

# EQUITY NOTE: ZWACK UNICUM

**Recommendation: HOLD**

**Target price (12M): HUF 17,891**

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## Highlights

We maintain our HOLD recommendation on Zwack Unicum (Zwack HB; ZWCG.BU) with a new 12M target price of 17,891 HUF/share, 2% higher than the HUF 17,550 closing price on May 24, 2018. Estimated total return is 8% on a 12-month forecast period.

## Summary/Earnings Highlights

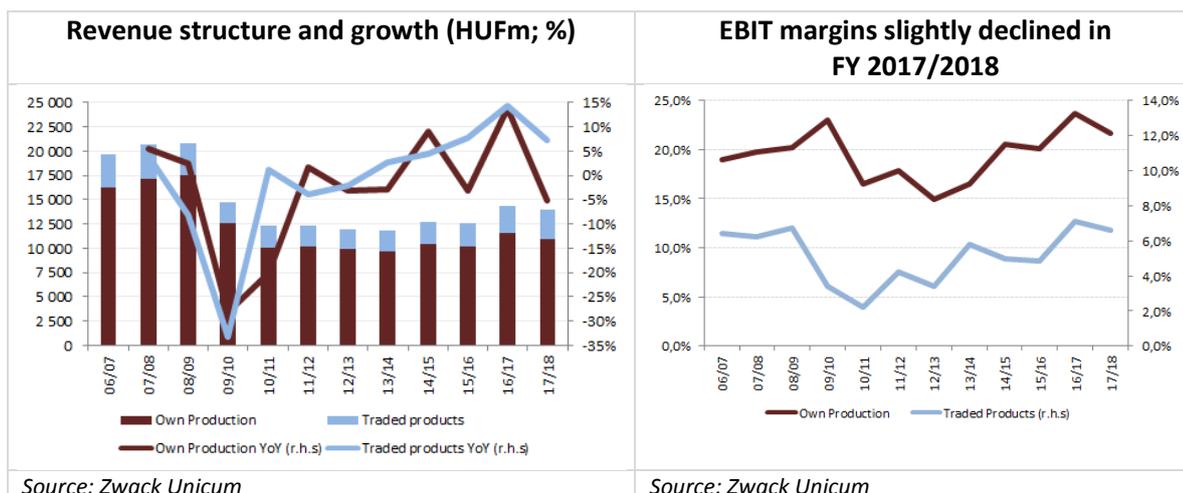
- Zwack Unicum reported less than 1% net sales decline in January-March 2018, with domestic sales falling 4% and exports jumping 15% YoY. Zwack Unicum's full-year net sales dropped 2% to HUF 14.0bn.
- Gross profit in the January-March period declined by 10% YoY, while other profit figures resulted generally in smaller losses than one year ago in the weakest period of the year. Full-year EBIT and EBITDA suffered double-digit decline. Full-year net profit decreased by only 1% YoY thanks to the corporate tax cut, resulting in HUF 1,083 EPS in FY 2017/2018 compared to HUF 1,094 one year ago.
- Full-year profit margins declined due to changes in the composition of sold products. The share of own production decreased throughout the year owing to earlier heavy stockpiling of 'Kalinka' vodka, while the share of the traded portfolio with lower profit content increased somewhat last year.
- Current macro environment with fast wage growth and low unemployment supports steady and strong consumption growth, providing Zwack with positive sales outlook. Though, Zwack's sales figures still do not reflect the effects of this favourable economic environment. If sales fail to increase in the coming quarters, that adds downside risk to profit expectations and the equity value as well.
- Besides, regulatory changes pose real risk to the positive prospects as the EU expressed criticism on the discriminative taxing policy of spirits in Hungary. Currently, herbal liqueurs and 'pálinka' are exempt from the so called Public Health Tax (NETA), while losing the exemption may result in strong sales decline as demand tightens.
- We revised slightly our sales and earnings forecast. However, due to uncertainties surrounding legal changes, the effect of new taxation is not yet calculated in the forecast. We expect HUF 14.6bn sales income, HUF 3.0bn EBITDA and HUF 1,069 EPS in the present business year.
- Zwack also announced dividend payment of HUF 1,050 per share (93% payout ratio) offering 6% dividend yield. The Management's dividend proposal is expected to be approved by the shareholders on the AGM to be held on June 27, 2018.

## Financial highlights of Q4 earnings report

**Sales revenues in January-March slightly fell, despite the low base period.** Sales in the January-March period are usually sluggish, but it came as a small surprise that domestic net revenues declined last quarter even compared to the relatively low base period in

2017 (higher taxes on Kalinka vodka took effect on January 1, 2017). Domestic sales fell by 4% YoY, even Easter failed to support growth, but the export sales' 8% surge somewhat offset its negative effect. However, export growth may well be a one-off effect, YoY export sales to Germany increased by a third in January-March, as the delivery of the summer promotional packages has been forwarded to the distributor as early as in March. Sales of own production grew by 3% in January-March, while the sale of traded brands fell 12%.

Zwack's full-year net sales income dropped by 2% to HUF 14.0 bn. The decline caused no surprise as due to previous heavy stockpiling, sales shrank throughout the year except one quarter.

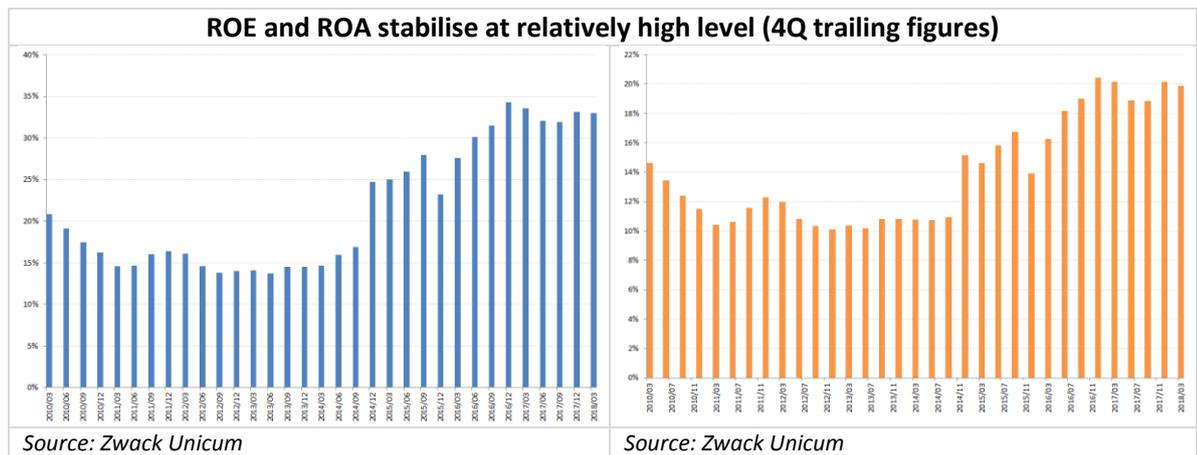


**Declining margins with counterbalancing effect of the significant corporate tax rate cut.** In the January-March period gross profit fell by 10% YoY, while losses in the level of operating and net income, usual in the last quarter of the financial year shrank. Thanks to the significant corporate tax rate cut (corporate tax rate fell from 19% to 9%, uniformly), Zwack's effective tax rate fell from 24% near 15% in a year, resulting in HUF 312m net loss in the latest quarter, the same amount as one year ago. Gross profit margin in the January-March period fell relatively far from the level Zwack usually performs in this period of the year. Material costs jumped by 10% YoY, the company reported significant price increase of certain herbal ingredients, also adding to higher inventory values.

Zwack Unicum's full-year EBIT sank 13% YoY, while EBITDA fell by 12% and net profit declined by 1%. The full-year EPS amounted to HUF 1,083 slightly lower than the HUF 1,094 level in the previous business year.

With own production falling and the sales of the distributed products increasing YoY, Zwack's profit margins deteriorated in the FY of 2017/2018. Gross profit margin decreased to 56.8% from 57.7% one year earlier, EBIT margin declined to 18.5% from previous 20.7%, and EBITDA-margin shrank to 22% vs. 24% one year ago as payroll costs increased. Net profit margin improved slightly, to 15.8% due to tax changes.

Profitability stabilised in the past four quarters at relatively high level. The 4Q rolling ROE and ROA slightly decreased compared to the previous quarter, but remained close to 33% and 20% respectively, well above the industry average. In terms of historical comparison, the figures of this latest quarter are the fourth best ones in the past seven years beginning from the legalization of home distilleries in 2010.



**Economic background – Supporting macro environment, strong competition in the spirits market.** The current macro-environment is still expected to be favourable for Zwack, as the ongoing fast wage growth with low unemployment will result in rapid consumption growth and is likely to positively affect demand for its products. Monetary policy is also supportive, as not only euro, but also HUF interest rates could remain low for an extended period, while the National Bank is expected to keep the HUF at current levels, but an appreciation would result in stronger price competition through imported spirits. However, Zwack’s sales figures fail to reflect the positive effects of the favourable economic environment. Although the January-March period is the weakest quarter, this was the first one free from the “Kalinka” stockpiling effect. Despite the low base period, domestic sales did not show new strength. If the sales income fails to gather momentum in the coming quarters, it adds a downside risk to our forecasts and valuation.

**Regulatory changes add to concerns.** The EU expressed criticism on the currently effective discriminatory taxing policy of spirits in Hungary. The European Commission lately sent Hungary a reasoned opinion for granting an exemption from the public health tax to fruit distillates, such as 'pálinka', as well as to herbal liqueur which are mostly produced domestically.

According to the regulation in effect sales of bitters and 'pálinka' are exempted from paying the so-called Public Health Tax (NETA in Hungarian), while other spirits between 35 and 45 degrees of alcohol are subject to HUF 700 tax per litre. Calculating with about 3 million litres yearly consumption of Unicum, it means more than HUF 2bn increase in tax payment only in terms of Zwack’s Unicum product line. Zwack may decide to fully pass higher taxes on to customers by raising the selling price by the same amount, but it would risk significant decline in demand and its market position in a very price sensitive market. As forecasting legal outcomes goes beyond the capacity of this present equity research, our earnings forecast for the present does not calculate with tax changes. Regulatory changes pose real downside risk to our sales forecast.

**Revision of our forecast.** In light of the developments of the January-March period, we revised our sales, cost and profit forecasts. In the present financial year (April 01, 2018 – March 31, 2019) we expect HUF 14.6bn net sales income, HUF 2.5bn EBIT and HUF 1,069 full-year EPS, slightly down from the earlier sales forecast of HUF 14.9bn, while EBIT and EPS forecasts have been decreased by 7% each. Next year dividend per share is expected to remain at the present level of HUF 1,050.

**Valuation.** We raise our 12-month target price to HUF 17,891/share from the previous HUF 17,781/share. We revised our sales and earnings forecast slightly down but possible

tax changes are not yet implemented due to lack of information. Changes in net debt due to higher cash and smaller debt liabilities compared to the previous forecast explain changes in equity value.

Profit & Loss Statement (HUF m)	2015/2016	2016/2017	2017/2018	2018/2019F	2019/2020 F	2020/2021F
Domestic net sales	11 033	12 854	12 418	13 039	13 626	14 171
Export sales	1 425	1 427	1 540	1 532	1 563	1 594
<b>Net sales income</b>	<b>12 458</b>	<b>14 281</b>	<b>13 958</b>	<b>14 571</b>	<b>15 188</b>	<b>15 765</b>
Material-type costs	5 306	6 044	6 032	6 266	6 531	6 779
<b>Gross profit</b>	<b>7 152</b>	<b>8 237</b>	<b>7 926</b>	<b>8 305</b>	<b>8 657</b>	<b>8 986</b>
<b>Total operating expenditures</b>	<b>5 781</b>	<b>6 021</b>	<b>6 051</b>	<b>6 354</b>	<b>6 796</b>	<b>6 964</b>
<b>EBIT</b>	<b>2 160</b>	<b>2 959</b>	<b>2 580</b>	<b>2 535</b>	<b>2 469</b>	<b>2 652</b>
<b>Pre-tax profit</b>	<b>2 177</b>	<b>2 940</b>	<b>2 582</b>	<b>2 530</b>	<b>2 459</b>	<b>2 637</b>
Tax	483	714	378	354	295	316
<b>Profit after tax</b>	<b>1 694</b>	<b>2 226</b>	<b>2 204</b>	<b>2 175</b>	<b>2 164</b>	<b>2 321</b>
Dividend	1 725	2 137	2 137	2 137	2 035	2 137
<b>EPS (HUF)</b>	<b>832</b>	<b>1 094</b>	<b>1 083</b>	<b>1 069</b>	<b>1 063</b>	<b>1 141</b>
<b>DPS (HUF)</b>	<b>850</b>	<b>1 050</b>	<b>1 050</b>	<b>1 050</b>	<b>1 000</b>	<b>1 050</b>

Balance sheet (HUFm)	2015/2016	2016/2017	2017/2018	2018/2019F	2019/2020F	2020/2021F
Property, plant, equipment	2 845	2 891	3 205	3 500	3 710	3 803
Intangible assets	119	106	89	94	103	103
<b>Non-current assets</b>	<b>3 283</b>	<b>3 157</b>	<b>3 447</b>	<b>3 840</b>	<b>4 069</b>	<b>4 168</b>
Inventories	1 876	1 862	2 185	2 496	2 321	2 289
Receivables and other current assets	2 162	2 208	2 275	2 395	2 604	2 549
Cash and cash equivalents	2 257	2 809	2 770	2 768	2 886	2 995
<b>Current assets</b>	<b>6 295</b>	<b>6 879</b>	<b>7 230</b>	<b>7 660</b>	<b>7 811</b>	<b>7 834</b>
<b>TOTAL ASSETS</b>	<b>9 578</b>	<b>10 036</b>	<b>10 677</b>	<b>11 500</b>	<b>11 879</b>	<b>12 001</b>
Share capital	2 000	2 000	2 000	2 000	2 000	2 000
Capital reserve	165	165	165	165	165	165
Retained earnings	4 045	4 558	4 662	4 701	4 729	5 014
<b>Total Equity</b>	<b>6 210</b>	<b>6 723</b>	<b>6 827</b>	<b>6 866</b>	<b>6 894</b>	<b>7 179</b>
Long-term loans and other liabilities	360	427	410	406	389	389
<b>Non-current liabilities</b>	<b>360</b>	<b>427</b>	<b>410</b>	<b>406</b>	<b>389</b>	<b>389</b>
Loans and credits	0	0	0	20	23	11
Payables and other short-term liabilities	2 310	2 889	3 384	4 136	4 545	4 397
<b>Current Liabilities</b>	<b>3 008</b>	<b>2 886</b>	<b>3 440</b>	<b>4 228</b>	<b>4 597</b>	<b>4 433</b>
<b>TOTAL EQUITY AND LIABILITIES</b>	<b>9 578</b>	<b>10 036</b>	<b>10 677</b>	<b>11 500</b>	<b>11 879</b>	<b>12 001</b>

CONSOLIDATED CASH FLOW (HUFm)	2015/2016	2016/2017	2017/2018	2018/2019F	2019/2020F	2020/2021F
EBITDA	2 674	3 474	3 068	3 033	3 161	3 281
Cash flow from operation	2 132	2 601	2 854	3 014	3 198	2 898
Cash flow from investment	-698	-371	-765	-871	-901	-708
FCFF	1 434	2 230	2 089	2 143	2 297	2 190
FCFE	1 445	2 232	2 091	2 159	2 291	2 165

Sources: Zwack Unicum, OTP Research

## Deduction of 12M Target Price

Zwack's valuation (HUFm)	Base Year	2019/2018	2020/2019	2021/2020	2022/2021	2023/2022	FCFE in the explicit period
FCFE	2 091	2 159	2 291	2 165	2 241	2 256	
Discount factor	0,91	0,92	0,92	0,91	0,91	0,91	
DCF	1 913	1 979	2 098	1 977	2 045	2 051	10 151
Terminal Value (HUFm)							33 007
Present Value (HUFm)							31 034
Net debt							-2 342
Equity value (HUFm) - March 31, 2019							33 376
Number of shares							2 035 000
Expected return on equity							9,1%
12M Target price							<b>17 891</b>
Current price							17 550
Upside/Downside							2%
TR Upside/Downside							8%

### Risks surrounding Zwack's economic activity

**Regulatory risk:** In recent years regulatory changes in the industry caused headwinds to the company's profitability. The most notable was the liberalization of spirit distillation at home in small quantities in 2010. The EU lately expressed criticism on discriminative taxing policy of spirits in Hungary and starts infringement process against Hungary (see above).

**Exchange-rate risk:** As the company operates in foreign markets as well and the share of export is increasing among the revenues, exchange-rate risk could be an issue in the future, if not managed properly. Moreover the price of most of its new raw materials is denominated in EUR, so a significant depreciation of the HUF against the EUR could decrease the company's profitability. But in the short run, the fundamentals of the Hungarian economy are strong, so the risk of sharp HUF depreciation is low. Moreover the loss on exchange rates could be somewhat offset by the higher export revenue.

**Cost-inflation risk:** Due to the improving economic conditions and labour shortages in various industries, real wages started to increase significantly in 2016 and they are expected to do so in the near future. As Zwack's business is labour-intensive (the share of personnel cost is almost 45%), it will be heavily affected by future wage increases which could erode margins.

**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. \(Also available in Hungarian\)](#)

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OTP Bank Plc's recommendations and price targets history for Zwack Unicum in the past twelve months:

Date	Recommendation	Target Price	Publication
15/12/2017	BUY	HUF 17,668	Initiation Coverage
06/02/2018	HOLD	HUF 17,781	Quarterly Earnings Update
24/05/2018	HOLD	HUF 17,891	Quarterly Earnings Update

[The list of all recommendations made in the past 12 months is available here.](#)

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