otp Research

EQUITY NOTE: ZWACK UNICUM

Recommendation: HOLD (unchanged)

Target price (12M): HUF 17,083 (revised up)

15 Dec 2020

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We maintain our HOLD recommendation for Zwack Unicum (Zwack HB; ZWCG.BU) with a new 12M target price of 17,083 HUF/share, revised up from previous 15,407 HUF/share.

With better-than-expected revenue and profit figures in the July-September period, Zwack gave evidence of its ability to swiftly recover once things normalize. However, it is mild comfort regarding the current business year. The second-wave restrictions implemented in November, hitting on-the-site consumption, endanger on-trade sales again as half of Zwack's revenues come from the restaurant industry. The present restrictions can also be a drag on retail sales of spirits even in the Christmas season as festivities are expected to be disallowed.

However, covid vaccines are within reach, which is expected to totally change the landscape. With mass vaccination starting up next year, business as usual may return by the middle of the year/second half of 2021. Considering this, we updated our free cash-flow valuation and dividend discount models, and shifted the forecast horizon by one year. Uncertainties on short-term forecast are still high and the schedule of vaccination in Hungary is yet to be published, adding considerable downside risks to our forecast. On the other hand, if immunization proceeds as it is hoped, domestic tourism and restaurant industry is expected to recover quickly and Zwack will benefit from this development. This fact may add upside risk to our forecast.

The new target price is 1.4% higher than the HUF 16,850 closing price on 14 December 2020. Expected total return is 4.1% on a 12-month horizon, supposing that dividend payment after the current business year also befalls in the next 12 months. (As it was announced, Zwack starts dividend payment after the FY 2020/2019 at the end of January 2021.)

Zwack Unicum's shares dropped 4.5% YTD, while the BUX lost 8.1% this year. In Q3 2020 Zwack sank 2.7% with a quarterly range of HUF 16,800–16,100; and the BUX index declined 8.1%.

Summary/Earnings Highlights

- Zwack reported higher-than-expected HUF 3.4bn net sales revenue in July-September 2020. Net sales revenues added 0.2% YoY, with domestic revenues gaining 0.9% and exports dropping 3.9% in HUF terms. On a quarterly basis, Zwack's revenues showed strong recovery, with net revenues jumping almost 50% in July-September after lockdowns and other restrictions severely hit revenues in the previous quarter.
- As restrictions were lifted, on-trade sales badly hit by the closure of restaurants and bars showed recovery in the summer months, but revenues in September faded again as worries about second wave strengthened.

- With falling cumulative sales in the first two quarters of the business year, Zwack's costs also decreased as many cost items are related to sales and marketing activities. As a consequence, profitability improved a lot and quarterly EBIT and EBITDA rates rose stronger than one year ago. We note that this improvement is not expected to persist: as cumulative revenues declined provisionally due to the special environment the pandemic created, the costs linked to sales activity will also reappear as the market recovers.
- Net profit turned positive after HUF 33 net loss in April-June: Zwack closed the July-September period with HUF 685 million net profit (60% YoY) and HUF 337 quarterly EPS. However, the 12-month trailing EPS declined to HUF 829 vs HUF 1,058 a year ago.
- This and next year's outlook, however, still bears some uncertainty, but the real effectiveness of covid vaccines and the timing of mass immunisation are not certain either. With covid vaccines within reach, the whole economic landscape is expected to change for the better, vaccination is expected to act as a potential supercharger for the economies.
- We have updated our valuation models and shifted the forecast horizon by one year. We still expect the current business year's EPS to fall to HUF 440, from HUF 833 in 2019/2020 but the focus is on the 2021-2026 period. Next business years' sales revenue is forecast to climb HUF 13.9bn, EBIT and EBITDA are expected to increase to HUF 1.9bn and HUF 2.5bn, respectively. EPS of the next financial year is expected to reach HUF 706.
- The new HUF 17,083 target price reflects our expectations for the next 12 months, although the uncertainty regarding the schedule of vaccination in Hungary still lingers. We maintain our HOLD recommendation and we note that, if Zwack maintains its regular payment and dividend payout after the current business year will not be postponed, then shareholders may get dividends of two business years in 12 months' time.

Financial highlights of Zwack's FQ2 2020 earnings report

Financial Q2 (HUFm)	2020 July-Sep	2019 July-Sep	YoY Change
Domestic sales	2 992	2 966	1%
Export sales	414	431	-4%
Net sales income	**3 406**	**3 397**	**0%**
Material-type costs	1 288	1 194	8%
Gross profit	**2 117**	**2 203**	**-4%**
Personnel costs	636	691	-8%
Depreciation	117	129	-9%
Other operating expenses	680	1 022	-33%
Total operating expenditures	**1 433**	**1 842**	**-22%**
Other incomes	124	176	-30%
EBIT	**808**	**537**	**50%**
Pre-tax profit	**806**	**538**	**50%**
Tax	121	109	11%
After-tax profit	**685**	**429**	**60%**

Financial Q2 (HUFm)	2020 July-Sep	2019 July-Sep	YoY Change
EPS (HUF)	**337**	**211**	**60%**
4Q-rolling EPS (HUF)	**829**	**1058**	**-22%**
EBITDA (HUFm)	**925**	**666**	**39%**
Gross profit rate	**62.2%**	**64.9%**	**-2.7 pp**
EBIT rate	**23.7%**	**15.8%**	**7.9 pp**
EBITDA rate	**27.2%**	**19.6%**	**7.6 pp**
ROE	**11.6%**	**8.7%**	**2.9 pp**
4Q-rolling ROE	**37.9%**	**39.2%**	**-1.3 pp**
ROA	**5.1%**	**3.8%**	**1.3 pp**
4Q-rolling ROA	**17.3%**	**19.9%**	**-2.6 pp**

Sources: Zwack Unicum, OTP Research

Sales performance brought some relief ahead of the second wave. Zwack's sales performance in the July-September period reflected the improvement of the economic environment after lockdown restrictions had been eased. Net sales revenues increased to better-than-expected HUF3.4bn, 47% up in quarter/quarter comparison. Over the past year, revenues remained flat, which is practically in line with the sales performance of the food and beverages industry in the July–September period.

Domestic revenues added 1% YoY and 48% QoQ. In the April–June period, domestic revenues plunged 24% YoY. After lockdown restrictions had been gradually eased in May, and bars and restaurants had reopened, on-trade sales, which normally delivers about half of Zwack's revenues, also revived in the summer. Growing concerns over the second wave however, set back restaurants' turnover again in September, Zwack announced.

Zwack's revenues from the retail segment declined 12% YoY in the April-September period with presumably double-digit growth in July-September, after having stagnated in the financial first quarter (April-June). At the same time, the retail turnover in April-September increased by 3.1% in volume and 7.9% in current prices, market research data reflect.

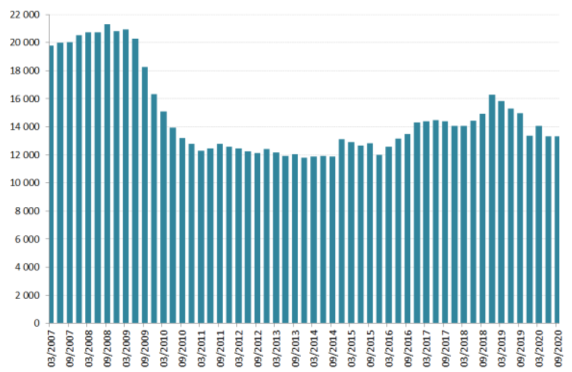
In terms of quality segments, sales of Zwack's prime products fell slightly more than 15% YoY in the first six months of the current business year, after plunging 30% in the April–June period. Quality products' turnover growth slowed in the past quarter to near 7% from around 9% in April-June.

Sales of own production also recovered somewhat in the past quarter as revenues decreased by 3% YoY after a 20% plunge in the April–June period.

Revenues from the distributed portfolio nose-dived in the April-June period, with 37% YoY plunge and sales of Diageo products falling 31%. The recovery arrived in the consecutive quarter as the revenue decline slowed to 3% YoY in the distributed portfolio, with strong revenue growth in the Diageo segment but persistently eroding revenues in the segments of other traded products.

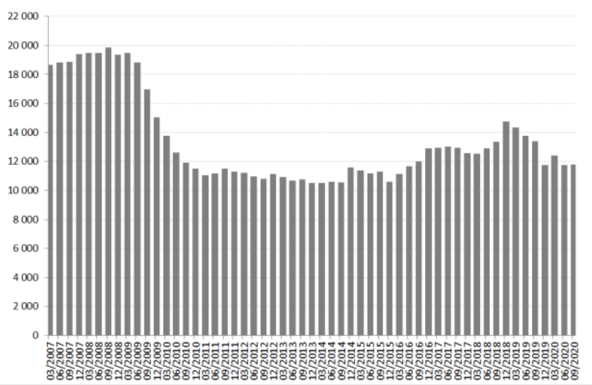
However, exports' revenues were still dragged down in the past quarter. Although export sales jumped 38% in quarter/quarter terms, year/year comparison showed 4% drop. In the April–June period, when lockdown restriction affected revenue dynamics the most, Zwack's export sales fell more than domestic revenues did, and its recovery in the past quarter was also fainter.

12M total net sales revenues (HUFm)



Sources: Zwack Unicum, OTP Research

12M domestic net sales revenues (HUFm)



Sources: Zwack Unicum, OTP Research

With recovering revenues, profitability recalling better times also returned in the July–September period. As demand recovered and revenues gained momentum, profitability also improved. In the April-June and the July-September periods, material-type costs remained at the same level as in normal times, snapping about 38% of total net sales. Gross profit stood at 62% in the quarter ending 30 September, slightly below the long-term average as material-type costs were 8% higher than a year before, mainly due to the HUF's depreciation.

With recovering revenues and year/year decreasing costs, Zwack's profitability rates made a big step upwards from the low levels of the April-June period. The 23.7% EBIT rate (FQ1: 0.9%) and 27.2% EBITDA rate (FQ1: 5.9%) in the past quarter reflect considerable improvement – not only in quarterly but on a yearly basis as well. Despite the general wage increase at the beginning of the current business year and higher payroll, personnel expenses dropped YoY as social contribution tax and other cost items linked to dividend payment have declined. The pandemic also helped save marketing costs, as promotional events had to be cancelled during the quarter and probably in the remaining part of the year as well.

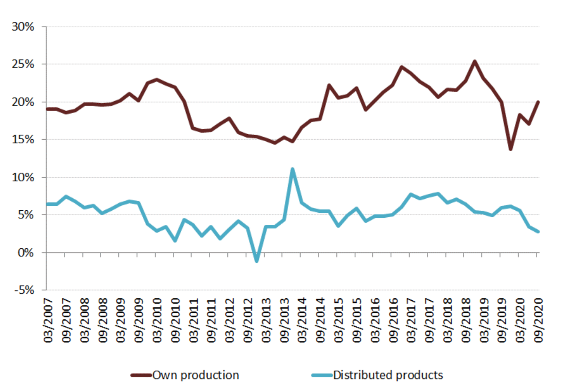
We note that the profitability improvement is not expected to be a permanent phenomenon as cost saving is related to the special economic environment the pandemic brought. With sales activity and thus revenue growth returning, sales-related marketing costs are also expected to 'recover'.

As a result of fallen costs, quarterly EBIT increased to HUF 808m, 51% higher than a year earlier, and EBITDA rose to HUF 925m (+39% YoY). Comparing last quarter's profitability figures to previous FQ2s', we arrive at the surprising fact that those in the latest quarter were the best in the past 14 years. Although Zwack had to deal with some financial loss due to higher than usual interest expenses stemming from higher indebtedness, pre-tax profit also jumped 50% in one year. Net quarterly profit increased to higher-than-expected HUF 685m, showing 60% bottom-line growth in a year's time.

Segment information also reflects improving profitability in the July-September period: own production's operating margin jumped to 28% while the one of the distributed portfolio turned positive after the previous two quarters' negative margins. 12M profitability rates are a different story, with 12M trailing EBIT rate of on production climbing up from historic lows in the last quarter of 2019 but the same indicator of the distributed portfolio eroded further.

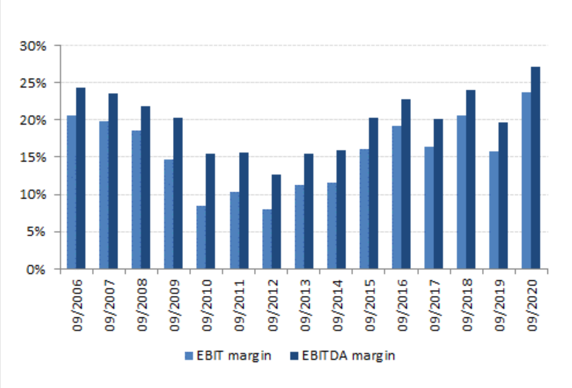
(As we wrote earlier, Zwack announced changes to its accounting policy, effective from the start of 2019. The modifications affect mainly the accounting of material costs, other incomes and other costs, while some changes in the accounting of certain allowances (bonuses for long service and retirement 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.)

12M EBIT margin of own production and distribution



Sources: Zwack Unicum, OTP Research

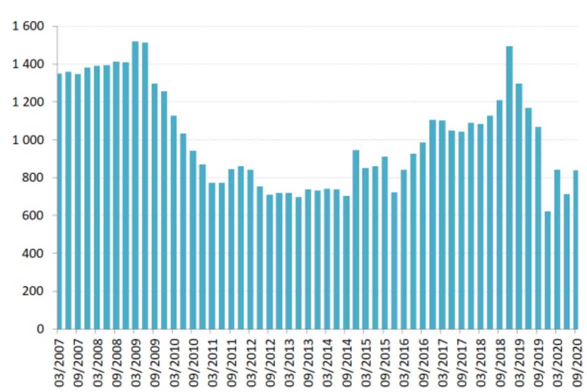
Profitability ratios in the earlier individual FQ2s[1]



Sources: Zwack Unicum, OTP Research

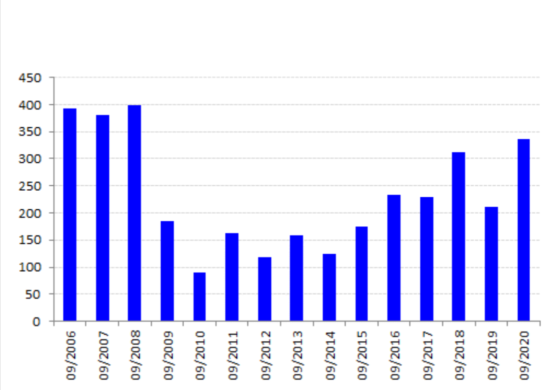
Zwack's liquidity and leverage remained sound during the pandemic. At the beginning of the current year, Zwack made important B/S adjustments to fend off the economic unease arising from the covid epidemic. The management decided to stockpile more Unicum in the wake of the covid crisis in order to get prepared for raw material shortages or shutdowns in case of worsening pandemic situation. In April-June, inventories remained at this elevated level and in the past quarter inventories climbed further, presumably as the company was preparing for the Christmas season. Previously, Zwack reported that it had 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 July-September period Zwack's liquidity ratios improved in quarterly and yearly terms as well. At the same time, leverage slightly dropped compared to the previous quarter, yet it stands above the figure registered in last year's corresponding quarter. Net debt/EBITDA and total debt/EBITDA ratios also reflect the slight improvement compared to the April-June period.

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 FQ2s (July-September periods)



Source: Zwack Unicum

Comments

- 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. However, Q3 brought recovery. The retail market of distilled beverages expanded by 3.1% in real terms and by nearly 8% in current prices, market survey data for the April-September period show. This means obviously

[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*

faster growth compared to 1.5% real term growth and 5.6% growth in current prices, registered in the April-June period.

- Retail trade statistics from KSH (Hungarian Central Statistical Office) show slower developments in the FMCG sector: retail trade in shops selling foods, beverages and tobacco increased by 1.0% YoY in the July-September period, after almost 5% drop in the previous quarter, according to the seasonally and working day-adjusted data.
- Zwack reported better-than-expected sales figures for July-September 2020 as demand returned after restrictions had been eased. 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, and it gathered momentum during the summer as well. However, the suspension of mass gatherings remained a drag on recovery and the restrictions due to the second wave of pandemic introduced in November gave a further blow to the hospitality sector.
- In these circumstances, short-term outlook for the remaining part of the year is gloom, as on-trade segment fails to support revenues to get back to the pre-covid path. Service sector PMIs in Europe also reflect deteriorating short-term outlook for the service industries as the latest figures in October and November failed to show the improvement that occurred in the manufacturing industries.
- Although Q4 is a very strong season for Zwack, with on-site consumption prohibited, retail segment is not expected to offset the lack of on-trade revenues. Zwack earlier forecast yearly net profit to decline by over 80% YoY in this financial year, but in its latest announcement the company did not reiterate this expectation.
- The fact that covid vaccines are within reach may drastically change the outlook and may help the battered hospitality and other service industries to recover, starting from 2021. Nevertheless, this development cannot save the current business year for Zwack. The next business year, from the middle of 2021, however, may witness swift recovery once mass vaccination against covid begins.

Conclusions

- The current situation, with second-wave restrictions implemented, makes short-term forecasting challenging. The prohibition of on-the-site consumption in restaurants and the introduction of night curfew from 8pm to 5am reduces spirit consumption in bars and restaurant practically to zero, as the lack of Christmas and New Year's festivities will also take its toll on spirit consumption.
- We maintain our earlier forecasts of HUF 11.3bn net sales revenues and HUF 1.2bn EBIT in the current business year. EPS is expected to decline to HUF 440, although we see risks lying on the downside.
- In this scenario, we expect revenues to increase to HUF 13.9bn in FY 2021/2022, with EBIT to climb to 1.9bn and net income to reach 1.4bn. We emphasize that the current forecast bears considerable downside risks due to the uncertainties regarding the successfulness and the timing of the vaccination. On the other hand, if vaccination proceeds as it is hoped, Zwack will definitely benefit from the quick restoration of the domestic tourism and restaurant businesses.
- We made some modifications in our valuation models and shifted the forecast horizon by one year. Accordingly, our DCF (FCFE) model resulted in 18,176

HUF/share target price, up from the previous 15,206 HUF/share. Valuation from DDM reflecting future dividend payments also increased: the 12-month target price the model gave is HUF 16,180, up from the previous HUF 15,607.

- The new target price is 17,083 HUF/share, 1.4% higher than the HUF 16,850 closing price on 14 December 2020. Calculating with 300 HUF/share yearly dividend after FY 2019/2020, scheduled to be paid out in January 2021, plus HUF 165 expected DPS after the current business year, the 12-month estimated total return would be 4.1%.
- 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	12 477	13 658
Export sales	1 540	1 501	1 679	1 137	1 441	1 592
Net sales income	13 958	15 739	13 960	11 251	13 917	15 250
Material-type costs	5 149	5 723	5 287	4 613	5 428	5 795
Gross profit	8 809	10 016	8 673	6 638	8 490	9 455
Total operating expenditures	6 599	7 355	6 965	5 726	7 016	7 564
EBIT	2 561	3 079	2 169	1 224	1 885	2 439
Pre-tax profit	2 563	3 310	2 184	1 201	1 867	2 441
Tax	377	460	488	306	429	561
Profit after tax	2 186	2 850	1 696	895	1 437	1 880
Dividend	2 137	2 442	611	336	719	1 692
EPS (HUF)	1 074	1 288	833	440	706	924
DPS (HUF)	1 050	1 200	300	165	353	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	92	83	75
Non-current assets	3 447	3 582	3 585	3 807	3 766	3 729
Inventories	2 185	2 386	2 661	2 574	3 002	2 608
Recievables and other current assets	2 275	2 115	3 007	3 622	3 396	2 923
Cash and cash equivalents	2 770	3 064	2 709	2 955	2 785	2 991
Current assets	7 230	7 565	8 377	9 151	8 363	8 521
TOTAL ASSETS	**10 677**	**11 147**	**11 962**	**12 958**	**12 130**	**12 250**
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	4 296	4 076	5 033
Total Equity	**6 557**	**7 080**	**6 176**	**6 461**	**6 241**	**7 198**
Long-term loans and other liabilities	410	472	453	417	400	384
Non-current liabilities	410	472	453	417	400	384
Loans and credits	0	0	1 250	2 500	1 250	220
Payables and other short-term liabilities	3 384	3 567	4 071	3 545	4 164	4 375
Current Liabilities	3 710	3 595	5 333	6 080	5 488	4 668
TOTAL EQUITY AND LIABILITIES	**10 677**	**11 147**	**11 962**	**12 958**	**12 130**	**12 250**

CONSOLIDATED CASH FLOW (HUFm)	2017/2018	2018/2019F	2019/2020F	2020/2021F	2021/2022F	2022/2023F
EBITDA	3 049	3 643	2 646	1 701	2 479	3 101
Cash flow from operation	2 854	3 215	1 482	399	2 490	4 507
Cash flow from investment	-765	-655	-480	-679	-533	-605
FCFF	2 089	2 560	1 002	-280	1 956	3 902
FCFE	2 091	2 563	2 264	814	831	2 874

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*	2025/2026*	FCFE in the explicit period
FCFE	2 264	814	831	2 874	2 034	2 781	2 804	
Discount factor	0,92	0,92	0,91	0,91	0,91	0,91	0,91	
DCF	2 076	745	760	2 623	1 854	2 519	2 540	10 295
Terminal Value (HUFm)								35 597
Net Present Value - FCFE (HUFm)								32 839
Net debt								-1 006
Equity value (HUFm)								33 845
Number of shares								2 035 000
Expected return on equity								9,3%
12M Target price (DCF)								18 176
12M Target price (DDM)								16 180
12M Weighted Target price (HUF) - Dec 31, 2021								**17 083**
Current price								16 850
Upside/Downside								1,4%
TR Upside/Downside								4,1%

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, the sectors that took the biggest hit from covid-19. While 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 most depressed quarters this year. With restrictions lifted, Zwack's revenues showed recovery in Q3, but September was also somewhat depressed in the wake of the second wave of pandemic. With on-site consumption prohibited and night curfew introduced, the new restrictions implemented in November added a further blow to the restaurant industry. Zwack is likely to lose a considerable part of its on-trade revenue in the last quarter of 2020. But the covid vaccines are gamechangers, and with mass immunization the economic damages of pandemic are expected to quickly diminish. Once covid vaccination starts in Hungary, the hospitality sector is expected to revive and Zwack may easily be one of the recovery's beneficiaries.

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.

In the summer, the EU's decision-making body modified the initiative on the taxation of home-distillery of 'palinka'. According to the new regulation, every citizen of full age in the EU is entitled to distil tax-free 86 litres of fruit spirits a year. Hungary will introduce the new regulation from 1 January 2021.

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 material 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 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.

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:

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

Date	Recommendation	Target Price	Publication
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
15/12/2020	HOLD	HUF 17,083	Quarterly Earnings Update

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

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This document was finalized at 3:24:38 PM on 15 December 2020