otp Research

EQUITY NOTE: ZWACK UNICUM

Recommendation: HOLD (unchanged)

Target price (12M): HUF 15,214 (revised down)

21 May 2020

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We maintain our **HOLD** recommendation for Zwack Unicum (Zwack HB; ZWCG.BU) with a **new 12M target price of 15,214 HUF/share** revised down from previous HUF 15,685/share. The current covid pandemic changed essentially the economic environment and limited growth prospects for a while. Though Zwack delivered very strong revenue growth in Jan-March 2020 partly because of base effect and partly due to unusually strong demand in end-March as a covid-related one-off effect. Higher taxes weighed on sales performance throughout 2019 and looking ahead, growth expectations must be redesigned again after the covid crisis hit several industries. Although Zwack operates in the non-cyclical consumer sector, a half of its revenues comes from the restaurant industry, another subsector severely hit by lockdown and social distancing rules. Although disease-related restrictions were recently lifted, uncertainties concerning the short-term and medium-term outlook have remained.

The new target price is 9% below the HUF 16,700 closing price on 21 May 2020. Expected total return is negative 5% in a 12-month horizon, though considering the current situation, dividend payment may also bear some grade of uncertainty.

Shares of Zwack Unicum lost 1.5% on 21 May 2020, on the day after the earnings report was published, while the BUX decreased 0.4%. In Q1 2020 Zwack dropped 6.8% with a quarterly range of HUF 17,700 – 16,450. YTD return is negative 5.4%.

Summary/Earnings Highlights

- Zwack reported HUF 2.1bn net sales revenue for Jan-March 2020, with top-line growth of 52% YoY. Quarterly sales revenue exceeded our forecast as Zwack experienced unusually strong demand growth in late March in the wake of national lockdown. However, even with the unexpectedly robust sales in the Jan-March period (financial Q4) partly as a one effect of covid-related shopping spree, Zwack ended the past four quarters with 11% revenue decline due to the subdued demand in April-December 2019.
- Domestic sales revenues of own-manufactured products jumped by over 80% YoY in the past quarter, while the distributed portfolio gained 20% YoY. Exports also picked up, rising 20% YoY in the quarter.
- Due to the better-than-expected sales performance, EBIT and EBITDA margins improved, but remained in negative territory as usual in this part of the year. The Jan-March period is a low season for Zwack with below average revenues (around 10% of total net sales) but average level costs. Due to better than usual sales performance, quarterly EBIT in Jan-March 2020, although negative, was much favourable (HUF -222m vs HUF -800m) in a year/year basis.
- 12M-trailing EPS fell to HUF 833 in the past financial year, from HUF 1,288 reported a year ago.

- Meanwhile, Zwack also got prepared to meet the challenges the covid epidemic posed. 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. With the new facility fully drawn down, Zwack's debts/total assets ratio will increase to 19% from 10% at the end of Q1 2020.
- As about half of Zwack's revenues come from on-trade sale, almost two months' revenue vanished during the lockdown. The pace of recovery in this segment is also uncertain. Zwack expects drastic consumption decline in Hungary this year, and the covid-related restrictions may put a considerable part of this year's profit in peril, the company announced.
- As this year's outlook became worse and uncertainties heightened, we revised down our revenue and profit forecasts: we expect HUF 10.5bn sales revenue for the current business year, with HUF 1.4bn EBIT and HUF 1.1bn after-tax profit.
- This year's 12M-trailing EPS is expected to fall to HUF 551, from HUF 833 in 2019/2020.
- We also updated our valuation models (DCF, DDM) in line with the new forecast figures. The new HUF 15,214 target price reflects our expectations for the next 12 months, though the uncertainty is considerable in the current situation.

Financial highlights of Zwack's Q1 2020 earnings report

Financial Q3 (HUFm)	Jan-Mar 2020	Jan-Mar 2019	YoY Change
Domestic sales	1 737	1 079	61%
Export sales	362	302	20%
Net sales income	**2 099**	**1 381**	**52%**
Material-type costs	802	619	30%
Gross profit	**1 297**	**762**	**70%**
Employee benefits	669	722	-7%
Depreciation	130	173	-25%
Other operating expenses	774	746	4%
Total operating expenditures	**1 573**	**1 641**	**-4%**
Other incomes	54	79	-32%
EBIT	**-222**	**-800**	**-72%**
EBITDA	**-92**	**-627**	**-85%**
Pre-tax profit	**-207**	**-797**	**-74%**
Tax	61	-80	-176%
After-tax profit	**-268**	**-717**	**-63%**

Financial Q3 (HUFm)	Jan-Mar 2020	Jan-Mar 2019	YoY Change
EPS (HUF)	**-132**	**-352**	**-63%**
4Q-rolling EPS (HUF)	**833**	**1 288**	**-35%**
Gross profit rate	**61.8%**	**55.2%**	**6.6 pp**
Operating profit rate	**-10.6%**	**-57.9%**	**47.3 pp**
EBITDA rate	**-4.4%**	**-45.4%**	**41.0 pp**
ROE	**-4.2%**	**-9.6%**	**5.4 pp**
4Q-rolling ROE	**25.6%**	**38.4%**	**-12.8 pp**
ROA	**-2.2%**	**-5.4%**	**3.2 pp**
4Q-rolling ROA	**14.7%**	**24.0%**	**-9.3 pp**

Sources: Zwack Unicum, OTP Research

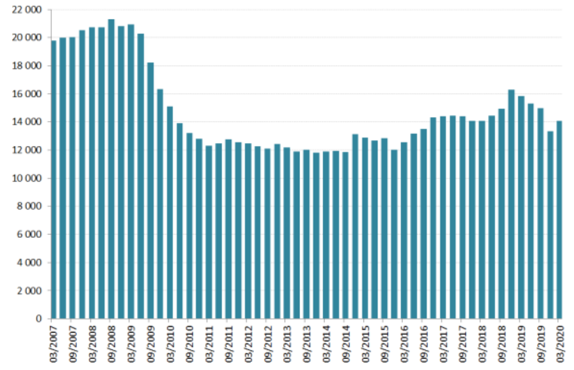
Domestic revenue growth has returned last quarter but temporary effect had a role. After four quarters of considerable revenue decline in 2019 due to customers' earlier inventory building back in 2018, Zwack delivered 52% top-line growth in Jan-March 2020. As we wrote earlier, wholesalers' heavy stockpiling ahead of the tax increase (effective from Jan 1, 2019) put a break on domestic sales growth last year. With that past stockpiling effect fallen out, and given the low basis, revenue growth returned in the first three months of 2020.

Zwack's quarterly domestic revenues were also boosted by retail chains in March, with unusually strong purchasing activity in the last days of the month as a temporary effect of shopping frenzy heightened ahead of the lockdown in Hungary.

Domestic sales of own-produced products jumped more than 80% YoY last quarter, while revenues from the distributed portfolio gained 20% YoY. Total domestic revenues increased by 61% in a yearly comparison.
Exports also picked up in the last quarter of FY 2019/2020, with robust revenue growth in Italy and Germany. Quarterly export sales rose by 20% YoY.

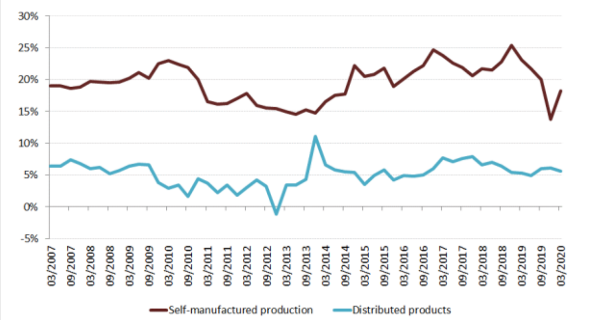
Stable consumer demand and growing domestic retail sales characterised the market of spirits before the covid outbreak. The retail market of distilled beverages expanded between April 2019 and March 2020, the market research survey shows. The retail market increased by 11.9% in value and by 2.1% in real terms, Zwack announced based on survey data. Retail trade statistics of alcoholic beverages from KSH (Hungarian Central Statistical Office) also underpinned persistent consumer demand in 2019. Although detailed retail statistics for Q1 2020 are not yet available, the seasonally and working day-adjusted data show that growth in the product group of foods, beverages and tobacco accelerated in Jan-March.

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



Sources: Zwack Unicum, OTP Research

12M EBIT margin of self-manufactured and distributed products



Sources: Zwack Unicum, OTP Research

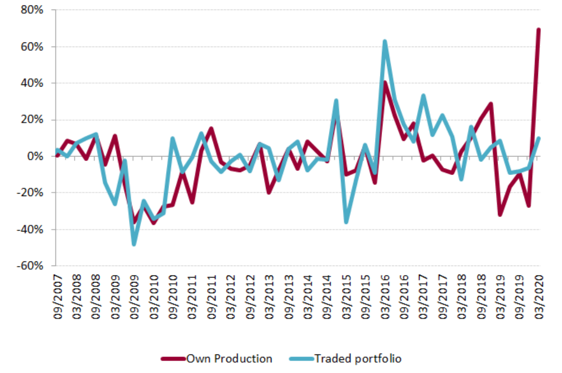
Profit rates remarkably improved last quarter due to higher-than-expected sales growth. Due to seasonal effects, Zwack operates normally with deeply negative EBIT and EBITDA rates in the Jan-March periods. This year however, Zwack benefited from an unexpectedly robust demand after the logistics system of retail chains had become overfraught due to the covid-epidemic-induced shopping spree in late March. Retail chains quickly stepped up order volumes and multiplied their purchases. As a consequence, Zwack's EBIT margin improved to -11%, from -58% one year earlier, and EBITDA climbed to -4%, from the depth of -45% in Jan-March 2019. However, material-type costs jumped almost 30% YoY after reporting decline in every quarters of Y2019. Gross profit increased to HUF 1.3bn (+70% YoY).

With 4% drop in total operating expenses, EBIT showed HUF 222m loss vs. HUF 800m loss in Jan-March 2019. Quarterly net income was negative, HUF -268m in the quarter, or HUF -132 earnings per share. The 12M cumulated EPS amounted to HUF 833 vs. HUF 1,289 in FY2018/2019.

Segment information shows remarkable profitability improvement in own-manufactured products as EBIT margin improved to -11% from -79% one year ago. Operating margin in the segment of distributed portfolio somewhat deteriorated – it decreased to 10% from 7% one year earlier.

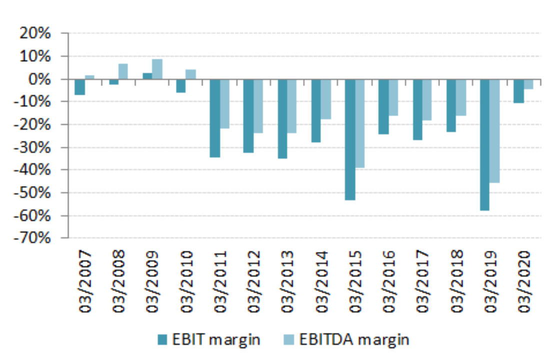
Previously, Zwack announced some changes to its accounting policy, effective from the start of 2019. The modifications affect mainly the accounting of material-type costs, other incomes and other costs, while some changes in the accounting of certain allowances (bonuses for long service and retirement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

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



Sources: Zwack Unicum, OTP Research

Profitability ratios in the earlier individual FQ4s[1]

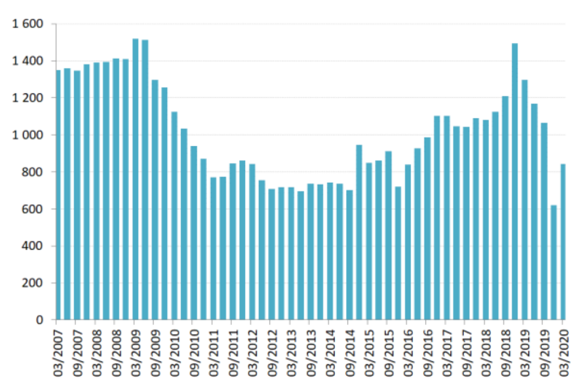
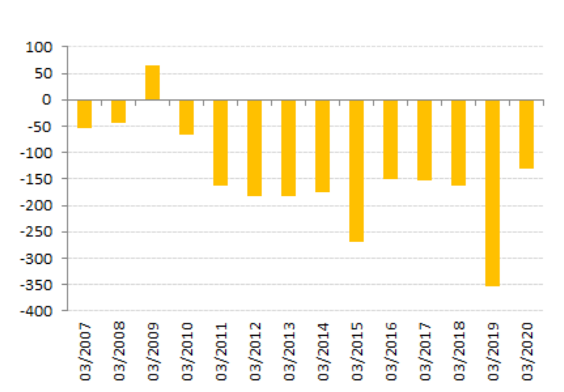


Sources: Zwack Unicum, OTP Research

Zwack reacted very early to the threats of the covid epidemic. Zwack made several B/S adjustments in the past quarter. 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 covid crisis in order to get prepared for raw material shortages or shutdowns in case of worsening pandemic situation, Zwack reported.

The company also announced that, in agreement with the main owners, it had taken a new loan facility totalling HUF 2.5bn, to cover operational expenses. The first tranche of HUF 1.25bn was drawn down at the end of March, and the second tranche at the end of April. Zwack expects the new credit lines to ensure the financial safety in the FY 2020/2021, to maintain solvency to suppliers, employees and the tax authority, and to safeguard the company's goodwill, Zwack declared in the recent earnings report.

[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*

12M-trailing EPS is still above the long-term average (HUF)	Quarterly EPS in the past individual FQ4s (Jan-March period)
	
Source: Zwack Unicum	*Source: Zwack Unicum*

Short-term outlooks are bleak. The lockdown introduced in Hungary in late March practically wiped out Zwack's on-trade sales, which account for half of the company's revenues, as bars and restaurants remained closed. Although the consumption of spirits in the prime segment has been growing in the past few years, Zwack expects steep decline near term due to the current covid epidemic.

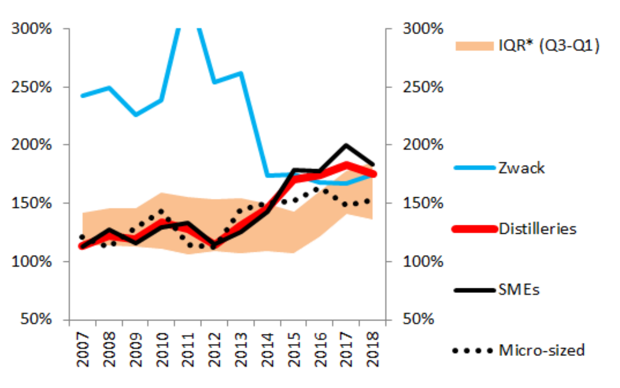
The restrictions introduced to flatten the curve of new covid-19 cases also endangers Zwack's earlier profit plans. Depending on the duration of the restrictive measures, a dominant part of the expected income may turn to dust in worst case, the company said.

Comments

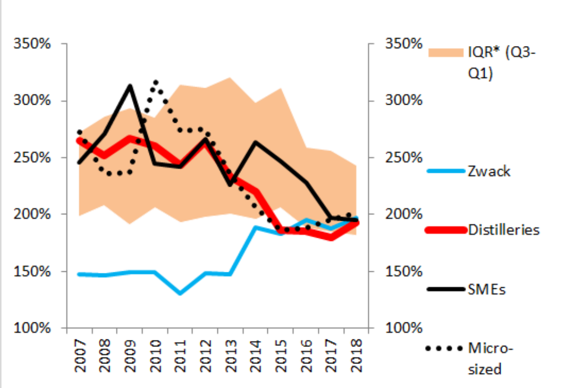
- Zwack reported better-than-expected sales figures for Jan-March 2020 as unexpected panic shopping added impetus to the company's domestic revenue growth as a one-off effect.
- As a repercussion of retail chains' purchasing many times the usual monthly order volume in March, sales performance in the consecutive months is expected to be weak.
- After the lockdown was lifted from the middle of May in Hungary, and a week later in Budapest and in the county of Pest, sales activity might slowly recuperate in the on-trade segment.
- However, due to the current crisis, consumers' purchasing power is expected to weaken, while customers are expected to be more careful. Besides, the suspension of mass gatherings until mid-August may also fail to add support to the recovery.
- In the current situation, investors' focus turns from P/L statement to corporate B/S. In terms of liquidity, Zwack's position has been stable for years. In comparison with other subsectors of the Hungarian economy, its liquidity was near or above the upper quartile, while its leverage was near or below the lower quartile.
- Retrospectively, Zwack's indebtedness has been traditionally low for many years. With the recent borrowing, the total debt/total assets ratio increased to 10% by the end of last quarter from the practically zero level at the end of 2019. With the second tranche of the loan facility, debt/assets ratio is expected to rise to 18-20% in the current financial year. With sufficient cash and low indebtedness, Zwack's net debt/EBITDA ratio has been negative for long and the recent borrowing does not change radically.
- Zwack ended FY 2019/2020 with HUF 1.7bn net income vs. HUF 2.6bn after-tax profit in the previous business year. In the past couple of years, dividend payout ratio averaged 95%. This year it would mean HUF 792 DPS, however in the present

uncertainty regarding economic outlook, decreasing dividend payout ratio or suspending dividend payment would not come as a surprise.

Current ratio in the distillery industry in Hungary*



Leverage in the distillery industry in Hungary*



Sources: GKI, National Tax and Customs Administration, OTP Research

**Calculation is based upon the financial reports of Hungarian enterprises with double-entry bookkeeping, which were submitted to the National Tax and Customs Administration. Upper and lower quartiles are calculated with financial data of companies classified in 22 economic subsectors.*

Conclusions

- The current pandemic situation totally alters the economic landscape and puts economies to a very different growth path compared to what was expected at the beginning of this year.
- The European Commission's latest forecasts expect GDP to decline by 7.4% in the EU and fall by 7.7% in the euro area this year vs earlier forecasts of 1.4% and 1.2% growth rates, respectively. The EC expects GDP to decline by 7.0% in Hungary, with private consumption falling 6% YoY in 2020. Forecasts for 2021 reflect 6.0% GDP growth and 5.5% private consumption in Hungary.
- The current situation, with restrictions only recently lifted, makes forecasting the next 12 months challenging.
- We maintain our conservative approach and expect this year's sales revenue to decrease to HUF 10.5bn, while EBIT may drop to HUF 1.4bn. EPS is expected to decline to HUF 551 in the current business year. In this scenario, we expect revenues to increase to HUF 13bn in FY 2021/2022, with EBIT to climb to 1.7bn and net income to reach 1.3bn. 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 or the risk of a second wave of pandemic.
- We made some modifications in our valuation model. Besides the revision of our forecast, higher yields and illiquidity discount also had a role in the decrease of enterprise value. Our DDM model has been also updated.
- As a result, our DCF (FCFE) model resulted in 14,594 HUF/share target price, down from the previous 15,336 HUF/share. Valuation from DDM also deteriorated, the 12-month target price the model issued is HUF 15,834, down from the previous HUF 16,305.
- The new target price is HUF 15,214/ share 8.9% down from the HUF 16,700 closing price on 21 May 2020. With calculating lower than usual payout ratio in the

current covid-crisis, and HUF 667/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	9 425	12 247	13 658
Export sales	1 540	1 501	1 679	1 108	1 431	1 592
Net sales income	13 958	15 739	13 960	10 533	13 678	15 250
Material-type costs	5 149	5 723	5 287	4 403	5 471	5 795
Gross profit	8 809	10 016	8 673	6 130	8 207	9 455
Total operating expenditures	6 599	7 355	6 965	4 992	6 883	7 564
EBIT	2 561	3 079	2 169	1 484	1 735	2 439
Pre-tax profit	2 563	3 310	2 184	1 456	1 708	2 441
Tax	377	460	488	335	393	561
Profit after tax	2 186	2 850	1 696	1 121	1 315	1 880
Dividend	2 137	2 442	1 357	897	1 184	1 692
EPS (HUF)	1 074	1 288	833	551	646	924
DPS (HUF)	1 050	1 200	667	441	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	3 314	3 148	3 790
Intangible assets	89	84	102	103	93	83
Non-current assets	3 447	3 582	3 585	3 584	3 412	4 051
Inventories	2 185	2 386	2 661	3 343	3 224	2 608
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	2 955	2 785	2 991
Current assets	7 230	7 565	8 377	9 828	9 406	8 521
TOTAL ASSETS	10 677	11 147	11 962	13 412	12 818	12 572
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	4 480	4 999	4 367
Total Equity	6 557	7 080	6 176	6 645	7 164	6 532
Long-term loans and other liabilities	410	472	453	472	472	472
Non-current liabilities	410	472	453	472	472	472
Loans and credits	0	0	1 250	2 500	200	220
Payables and other short-term liabilities	3 384	3 567	4 071	3 760	4 914	5 274
Current Liabilities	3 710	3 595	5 333	6 296	5 182	5 567
TOTAL EQUITY AND LIABILITIES	10 677	11 147	11 962	13 412	12 818	12 572

CONSOLIDATED CASH FLOW (HUFm)	2017/2018	2018/2019F	2019/2020F	2020/2021F	2021/2022F	2022/2023F
EBITDA	3 049	3 643	2 646	1 913	2 309	3 101
Cash flow from operation	2 854	3 215	1 482	79	3 361	4 028
Cash flow from investment	-765	-655	-480	-409	-382	-1 280
FCFF	2 089	2 560	1 002	-329	2 978	2 748
FCFE	2 091	2 563	2 264	899	658	2 769

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	899	658	2 769	1 382	2 334	
Discount factor	0,92	0,92	0,91	0,91	0,91	0,91	
DCF	2 076	824	601	2 521	1 258	2 116	7 320
Terminal Value (HUFm)							30 248
Net Present Value - FCFE (HUFm)							26 228
Net debt							-1 006
Equity value (HUFm)							27 234
Number of shares							2 035 000
Expected return on equity							9,1%
12M Target price (DCF)							14 594
12M Target price (DDM)							15 834
12M Weighted Target price (HUF)							**15 214**
Current price							16 700
Upside/Downside							-8,9%
TR Upside/Downside							-4,9%

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 must have 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.

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
06/02/2019	HOLD	HUF 16,271	Quarterly Earnings Update
23/05/2019	HOLD	HUF 16,056	Quarterly Earnings Update
30/05/2019	HOLD	HUF 16,056	Comment
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

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