail market of spirits (11% nominal YoY growth). The retail market of Hungarian spirits showed more than 7% nominal growth in the period of April–December 2018, while the real growth rate climbed to 3.5%. Recently published retail statistics of specialized and non-specialized food shops reflects only modest growth in Q4 2018 and in 2018 as a whole (+1.8% and +3.4% YoY respectively; preliminary, unadjusted figure) for the total market — compared to that, the spirits' market shows relative outperformance.
- Zwack Unicum reported HUF 7.0bn total quarterly sales income, 23% higher than in the corresponding period of 2017. Domestic sales revenues jumped by 26% to HUF 6.5bn, a level last seen 10 years ago. According to Zwack Unicum's announcement, the growth volume due to heavy stockpiling equals three or four months of extra sales revenues. Nominal sales growth was not only fuelled by higher sales volume but also rising average sales prices as the company informed, while quarterly CPI showed only modest price gain in Q4 in the segment of spirits.
- Sales revenues of self-manufactured production jumped by 29% YoY to HUF 5.7bn, a level not seen in the past ten years when comparing the previous October–December 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 clearly due to the stockpiling. The strong consumption background had a minor role in the positive developments in the last quarter of 2018, Zwack Unicum said.
- In contrast with the previous quarter (July–September 2018) the sales of the distributed products picked up and increased by 5% YoY in the October–December period. Zwack reported cumulative 5.1% YoY increase in the sales of Diageo products, while the cumulative sales growth of other traded products speeded to near 8% in April–December.

4Q-rolling sales revenues (total, HUFm)



Sources: Zwack Unicum, OTP Research

4Q-sales of self-manufactured and distributed products (HUFm)

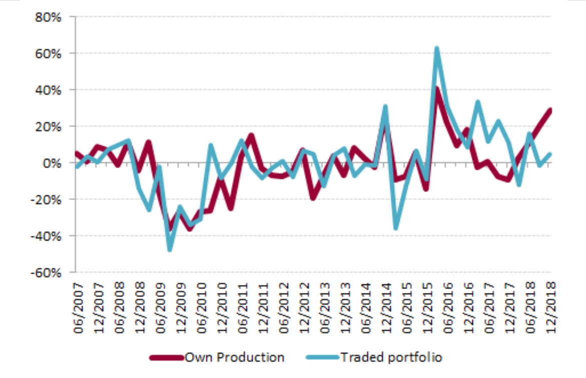


Sources: Zwack Unicum, OTP Research

- As the share of the self-manufactured products in the total sales income with higher margins increased (to 81% from 79% in the previous quarters), Zwack was able to improve the profitability further. Though material-type costs also increased significantly along with rising sales, slower cost increase compared to sales resulted in higher gross profit in Q4. Quarterly gross profit increased to HUF 4.1bn (+26% YoY), while gross profit margin improved to 58.7% from 47.7% one year before.

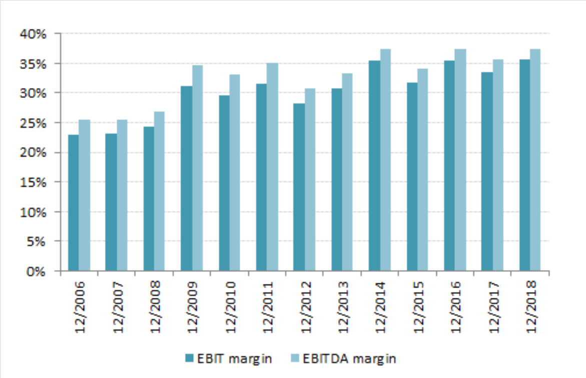
- Despite the 17% increase of other operational costs, EBIT jumped to HUF 2.5bn (+31% YoY) and EBITDA rose to HUF 2.6bn (+30% YoY) the highest in more than a decade. As quarterly sales growth came from the self-manufactured products with much higher profit content than the distributed portfolio (42.2% vs. 7.9% EBIT ratio), overall quarterly profit margins improved. EBIT ratio exceeded 35% showing 2pp improvement y-o-y. Zwack's profitability ratio improved despite rising wage costs (due to overall wage increase at the beginning of 2018 and the deferred personnel-related expenses related to long-term incentives during the year). Zwack also kept on spending more on product marketing, to support sales.

Quarterly sales growth of the self-manufactured and the distributed products (YoY change)



Sources: Zwack Unicum, OTP Research

Profitability ratios in the earlier individual FQ3s

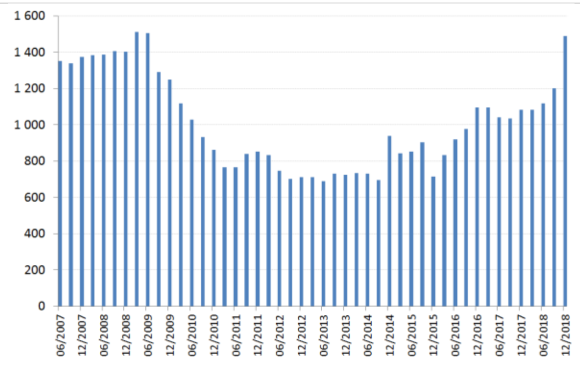


Sources: Zwack Unicum, OTP Research

- Quarterly pre-tax profit grew by 31% YoY, while after-tax profit rose by astonishing 36% YoY due to lower tax payment obligation, to HUF 2.2bn. Effective tax rate fell to 11% in October-December down from 17% in July-September, 19% in April-June and 22% in January-March. After-tax profit margin improved to 31.5% from 28.7% a year earlier, well above the long-term average when comparing the same period of previous years.

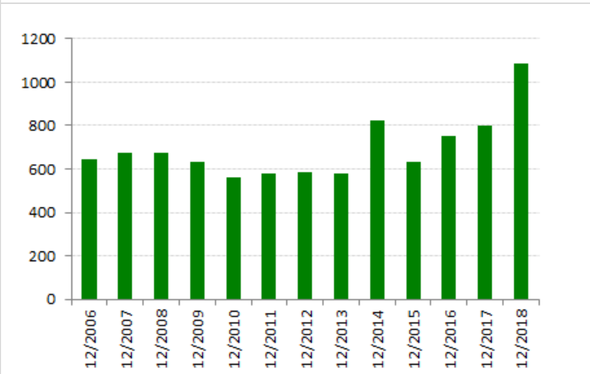
- Zwack reported a quarterly EPS of HUF 1086, up from HUF 800 a year earlier. In historical comparison, EPS of October-December 2018 is the highest in more than a decade. Cumulative four-quarter EPS leapt to HUF 1,488, the biggest value in the last ten years.

4Q-trailing EPS (HUF)



Source: Zwack Unicum

Quarterly EPS in the past individual FQ3s



Source: Zwack Unicum

Comments

- Zwack's sales and profit figures in the last quarter of 2018 exceeded our quarterly forecast. As it had been announced, the public health product tax (NETA in Hungarian) rose by 20% from January 1, 2019 and from that day Unicum and 'pálinka' has been taxed, marking the end of the tax exemption the company benefited from in the past years. As it was expected, wholesalers and retailers started building inventories while robust consumption also supported strong sales growth.
- As the outstanding sales growth and the rising profitability is not a result of some organic developments, such improvements will not be sustainable. 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 and afterwards is expected to be much less appealing.
- In light of stronger than expected stockpiling in the last quarter of 2018 (we expected more gradual inventory building in the second half of the last year) we revised our forecast for the current quarter more to the downside. 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 MHCS and Hennessy will be terminated by the end of February 2019, which may also add to concerns about future sales developments.
- Zwack Unicum also issued warning of less prosperous quarters of the next business year. Due to falling sales volumes – as a consequence of tax-related price increase – Zwack Unicum expects sales revenues of the next business year decline more than 10%. Higher expected packaging costs put profitability under pressure the company plans to offset by cutting marketing and other operational costs. Total net profit may decline more than 40% in the next business year starting on Apr 1, 2019 – Zwack Unicum announced.

Conclusion

- After recently announced financial figures of the last quarter of 2018 we revise our short-term forecast and long-term forecast. As demand (both from retailers and consumers) was stronger than anticipated we decreased our sales and profit forecast for the current quarter (ending on March 31, 2019). Moreover, we revised down our forecast for the next business year. Even if we ignore the effect of stockpiling, the coming years will be characterized by steady but slowing consumption growth.
- As part of the revision we also shifted by one year the forecasting period and thus the valuation models. Our current models evaluate Zwacks' operation in the period of 2019–2024. Due to the forecast changes the very successful current business year drops out resulting in falling FCFE values in the cash-flow valuation and also affects our DDM-model. As a result of the recent modifications our new 12-month target price declines to HUF 16,271/share from previous HUF 16,806/share and we still maintain the HOLD recommendation.
- The new target price is 4.8% down from HUF 17,100 closing price as of Feb 6, 2019. As dividend is expected to increase to HUF 1,250/share after the current business year total return is expected to improve to 1.6% on a 12M-horizon and expected dividend yield may exceed 7%.

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.

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	14 209	12 319	13 658
Export sales	1 425	1 427	1 540	1 602	1 650	1 683
Net sales income	12 458	14 281	13 958	15 810	13 969	15 341
Material-type costs	5 306	6 044	6 032	6 663	6 375	6 926
Gross profit	7 152	8 237	7 926	9 147	7 594	8 414
Total operating expenditures	5 781	6 021	6 051	6 563	6 668	7 354
EBIT	2 160	2 959	2 580	3 270	1 549	1 718
Pre-tax profit	2 177	2 940	2 582	3 271	1 551	1 718
Tax	483	714	378	455	217	240
Profit after tax	1 694	2 226	2 204	2 816	1 334	1 477
Dividend	1 725	2 137	2 137	2 544	1 221	1 323
EPS (HUF)	832	1 094	1 083	1 384	656	726
DPS (HUF)	850	1 050	1 050	1 250	600	650

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	3 854	4 051	4 164
Inventories	1 876	1 862	2 185	2 339	2 600	2 604
Recievables and other current assets	2 162	2 208	2 275	2 534	2 105	2 354
Cash and cash equivalents	2 257	2 809	2 770	2 508	2 990	2 988
Current assets	6 295	6 879	7 230	7 381	7 695	7 946
TOTAL ASSETS	**9 578**	**10 036**	**10 677**	**11 235**	**11 746**	**12 110**
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	4 340	4 437	4 742
Total Equity	**6 210**	**6 723**	**6 827**	**6 505**	**6 602**	**6 907**
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	4 223	4 709	4 780
Current Liabilities	3 008	2 886	3 440	4 323	4 756	4 814
TOTAL EQUITY AND LIABILITIES	**9 578**	**10 036**	**10 677**	**11 235**	**11 746**	**12 110**

CONSOLIDATED CASH FLOW (HUFm)	2015/2016	2016/2017	2017/2018	2018/2019F	2019/2020F	2020/2021F
EBITDA	2 674	3 474	3 068	3 810	2 129	2 374
Cash flow from operation	2 132	2 601	2 854	3 806	2 510	1 952
Cash flow from investment	-698	-371	-765	-927	-758	-749
FCFF	1 434	2 230	2 089	2 879	1 752	1 203
FCFE	1 445	2 232	2 091	2 900	1 757	1 191

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	2024/2023	FCFE in the explicit period
FCFE	2 900	1 757	1 191	2 183	1 289	1 887	
Discount factor	0,92	0,92	0,92	0,91	0,91	0,91	
DCF	2 668	1 613	1 091	1 997	1 174	1 720	8 543
Terminal Value (HUFm)							28 636
Net Present Value - FCFE (HUFm)							26 548
Net debt							-2 578
Equity value (HUFm)							29 126
Number of shares							2 035 000
Expected return on equity							8,9%
12M Target price (DCF)							15 587
12M Target price (DDM)							16 956
12M Weighted Target price (HUF)							**16 271**
Current price							17 100
Upside/Downside							-4,8%
TR Upside/Downside							1,6%

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. 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 since then. This landscape is hardly expected to change in the near future. As Zwack's business is somewhat labour-intensive (the share of personnel cost in total costs is around 20%), 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.

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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
06/02/2019	HOLD	HUF 16,271	Quarterly Earnings Update

Period	Recommendation	% of recommendations
Q1 2018	BUY	0
	HOLD	100
	SELL	0
Q2 2018	BUY	0
	HOLD	100
	SELL	0
Q3 2018	BUY	0
	HOLD	100
	SELL	0
Q4 2018	BUY	0
	HOLD	100
	SELL	0

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

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