otp Research

EQUITY NOTE: ZWACK UNICUM

Recommendation: HOLD (unchanged)

Target price (12M): HUF 15,407 (revised up)

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We maintain our HOLD recommendation for Zwack Unicum (Zwack HB; ZWCG.BU) with a new 12M target price of 15,407 HUF/share, revised up from previous 15,214 HUF/share. The current covid pandemic fundamentally changed the economic environment and has limited growth prospects for a while. Despite the tough circumstances and retailers' stockpiling in January-March 2020, Zwack's sales revenues in the April-June period declined less YoY than it was feared. Although domestic on-trade sales suffered huge decline in April and partly in May, demand returned when restrictions eased in Hungary. At the same time, the retail segment showed some resilience last quarter and remained at the base level in nominal terms. However, the outlook in the short and medium term is very uncertain, and getting prepared for different scenarios may cost the company much more than in usual times, and it erodes profitability.

Zwack operates in the non-cyclical consumer sector, half of its revenues comes from the restaurant industry, one of the subsectors worst hit by lockdown and social distancing rules. A second wave of pandemic is around the corner and it remains to be seen how it will be avoidable in Hungary without reintroducing some of the former restrictions. With such uncertainties regarding the outlook, we updated our free cash-flow valuation model with the recently reported quarterly data and we also implemented the changes in our rate expectations. We suppose that Zwack dividend payout regarding the current financial year may be cut, compared to our previous forecast.

The new target price is 6.3% below the HUF 16,450 closing price on 7 August 2020. Expected total return is negative 4.5% on a 12-month horizon, though considering the current situation, the forecast of dividend payout ratio may also bear some grade of uncertainty.

Shares of Zwack Unicum lost 0.9% on 6 August 2020, on the day after the earnings report was published, while the BUX added 0.9%. In Q2 2020 Zwack gained 2.1% with a quarterly range of HUF 17,200 – 16,350. YTD return is negative 6.8%.

Summary/Earnings Highlights

- Zwack reported higher than expected HUF 2.3bn net sales revenue in April-June 2020. However, sales declined 24.5% YoY, with domestic revenues dropping 24.1% and exports plunging 26.9%.
- Domestic sales showed gradual improvement month by month: revenues fell the most in April (near 40% YoY), while May saw about 25% decline, but June sales dropped only 1% YoY, Zwack reported.
- On-trade sales suffered the most last quarter as restaurants and bars remained closed, while sales to the retail segment remained roughly at the level seen one year before, the company also announced.
- With declining revenues, profitability also decreased as revenues from own production with higher profit content declined 21% YoY. Gross profit rate dropped

to 62% from 64% a year before. EBIT rate fell to 1.0% from previous 10% and EBITDA rate decreased to 6% from 14% a year earlier.

- Net profit turned negative in the quarter: Zwack closed the April-June period with HUF 32 million loss and HUF -16 quarterly EPS. 12-month trailing EPS declined to HUF 704 vs HUF 1,472 a year ago, and HUF 833 at the end of Q1 2020.
- Zwack also got prepared to meet the challenges the covid epidemic had posed. In Q1, the company stepped up production, and stockpiled Unicum to fend off raw material shortages or forced shutdowns. On the liabilities side, Zwack arranged new credit lines in order to secure that all its payment obligation will be fulfilled. Zwack still maintains inventories at an elevated level, as part of the preparation of a possible second wave of the epidemic.
- As this year's outlook bears a high level of uncertainty, we update our valuation model with the latest data announced and keep our conservative expectations for the current and the coming quarters. This year's EPS is expected to fall to HUF 440, from HUF 833 in 2019/2020.
- We also updated our model with our latest interest rate forecast. Under the present circumstances, we cut our dividend forecast for the current financial year. As a result, due to lower discount rates the free cash-flow model delivered higher corporate value while DDM put out a lower valuation.
- The new HUF 15,407 target price reflects our expectations for the next 12 months, although the uncertainty is considerable in the current situation.

Financial highlights of Zwack's Q2 2020 earnings report

Financial Q1 (HUFm)	Apr-June 2020	Apr-June 2019	YoY Change
Domestic sales	2 018	2 658	-24%
Export sales	301	412	-27%
Net sales income	**2 319**	**3 070**	**-24%**
Material-type costs	878	1 100	-20%
Gross profit	**1 441**	**1 970**	**-27%**
Employee benefits	707	738	-4%
Depreciation	115	126	-9%
Other operating expenses	649	863	-25%
Total operating expenditures	**1 471**	**1 727**	**-15%**
Other incomes	52	69	-25%
EBIT	**22**	**312**	**-93%**
EBITDA	**137**	**438**	**-69%**
Pre-tax profit	15	312	**-95%**
Tax	**47**	81	-42%
After-tax profit	**-32**	**231**	**-114%**

Financial Q1 (HUFm)	Apr-June 2020	Apr-June 2019	YoY Change
EPS (HUF)	**-16**	**114**	**-114%**
4Q-rolling EPS (HUF)	**704**	**1 472**	**-52%**
Gross profit rate	**62.2%**	**64.2%**	**-2.0 pp**
Operating profit rate	**0.9%**	**10.2%**	**-9.2 pp**
EBITDA rate	**5.9%**	**14.3%**	**-8.4 pp**
ROE	**-4.2%**	**-9.6%**	**-4.5 pp**
4Q-rolling ROE	**25.6%**	**38.4%**	**-35.7 pp**
ROA	**-2.2%**	**-5.4%**	**-2.3 pp**
4Q-rolling ROA	**14.7%**	**24.0%**	**-12.0 pp**

Sources: Zwack Unicum, OTP Research

Pandemic woes weigh on sales performance. Under the unusual economic conditions, amidst the covid restrictions imposed in Hungary in April, Zwack's sales revenue declined by 25% YoY in Q2. Domestic sales revenue, representing 87% of total revenues, fell 24%, while export sales dropped 27%.

With on-trade sales, which account for half of Zwack's revenues, practically vanishing as restaurants and bars remained closed in April and most of May, domestic sales revenues shrank considerably. At the same time, sales to retail partners equalled that of the base period in the past quarter. Zwack reported 40% YoY plunge in total domestic sales revenues in April and 25% in May, but it decreased only 1% in June, as restrictions eased and restaurants gradually re-opened. We also have to add that wholesalers' earlier heavy stockpiling ahead of the tax increase effective from 1 January 2019 put a break on domestic sales growth last year. In this regard, last year's revenue figures represent a relatively subdued level compared to previous years.

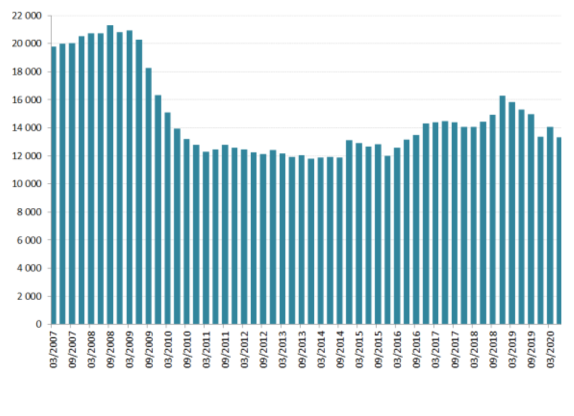
In quarter-on-quarter terms, net sales revenues increased by 10%, with domestic revenues adding 16% and exports dropping 17%. However, the January-March period was extraordinary as Zwack experienced unusually high order volumes from retail partners as pandemic outlooks worsened and expectations of a possible national lockdown intensified.

In line with Zwack's earlier forecast, the sales of prime products suffered steep decline (-30% YoY) due to the covid epidemic, but revenues in the quality segment grew by 9% in the same period. Sales revenues from own production fell 20% in April-June compared to the corresponding period a year earlier, while revenues from the distributed portfolio skydived. Revenues plunged 37%, with sales of Diageo products declining 31%.

Stable consumer demand and growing domestic retail sales characterised the market of spirits before the covid outbreak, but the pandemic put a break on growth in Q2. The retail market of distilled beverages kept on expanding between April and June 2020, though it slowed considerably, the market research survey shows. The retail market increased by 5.6% in value and by 1.5% in real terms, Zwack announced based on survey data, after 2.5% real growth a year earlier.

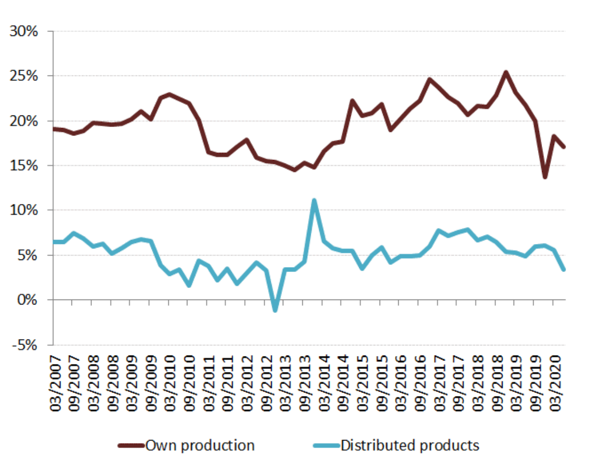
Retail trade statistics of alcoholic beverages from KSH (Hungarian Central Statistical Office) underpinned persistent consumer demand in 2019. In 2020 however, the seasonally and working day-adjusted data showed a mixed picture: retail trade in shops selling foods, beverages and tobacco decreased by 4.7% YoY in April-June after a similar rate of expansion in January-March. Sales in non-specialized food stores increased by 2.7% YoY in Q2, after jumping almost 10% in Q1.

4Q-rolling total net sales revenues (total, HUFm)



Sources: Zwack Unicum, OTP Research

12M EBIT margin of own production and distribution



Sources: Zwack Unicum, OTP Research

Profit rates noticeably deteriorated in Q2, simultaneously with falling revenues. With falling sales but considerable fixed costs, profit rates deteriorated in the April-June period. Although material costs declined by 20% YoY, the sharply falling sales caused gross profit rate to decrease to 62.2%, from 64.2% a year earlier. EBIT and EBITDA rates also declined despite decreasing personnel costs, depreciation, and other operating expenses. EBIT fell to HUF 22 million from HUF 312m one year earlier, while the HUF 137m EBITDA was less than a third of the sum registered in the corresponding period of last year. The 0.9% EBIT

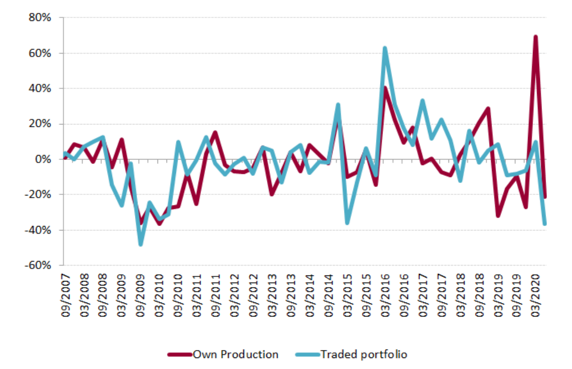
rate in April-June 2020 is among the weakest ones, excluding the quarters when Zwack's profitability turned negative due to seasonal characteristics.
The EBITDA rate fell to 5.9% last quarter when the base period's figure stood at 14% one year ago.

Profit rates improved in QoQ comparison: gross profit rate climbed 0.4ppt, EBIT rate jumped above zero, from -11% in January-March, and EBITDA also picked up (5.9% vs. -4.4%).

Segment information also reflects significant deterioration in profitability YoY: Zwack's own production delivered -7.9% EBIT rate vs. 6.0% EBIT margin a year ago, while the 2.9% EBITDA rate in April-June 2020 is far from the 11.3% margin reported a year earlier. 4Q cumulated figures are the lowest in the past five years in terms of own production (17.0% in April-June 2020), while regarding the traded product portfolio, we have to go back to 2012 to find lower figures (3.4% in the past four quarters).

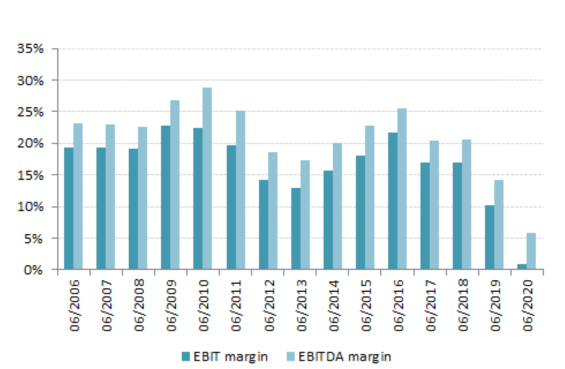
Previously, Zwack announced changes to its accounting policy, effective from the start of 2019. The modifications affect mainly the accounting of material costs, other incomes and other costs, while some changes in the accounting of certain allowances (bonuses for long service and retirement bonuses) have direct effect on retained earnings. Zwack publishes its financial reports in accordance with the new accounting rules, but enables YoY comparison for the base periods only (financial Q4 2017/2018 and the consecutive quarters). Therefore, long-term comparisons cannot be really precise.

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



Sources: Zwack Unicum, OTP Research

Profitability ratios in the earlier individual FQ1s[1]



Sources: Zwack Unicum, OTP Research

Zwack made important B/S adjustments to fend off the economic unease arising from the covid epidemic. Zwack made several balance sheet adjustments in the first quarter of 2020. The company expanded inventories by 12% YoY as a result of higher inventories of finished goods. The management decided to stockpile more Unicum in the wake of the covid crisis in order to get prepared for raw material shortages or shutdowns in case of worsening pandemic situation, Zwack reported earlier. In April-June, inventories remained at this elevated level as Zwack stockpiled raw materials and a special stock of finished products to handle shortages or production disruption if a second wave of the epidemic occurs.
In the worst case, companies may have to face lockdown in the coming months like this spring, and it does matter how they deal with liquidity issues. Zwack's current ratio

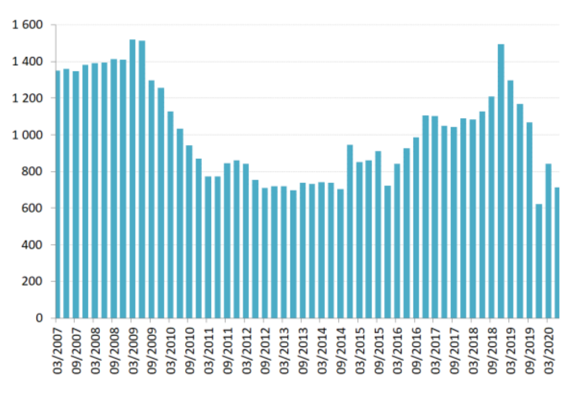
[1] *Financial data for April-June 2017 or earlier are not revised in line with the changes in the accountancy policy implemented as of January 1, 2019*

deteriorated to 137% by the end of June, from 157% at the end of March 2020 and from 159% at end-2019. Simultaneously, quick ratio and cash ratio also decreased in the past quarter, but to a lesser extent. These latter figures equal the five-year average, while in the case of current ratio Zwack operated at below-average level.

Trade receivables decreased in both year/year and quarter/quarter terms. Cash assets increased after the company had drawn down the second tranche of HUF 2.5bn loan facility, as Zwack announced in May.

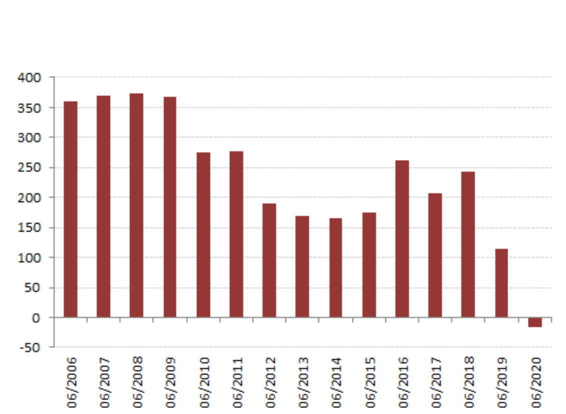
On 9 June 2020, Zwack Unicum announced to have obtained HUF 106m [non-refundable subsidy]() from Hungary's Ministry of Foreign Affairs and Trade. The subsidy targets financing capex and Zwack uses the sum to co-fund the purchase of a packaging and palletizing machine, the company informed. The state's financial assistance covers 50% of this investment.

12M-trailing EPS was below the long-term average in the past few quarters (HUF)



Source: Zwack Unicum, OTP Research

Quarterly EPS in the past individual FQ1s (Apr-June periods)



Source: Zwack Unicum

Short-term outlook is uncertain at best. The lockdown introduced in Hungary in late March practically wiped out Zwack's on-trade sales, which account for half its revenues, as bars and restaurants remained closed. However, monthly sales figures in the second quarter show gradual improvement as covid-related restrictions have been lifted from end-May. Still, tourism and the related industries cannot have a sigh of relief. The epidemic is flaring up again worldwide, and travel restrictions or obligatory quarantine for travellers have been introduced in several countries.

Although the consumption of spirits in the prime segment has been growing in the past few years, Zwack expects steep decline in revenues and profit in the near term due to the current epidemic. Although quarterly net loss was smaller than Zwack's and our own forecast, a possible second wave makes the outlook very uncertain. Zwack expects yearly net profit to decline by over 80% YoY in this financial year.

Comments

- Zwack reported weak, although better-than-expected sales figures for April-June 2020 as demand returned after restrictions had been lifted. Despite the unexpected panic shopping, driving sales as a one-off effect in Q1 2020, the retail market showed resilience in Q2.
- After the lockdown was lifted in the middle of May in Hungary, and a week later in Budapest and in the county of Pest, sales activity slowly recuperated in the on-trade segment as well.

- However, due to the current crisis, consumers' purchasing power is expected to weaken somewhat, and customers are also expected to be more careful. Besides, the suspension of mass gatherings also fails to add support to the recovery.
- The main risk in the present situation is the quickly changing and unpredictable environment. Like many other companies, Zwack makes efforts to prepare for different scenarios and the worst, including raw material shortages and production disruption. This consumes considerable financial resources and weigh on profitability.

Conclusions

- The current situation, with restrictions already lifted but chance of a second wave of the epidemic on the horizon makes forecasting the next 12 months challenging.
- We maintain our conservative approach and expect this year's sales revenue to decrease to HUF 11.3bn, while EBIT may drop to HUF 1.2bn. EPS is expected to decline to HUF 440 in the current business year. In this scenario, we expect revenues to increase to HUF 13.7bn in FY 2021/2022, with EBIT to climb to 1.7bn and net income to reach 1.2bn. We emphasize that the current forecast bears considerable risks both to the upside and the downside, due to uncertainties regarding e.g. the path of the recovery and the risk of a second wave of pandemic.
- We made some modifications in our valuation model. Besides the revision of our forecast, lower discount rates also had a role in the increase of enterprise value. Our DDM model has also been updated, we expect dividend payout ratio for the current business year to be cut compared to our previous forecast.
- As a result, our DCF (FCFE) model resulted in 15,206 HUF/share target price, up from the previous 14,594 HUF/share. Valuation from DDM decreased however, the 12-month target price the model gave is HUF 15,607, down from the previous HUF 15,834.
- The new target price is 15,407 HUF/share, 6.3% less than the HUF 16,450 closing price on 7 Aug 2020. Calculating with HUF 300/share yearly dividend, the 12-month estimated total return would be negative 4.9%.
- We maintain the previous HOLD recommendation.

Profit & Loss Statement (HUF m)	2017/2018	2018/2019	2019/2020	2020/2021F	2021/2022F	2022/2023
Domestic net sales	12 418	14 238	12 281	10 114	12 248	13 658
Export sales	1 540	1 501	1 679	1 137	1 431	1 592
Net sales income	13 958	15 739	13 960	11 251	13 678	15 250
Material-type costs	5 149	5 723	5 287	4 612	5 471	5 795
Gross profit	8 809	10 016	8 673	6 639	8 207	9 455
Total operating expenditures	6 599	7 355	6 965	5 705	6 883	7 564
EBIT	2 561	3 079	2 169	1 245	1 735	2 439
Pre-tax profit	2 563	3 310	2 184	1 219	1 708	2 441
Tax	377	460	488	324	393	561
Profit after tax	2 186	2 850	1 696	895	1 315	1 880
Dividend	2 137	2 442	611	336	1 184	1 692
EPS (HUF)	1 074	1 288	833	440	646	924
DPS (HUF)	1 050	1 200	300	165	582	831

Balance sheet (HUFm)	2017/2018	2018/2019	2019/2020F	2020/2021F	2021/2022F	2022/2023
Property, plant, equipment	3 205	3 330	3 336	3 548	3 513	3 477
Intangible assets	89	84	102	103	93	83
Non-current assets	3 447	3 582	3 585	3 818	3 776	3 733
Inventories	2 185	2 386	2 661	3 426	3 321	3 314
Recievables and other current assets	2 275	2 115	3 007	3 531	3 396	2 923
Cash and cash equivalents	2 770	3 064	2 709	2 816	2 660	3 117
Current assets	7 230	7 565	8 377	9 773	9 378	9 354
TOTAL ASSETS	**10 677**	**11 147**	**11 962**	**13 591**	**13 154**	**13 086**
Share capital	2 000	2 000	2 000	2 000	2 000	2 000
Capital reserve	165	165	165	165	165	165
Retained earnings	4 392	4 915	4 011	4 796	4 927	5 115
Total Equity	**6 557**	**7 080**	**6 176**	**6 961**	**7 092**	**7 280**
Long-term loans and other liabilities	410	472	453	474	473	471
Non-current liabilities	410	472	453	474	470	471
Loans and credits	0	0	1 250	2 361	1 250	220
Payables and other short-term liabilities	3 384	3 567	4 071	3 760	4 271	5 043
Current Liabilities	3 710	3 595	5 333	6 157	5 591	5 335
TOTAL EQUITY AND LIABILITIES	**10 677**	**11 147**	**11 962**	**13 591**	**13 154**	**13 086**

CONSOLIDATED CASH FLOW (HUFm)	2017/2018	2018/2019F	2019/2020F	2020/2021F	2021/2022F	2022/2023F
EBITDA	3 049	3 643	2 646	1 791	2 310	3 101
Cash flow from operation	2 854	3 215	1 482	-117	2 707	3 829
Cash flow from investment	-765	-655	-480	-757	-512	-599
FCFF	2 089	2 560	1 002	-874	2 194	3 231
FCFE	2 091	2 563	2 264	217	1 062	2 202

Sources: Zwack Unicum, OTP Research

Deduction of 12M Target Price

Zwack's valuation (HUFm)	Base Year 2019/2020	2020/2021	2021/2022	2022/2023	2023/2024	2024/2025	FCFE in the explicit period
FCFE	2 264	217	1 062	2 202	1 677	2 328	
Discount factor	0,92	0,92	0,91	0,91	0,91	0,91	
DCF	2 076	198	972	2 013	1 533	2 120	6 836
Terminal Value (HUFm)							32 088
Net Present Value - FCFE (HUFm)							27 316
Net debt							-1 006
Equity value (HUFm)							28 322
Number of shares							2 035 000
Expected return on equity							9,3%
12M Target price (DCF)							15 206
12M Target price (DDM)							15 607
12M Weighted Target price (HUF)							**15 407**
Current price							16 450
Upside/Downside							-6,3%
TR Upside/Downside							-4,5%

Source: OTP Research

Risks surrounding Zwack's economic activity

Covid-effect: Although Zwack operates in the non-cyclical consumer sector, a considerable part of demand for Zwack products comes from the catering and event business, some of the sectors mostly hit by covid-19. Although the pandemic had a positive effect on Zwack's sales performance in the January-March period, April sales plunged. We expect calendar Q2 and Q3 to be the mostly depressed quarters this year.

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 of discriminative taxing policy of spirits in Hungary and threatened to start infringement process against Hungary. The latest regulatory changes (increase of NETA) which took effect on 1 January 2019, were 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 exports among revenues is increasing, in case of HUF appreciation, the exchange rate risk can be an issue, if not managed properly. The HUF's weakening poses more risk on the cost side, as most of Zwack's raw materials' prices are EUR-denominated, 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 rather labour-intensive (the share of personnel cost in total costs is around 20%), it will be heavily affected by persistently high wages, which could dent 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
07/08/2019	HOLD	HUF 15,882	Quarterly Earnings Update
08/11/2019	HOLD	HUF 15,685	Quarterly Earnings Update
04/02/2020	HOLD	HUF 15,685	Quarterly Earnings Update
21/05/2020	HOLD	HUF 15,214	Quarterly Earnings Update
05/06/2020	HOLD	HUF 15,214	News Comment
10/06/2020	HOLD	HUF 15,214	News Comment
07/08/2020	HOLD	HUF 15,407	Quarterly Earnings Update

Period	Recommendation	% of recommendations
Q3 2019	BUY	0
	HOLD	100
	SELL	0
Q4 2019	BUY	0
	HOLD	100
	SELL	0
Q1 2020	BUY	0
	HOLD	100
	SELL	0
Q2 2020	BUY	0
	HOLD	100
	SELL	0

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

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