otp Research

EQUITY NOTE: RÁBA Automotive Holding

Recommendation: BUY (unchanged)

Target price (12M): HUF 1,317 (revised)

29 Aug 2019

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Highlights

We maintain our previous BUY recommendation on Rába Automotive Holding (RABA HB; RABA.BU) with a new 12M target price of 1,317 HUF/share. The target price is 15% higher than the HUF 1,150 closing price on 29 August. Total return is estimated at 16% on a 12-month forecast period. Although Q2 earnings report shows disquieting signs of the core business of Rába's axles unit, we maintain our forecast on a balanced sales growth in the short run, while risks surrounding economic growth in the EU and a possible global downturn still linger. Rába also faces challenges on the cost side and while part of the cost increase may affect operation only provisionally, rising energy and labour expenses need to be addressed. Higher expected net debt also added to factors resulting in lower enterprise value.

Summary

- Rába Automotive Holding announced HUF 12.9bn sales income in Q2 2019, in line with our expectation, 7% higher than a year earlier. Rába reported strong demand in some key export markets, and domestic sales performance remained also outstanding.
- However, not every business unit managed to maintain the dynamics in its core export market at the levels seen in previous years. The axle business unit lost momentum in the EU market in Q2; sales revenues in EUR terms declined 22% YoY after losing 9% in Q1.
- Rába is still struggling with rising energy prices and wages, and higher production and general administration costs put profitability under pressure again. Although steel raw material prices have been steadily coming down, the company failed to improve operating profitability in the latest quarter, due to other cost factors.
- As a result, quarterly EBIT decreased by 39% YoY, while EBITDA declined 18%. Profitability ratios deteriorated in both yearly and quarterly comparison. The deterioration of profit margin affected all the three business units.
- Quarterly EPS amounted to HUF 8 in Q2 2019, worse than in our forecast, while 12M-trailing EPS decreased to HUF 105 vs. HUF 111 in Q2 2018.
- We expect this year's EBIT to arrive at HUF 1.7, down from our earlier forecast of HUF2.1bn. EBITDA may increase to HUF 3.9bn, while net income is expected to grow to HUF 1.3bn. Our 12M EPS forecast for 2019 stands at HUF 96.

- Robust demand is sustained on Rába's key markets and we do not expect considerable change in that in the short run. However, when considering global growth outlook, we see downside risks. Uncertainty concerning global trade disputes is also a risk factor, and changes in trade policies may strongly affect the European automotive sector and its supply chain.

Financial highlights of Q2 2019 earnings report

April-June (HUFm)	2019 Q2	2018 Q2	YoY Change
Domestic sales	4 050	3 203	26%
Export sales	8 864	8 904	0%
Net sales income	**12 914**	**12 107**	**7%**
Direct cost of sales	10 411	9 555	9%
Gross profit	**2 503**	**2 551**	**-2%**
Cost of sales and marketing	198	180	10%
General managing costs	1 900	1 759	8%
Other operating expenses	183	204	-10%
Total operating expenditures	**2 281**	**2 143**	**6%**
Other incomes	77	85	-10%
EBIT	**299**	**494**	**-39%**
EBITDA	**829**	**1 015**	**-18%**
Pre-tax profit	**212**	**364**	**-42%**
Tax	102	121	-16%
After-tax profit	**110**	**243**	**-55%**

April-June (HUFm)	2019 Q2	2018 Q2	YoY Change
EPS (HUF)	**8**	**18**	**-56%**
12m-trailing EPS (HUF	**105**	**111**	**-5%**
Gross profit margin	**19.4%**	**21.1%**	**-1.7pp**
EBIT margin	**2.3%**	**4.1%**	**-1.8pp**
EBITDA margin	**6.4%**	**8.4%**	**-2.0pp**
ROE	**0.5%**	**1.2%**	**-0.7pp**
12m-trailing ROE	**6.8%**	**7.5%**	**-0.7pp**
ROA	**0.2%**	**0.6%**	**-0.4pp**
12m-trailing ROA	**3.4%**	**4.1%**	**-0.7pp**

Source: Rába Automotive

Sales performance keeps on showing mixed signs. Rába recently reported HUF 12.9 bn total net sales in Q2 2019, in line with our quarterly forecast. Total sales revenue increased by less than 7% YoY, and slowed down considerably compared to the 19% growth rate witnessed in Q1 2019. HUF-denominated quarterly export sales have slightly decreased from Q2 2018, despite the somewhat weaker HUF when comparing the quarterly average FX rates of the corresponding periods.

In the latest quarter, exports' share in total sales revenue shifted from the unusually low levels of 61% in Q1 2019 and Q4 2018, and increased close to the more typical 70%, despite massive domestic sales performance and the gap in sales to the CIS countries.

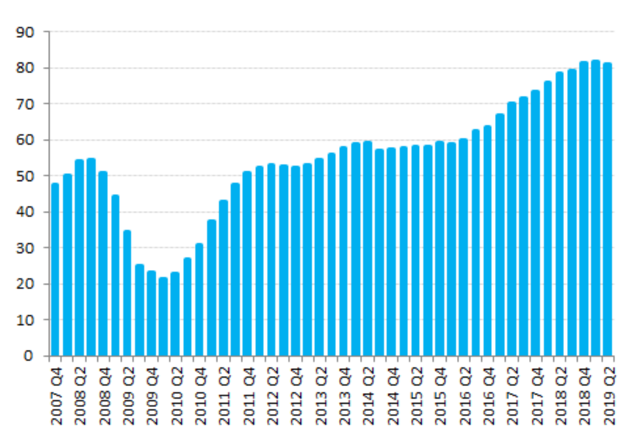
Sales to the EU – representing the biggest share (52% in Q2 2019, up from 47% in Q1 2019) in total sales revenue – declined by 3% YoY in HUF terms. Without the FX effect, quarterly EU sales revenues lost 3% YoY as well, making considerable difference compared to the double-digit quarterly growth rates in 2017 and 2018. Sales to the EU have decreased to HUF 7.0bn, or EUR 22.1m.

The axle business of Rába has the biggest share in EU sales revenues, even though this unit lost momentum in Q2 in this market again, just like in Q1. In Q2, revenue from sales to the EU decreased by 23% in HUF terms, or by 22% in EUR terms, after

9% EUR-denominated export decline in Q1. The parts and the vehicle units partially offset fading EU sales at the axle business unit: the parts unit's sales to the EU jumped by 22% (22% w/o FX effect), while the vehicle segment achieved 25% increase there (in HUF terms, or by 24% w/o currency effects).

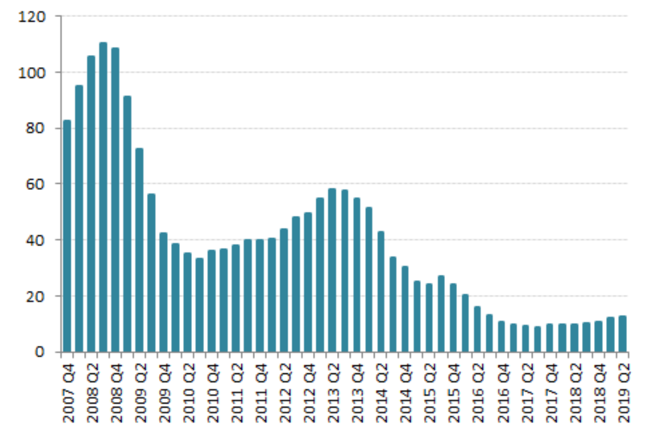
The rising trend of revenue growth in the EU market reversed for Rába in Q2 2019, although the registration figures of medium & heavy trucks and buses in the EU are still rising. What's more, May and June figures show outstanding growth both in the medium & heavy truck and bus markets. It is true, administrative changes are behind the stronger demand. New passenger car sales show signs of weakness in the EU, as the registration figures in this segment's sales started to decline in Q1 after several years of continuous growth, and Q2 registrations were also sluggish.

12m-trailing EU export sales revenue of Rába Automotive (EURm)



Sources: Rába Automotive, OTP Research

12m-trailing US sales revenue of Rába Automotive (USDm)



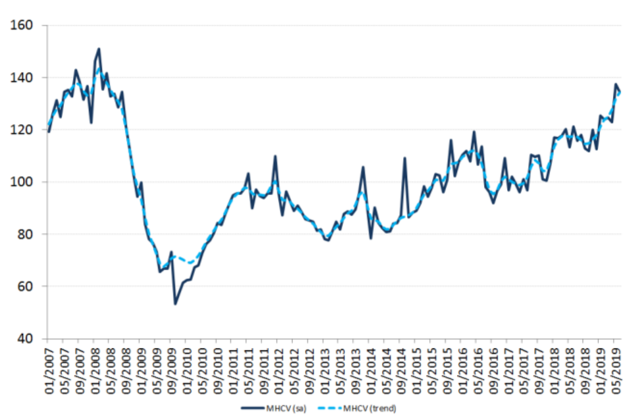
Sources: Rába Automotive, OTP Research

Dollar-denominated US sales growth slowed to 29% YoY in Q2 after reporting 40% YoY increase in Q1 2019. Demand on the US heavy truck market remains really strong, backed by the still favourable economic conditions: the monthly registration figures of heavy commercial vehicles showed double-digit yearly growth rates in the past nearly two years, as well as in the first seven months of 2019. The April-June period witnessed 17% YoY gain, up from the 13% and 15% growth rates registered in Q1 2019 and Q4 2018, respectively.

The US agricultural machinery market is still in good shape. This year's monthly figures still show strong rise in the sales of agricultural machinery, in almost each segment. The sales of two-wheeled farm tractors slowed to 4% YoY in January-June from 6% in January-March and after near 7% growth rate in 2018, but the sale of four-wheel farm tractors increased by 15% YoY in the first half of 2019 (after witnessing 25% YoY increase in January-March, and 13% growth rate in full-year 2018). The market of self-propelled combines however put on the brakes: this segment recorded 5% growth rate year to date, after gaining over 18% in 2018.

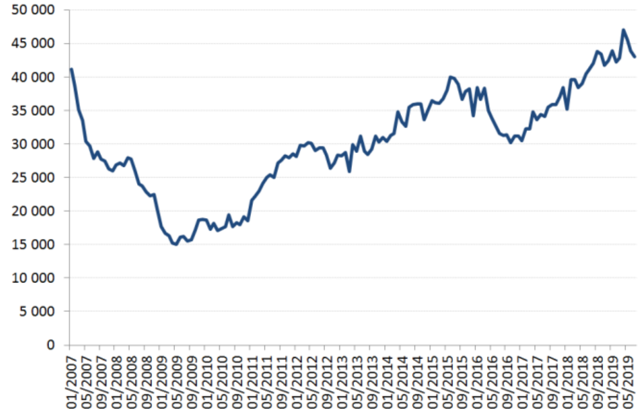
Only 7% of Rába's revenues come from the USA, and Rába has only a smaller share in the US truck business. But being a supplier to John Deere and Marmon-Herrington, Rába may have stronger position in other machinery segments. Rába also benefited from exchange rate changes in Q2 as the rising USD/HUF improved Rába's performance in HUF terms (+40% YoY).

New medium & heavy truck registrations in the EU (SA, 2015 average = 100)



Sources: ACEA, OTP Research

Heavy weight truck retail sales in the US (seasonally adjusted annual rate, thousand units)



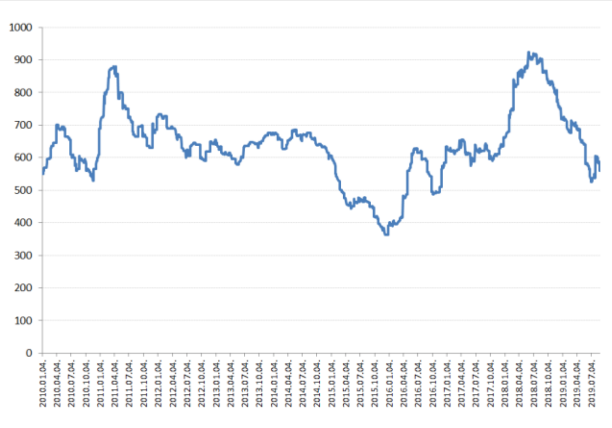
Source: US Bureau of Economic Analysis

The CIS market for Rába dried up the last quarter, export revenues in EUR fell to its fifth in Q2 2019. The whole Russian market of medium and heavy trucks keeps on hitting the brake, which does not support Rába's performance there. Truck registration figures in Russia witnessed 6% YoY fall in the January-June period. The sales of Rába in the CIS dived: the EUR 0.3m quarterly sales revenue is the lowest in almost four years.

However, sales performance in other markets can offer some solace in this latest quarter: Rába's EUR 2.4m revenue is about 70% higher than a year before, and the growth rate is even higher in HUF terms.

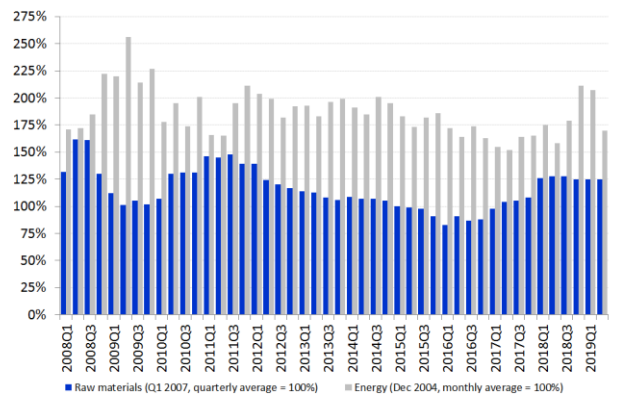
Repeated outstanding performance in the domestic market, similarly to the first quarter of 2019. The domestic revenues of the vehicle unit doubled YoY, while parts sales jumped by 13%, and the inland sales revenue of the axle unit declined 5% YoY in the April-June period. New information on the expected public orders under the "Zrínyi 2026" military development programme is yet to be published.

Steel market prices declined significantly in Q2 2019 (hot-rolled coil, USD/metric tonnes)



Source: Bloomberg

Input cost indices of Rába Automotive (quarterly averages)



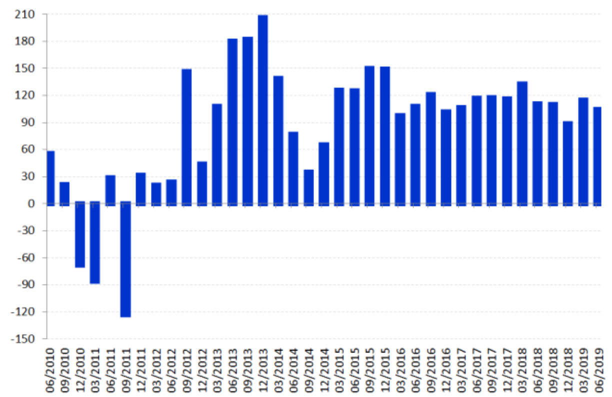
Source: Rába Automotive Holding

Base material prices on a declining path. Market conditions in the international steel market started to change in the second half of last year. Steel futures in the global commodity market dropped by the middle of summer from the peak reached at the end of June, and aside from some breaks, prices have been steadily coming down since then. By the end of June the benchmark price of hot-rolled coils declined 60% on a yearly horizon, while Q2 quarterly average price fell 10% from the Q1 quarterly average and it is 20% lower than the average price registered in the fourth quarter of 2018.

According to the input cost indices reported by Rába, raw material prices are roughly at the same level as a year ago. At the same time, the quarterly energy price index was 8% higher in Q2 2019 than in the corresponding period of 2018, increasing the direct cost of production.

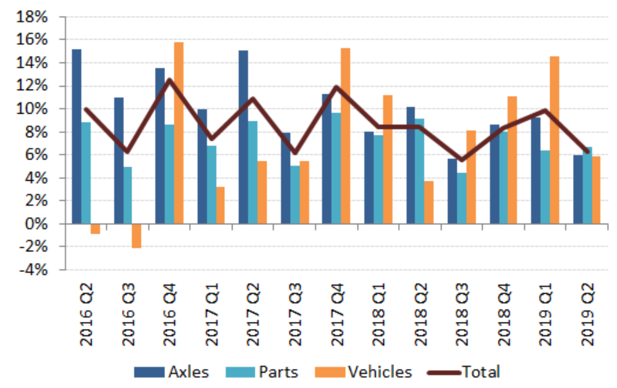
Due to the direct cost side effects, Rába's gross margin deteriorated to 19% in the past quarter. On the level of EBIT and EBITDA, we can also see significant deterioration. Due to the stabilization of somewhat higher general administration costs (partly as a result of double-digit wage growth and/or other undetailed cost items), EBIT margin fell to 2.3%, from 4.1% a year earlier. EBITDA margin declined to 6.4%, from 9.8% in Q1 2019 and 8.4% in Q2 2018.

The decline of 4Q EPS stopped in Q1 2019 (HUF)



Source: Rába Automotive Holding

EBITDA-margins at Rába's business units



Source: Rába Automotive Holding

The deterioration of EBIT and EBITDA margins affected all the three business units, but the decline of margins was the most noticeable at the vehicle unit. Its EBITDA margin fell to 6%, from the 8–15% levels reported in the previous three quarters, while the Q2 figure also falls below the long-term average.

The short-term sales outlook remains uncertain

- We maintain our expectation of strong demand in the short run, in and outside the EU. Under the circumstances, the recent market loss of Rába's axles business in the EU is a disquieting phenomenon. Besides, risks surrounding economic growth in the eurozone and in the global economy are multiplying.
- The slowdown in the USA and Russia this year is also part of the baseline scenarios. In the short run, right now there are no strong signals of losing steam. The US agricultural machinery market is expected to stabilize at an

- elevated level, but the tariffs imposed on steel products and agricultural commodities affect both the supply and the demand sides of the agricultural machinery market. The question is whether the replacement market may still allow modest gains, or farmers postpone their investment.
- Uncertainty surrounding global trade-related issues still lingers; it remains to be seen how any new measures affect the European commercial vehicle market.
- In November 2018 Rába Automotive announced the renewal of the framework contract (Vehicle Procurement Program, VPP) between its subsidiary Rába Vehicle Ltd. ('Rába Jármű') and the Hungarian Ministry of Defence. Although several news reports emerged in the press this year about the high-volume purchases of the Hungarian Ministry of Defence, new information on the expected public orders in the frame of the "Zrínyi 2026" military development program is yet to be published.
- We maintain our expectation of modest revenue gain this year. Domestic demand seems to be solid, while risks surrounding the core export markets of Rába point to the downside. However, the weakening HUF may cushion the potential decline of the sales revenues.
- On the costs side, Rába still faces challenges. It seems that in the present economic circumstances Rába lacks the tools to effectively manage rising energy and labour cost, which are the major drags on profitability. If the global economic downturn once occurs, the cost side may ease for Rába, though simultaneously the revenue side may also weaken.

Tables

CONSOLIDATED INCOME STATEMENT HUFm	2014	2015	2016	2017	2018	2019E	2020E	2021E
Domestic sales	19 526	17 838	16 216	15 233	15 827	16 459	16 729	16 234
Export sales*	28 390	28 315	26 413	28 609	32 805	32 648	32 549	32 406
Total sales revenue	47 916	46 154	42 629	43 842	48 632	49 107	49 278	48 640
Direct cost of sales	-38 725	-36 317	-33 200	-34 577	-38 262	-38 900	-39 348	-39 010
Gross profit	9 191	9 837	9 429	9 265	10 370	10 207	9 930	9 630
Indirect costs of sales	-7 299	-7 640	-7 429	-7 116	-8 620	-8 441	-8 066	-7 997
EBIT	1 891	2 196	2 000	2 149	1 751	1 766	1 864	1 633
EBITDA	4 122	4 465	4 122	4 100	3 790	3 850	3 925	3 591
Net financial profit/loss	-584	-104	-11	-101	-109	-110	-50	-50
Profit before tax	1 308	2 093	1 989	2 048	1 642	1 656	1 814	1 583
Tax	-456	-410	-612	-479	-445	-378	-396	-392
After-tax profit	852	1 682	1 378	1 569	1 197	1 278	1 418	1 191
Dividend	0	0	271,648	307	238	256	265	263
EPS	66	129	103	117	90	96	106	89
DPS			20	23	18	19	20	20

*Unconfirmed, estimated on the basis of official consolidated total sales and preliminary export sales figures.

CONSOLIDATED BALANCE SHEET	HUFm							
	2014	2015	2016	2017	2018	2019E	2020E	2021E
Property, plant, equipment	14 977	14 832	14 410	15 818	19 145	18 762	18 574	17 645
Intangible assets	1 071	789	500	282	183	185	166	158
Non-current assets	17 276	16 723	15 799	16 876	20 021	19 764	19 557	18 619
Inventories	6 629	6 211	5 728	7 008	9 072	8 103	8 853	9 021
Receivables and other current assets	11 304	8 375	10 075	9 864	12 264	11 851	12 788	11 215
Cash and cash equivalents	1 025	3 199	1 900	2 638	684	2 947	1 613	1 979
Current assets	18 976	17 807	17 703	19 562	22 054	22 641	23 254	22 216
TOTAL ASSETS	36 252	34 530	33 502	36 438	42 075	42 405	42 460	40 483
Share capital	13 048	13 138	13 473	13 473	13 473	13 473	13 473	13 473
Own shares	0		-109	-109	-109	-109	-109	-109
Capital reserve	73	64	0	0	0	0	0	0
Stock option reserve	97	67	0	0	0	0	0	0
Retained earnings	1 857	3 837	5 314	6 613	7 500	8 523	9 583	10 633
Total Equity	15 075	17 107	18 679	19 978	20 865	21 887	22 947	23 997
Long-term loans and other liabilities	6 424	3 006	2 239	4 373	5 916	5 324	4 659	3 993
Provisions	315	261	150	163	245	245	0	0
Non-current liabilities	6 739	3 267	2 434	4 619	6 262	5 420	4 308	3 642
Loans and credits	3 185	3 570	746	1 582	2 186	4 920	5 585	6 251
Payables and other short-term liabilities	11 252	10 587	11 541	10 140	12 489	10 804	10 409	9 996
Current Liabilities	14 438	14 156	12 389	11 841	14 948	15 097	15 205	12 843
TOTAL EQUITY AND LIABILITIES	36 252	34 530	33 502	36 438	42 075	42 405	42 460	40 483

CONSOLIDATED CASH FLOW	HUFm							
	2014	2015	2016	2017	2018	2019E	2020E	2021E
EBITDA	4 122	4 463	4 122	4 100	3 790	3 850	3 832	3 714
Cash flow from operation	3 778	6 641	3 244	1 075	1 218	3 179	1 343	4 302
Cash flow from investment	-3 278	-1 790	-1 203	-3 154	-5 184	-1 701	-1 855	-1 020
FCFF	500	4 851	2 041	-2 079	-3 966	1 478	-512	3 282
FCFE	1 107	1 924	-1 556	813	-1 898	3 535	-550	3 244

Sources: Rába Automotive, OTP Research

Deduction of 12M target price

Rába's valuation (HUFm)	2018	2019	2020	2021	2022	2023	FCFF in the explicit period
FCFF	-3 971	1 718	-512	3 282	-2 009	1 046	
Discount factor	0,92	0,94	0,93	0,93	0,93	0,93	
DCF	-3 663	1 609	-447	2 671	-1 518	731	3 046
Terminal value (HUFm)							27 700
Net present value (HUFm) of TV							19 120
Enterprise Value (incl. possible future property sale) HUFm							23 486
Net debt							7 297
Equity value - Dec 31 2018, HUFm							16 188
Number of shares							13 352 765
Expected return on equity							8,6%
12M Target price							**1 317**
Current price							1 150
Upside/Downside							14,5%
TR Upside/Downside							16,1%

Source: OTP Research

Risks surrounding Rába's economic activity

FX risk: As export sales have a dominant share in Rába's sales performance, the company is exposed to exchange rate fluctuations. About 60–70% of the total sales revenue is FX-dominated, which climbed from 65% in 2017 to 67% in 2018, and is expected to remain well above 60% in the coming years.

Raw material & energy prices: Raw material (steel) prices stopped increasing last year. Steel prices on the global commodity market started do decline in mid-2018. Since the second half of 2018, benchmark steel prices have been dropping, and by the middle of 2019 prices fell more than 20%, when comparing quarterly averages. At the same time rising energy prices put Rába's profitability under pressure.

Economic environment: Although the sales performance of Rába shows robust demand, the international economic environment adds downside risk to our forecast. The eurozone is expected to lose momentum, and risks (e.g. trade conflicts, just to name one) surround the global growth outlook. The base scenario our forecast is built upon bears considerable downside risks. And while the Hungarian monetary and exchange rate policy is also changing, in case of an external shock, the monetary policy will be able to accommodate itself to that situation through exchange rates.

Labour supply: The present labour market developments, particularly the prevailing labour shortage may arrive at a point when it may harm the companies' growth potential, and result in higher labour costs, or extra capex need to substitute labour force with robotisation, or may lead to chronic capacity shortage. Rába is located in Western Hungary, where unemployment practically vanished, and the local labour market is very supply-driven.

Risks surrounding Rába's property for sale: Although we do not expect this property to be sold soon, if it happens, the sales revenue adds relatively significant value to Rába's enterprise value. Should the property be reclassified as residential area, from the present classification as arable land, that would be a strong value generating factor.

Ownership: Apparently, the state-owned MNV's 75% ownership in Rába made no palpable changes to the company's operation or strategy. A significant part of MNV's asset portfolio consists of companies linked to public services – from this point of view Rába, an industrial manufacturer which operates under market conditions, does not seem to fit the owner's portfolio. MNV has not published a comprehensive strategy or a clear view on its goals with Rába, except the declaration at the time of the buyout on strengthening the state's presence in strategic sectors like the automotive industry. A further risk is that directives centrally declared on the operation of state-owned companies make no difference between companies, and do not take into consideration the sector's characteristics. Although we consider the dominant state ownership a real risk, this research does not factor it in.

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 Rába Automotive Holding in the past twelve months:

Period	Recommendations	Percent of Recommendations
Q3 2018	**BUY**	**100%**
	HOLD	0%
	SELL	0%
Q4 2018	**BUY**	**100%**
	HOLD	0%
	SELL	0%
Q1 2019	**BUY**	**100%**
	HOLD	0%
	SELL	0%
Q2 2019	**BUY**	**100%**
	HOLD	0%
	SELL	0%

Date	Recommendation	Target Price	Publication
17/05/2018	HOLD	HUF 1469	Quarterly Earnings Update
29/08/2018	BUY	HUF 1427	Quarterly Earnings Update
15/11/2018	BUY	HUF 1412	Quarterly Earnings Update
22/11/2018	BUY	HUF 1412	Equity Note
21/02/2019	BUY	HUF 1502	Quarterly Earnings Update
04/04/2019	BUY	HUF 1403	Equity Note
15/04/2019	BUY	HUF 1403	Equity Note
15/05/2019	BUY	HUF 1403	Quarterly Earnings Update
29/08/2019	BUY	HUF 1317	Quarterly Earnings Update

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

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