Company Analysis
Atlantic Group (ATGR)

Coffee *Price* Kept Them Awake at Night

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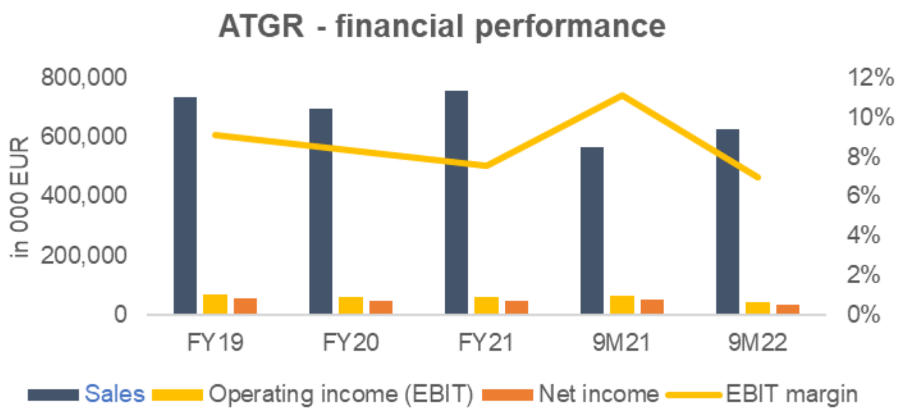
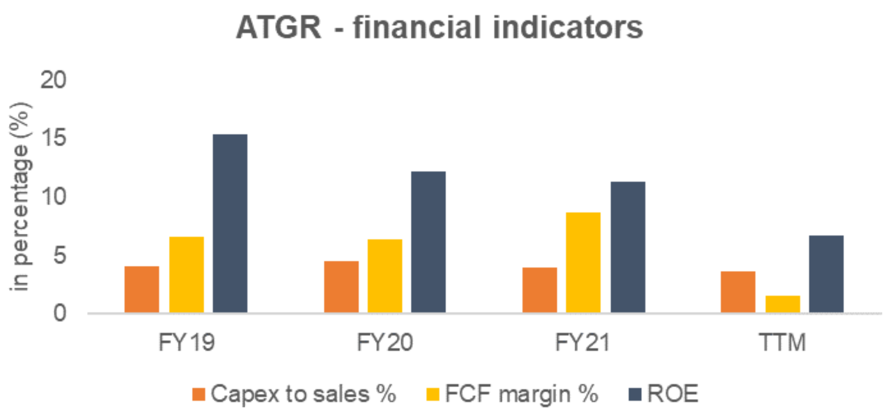
Executive summary



Source: Financial statements; Bloomberg Adria analysis



Source: Financial statements; Bloomberg Adria analysis

With the exception of 2020 for obvious reasons, **Atlantic Group** is **steadily growing its top line**. Double-digit inflation and tourism recovery have both contributed to top line increase, primarily in the coffee and beverages segment during the course of this year. On the other hand, **input cost inflation outpaced the sales growth** and resulted in margin contraction. In absolute terms, the main catalyst comes from the increase in material costs, particularly input costs of raw coffee, followed by the increase of energy costs.

In terms of geographical dispersion, not much has changed over the last 3 years, and Croatia is still the strongest ATGR's market, accounting for 34.6% of sales in 9M22, followed by Serbia with 23.5% and Slovenia with 17.1%.

Distribution is still the **largest segment in terms of sales**, accounting for 27.3% during 9M22, **followed by coffee segment** with 21.4%. Distribution is of particular importance for Atlantic given the strong brands in their distribution arm (e.g., Ferrero, Rauch, Mars, etc.) and the leverage it captivates in negotiating with retailers for the placement/sale of ATGR's own brands.

While the **cost of materials and energy were unsustainably growing** given the market environment, **cost of employees** has surprisingly been **under control**. Moreover, Atlantic is demonstrating **robust productivity** of its employees compared to its main regional competitor (i.e., Podravka), with the sales per employee indicator being higher by double-digit percentage.

Regarding **CAPEX**, Atlantic was slightly **inactive in the previous decade** due to past debt-generating actions i.e. the leveraged buyout of Droga Kolinska, however, course has been diverted in the last 3 years, demonstrated by average capex to sales ratio of 4.2% for the period 2019-2021. As for the working capital, ATGR displays **good working capital management skills**, particularly in respect of inventory management, with inventory turnover exceeding 5x a year.

On the horizon, we struggle to see a segment that can deliver high single or double-digit CAGR in sales, with the exception of Other segment which consists of recently launched brands such as Jimmy Fantastic and Boom Box. This segment is still in its early stages and hence, we predict continuous material growth upward of 20% CAGR for the following 5-year period, but is yet to become profitable. Spreads segment on the back of Argeta, Distribution segment and Donat segment are expected to deliver low to mid-single-digit growth in top line in the following 3-5 years, while we don't see growth potential in beverages and snacks segments.

We envisage a full recovery of profitability to materialize only in 2024-2025 due to projected contraction of economic activity in 2023 and above average inflation levels, which will maintain input costs at elevated levels.

ATGR’s challenges to **grow organically**, in conjuction with stable financial position i.e. low debt are indicative of **potential (sizable) acquisition** going forward. Fortenova break up may offer opportunities in ATGR's core segment, which would require major financial sacrifice equivalent to the one made for the acquisition of Droga Kolinska, however, it would also result in important consolidation of ATGR's market position.

Sales is increasing, however...

Bloomberg Adria

STATEMENT OF FINANCIAL PERFORMANCE

in 000 EUR	FY19	FY20	FY21	9M21	9M22	Change 9M
Sales	732,671	697,195	757,887	564,315	624,968	10.7%
Other income	10,072	10,174	11,070	6,807	8,632	26.8%
Total revenue	**742,743**	**707,370**	**768,957**	**571,123**	**633,600**	**10.9%**
Cost of trade goods sold	(215,898)	(207,686)	(229,893)	(165,463)	(181,147)	9.5%
Change in inventories	2,460	3,539	3,034	2,318	(3,960)	-270.8%
Material and energy costs	(200,105)	(190,282)	(206,921)	(152,431)	(201,970)	32.5%
Staff costs	(118,764)	(113,583)	(124,582)	(89,703)	(94,081)	4.9%
Marketing and promotion costs	(43,361)	(35,459)	(43,829)	(27,910)	(27,565)	-1.2%
Depreciation, amortisation and impairment	(37,540)	(36,415)	(38,070)	(25,378)	(26,479)	4.3%
Other operating costs	(71,259)	(68,390)	(71,026)	(48,931)	(56,892)	16.3%
Other losses/gains - net	9,228	(396)	534	(302)	2,685	-988.5%
Operating income (EBIT)	**67,502**	**58,699**	**58,205**	**63,324**	**44,193**	**-30.2%**
Finance costs - net	(674)	(538)	(314)	(1,631)	(1,655)	1.5%
Profit before tax	**66,828**	**58,161**	**57,891**	**61,692**	**42,537**	**-31.0%**
Income tax	(9,852)	(9,210)	(9,875)	(8,587)	(6,507)	-24.2%
Net income	**56,976**	**48,951**	**48,016**	**53,105**	**36,030**	**-32.2%**
Non-controlling interest	201	72	138	44	117	163.7%
Net income attributable to owners	**56,776**	**48,879**	**47,879**	**53,061**	**35,913**	**-32.3%**
EBIT margin	*9.1%*	*8.3%*	*7.6%*	*11.1%*	*7.0%*	***-4.1 pp***
EBITDA margin	*14.1%*	*13.4%*	*12.5%*	*15.5%*	*11.2%*	***-4.4 pp***
Net income margin	*7.7%*	*6.9%*	*6.2%*	*9.3%*	*5.7%*	***-3.6 pp***

Source: Financial statements; Bloomberg Adria analysis

Aside from the brief slowdown in 2020 caused by COVID-19 and related civil protection measures – which impacted mostly their coffee and beverage business segments – **Atlantic is continuously growing their top line.** A full covid recovery in 2022, alongside with increased pricing due to cost inflation has resulted in double-digit sales growth of 11%.

Inflation is severely reflected in their material and energy costs, which spiked by 32.5%. Although energy costs have increased by approx. 78% in 9M22, the bottom line result was relatively more affected by spike in material costs (~44m EUR). Shockingly, **material and energy costs for 9M22 have surpassed those for the whole year in both 2019 and 2020**.

The staff costs increase of 5% in the first 9 months was below the top-line increase and therefore, has – to some degree – offset negative impact on margins. The average number of employees was virtually at the same level; hence the growth **was driven by increased wages.**

In order to protect falling margins, the Management decided to keep a lid on marketing and promotion costs – the most common and reasonable way to protect margins. We expect other industry participants to run with the same practice (eg. already seen in Podravka's financials), which is favourable for Atlantic in order not to lose market share from competitors.

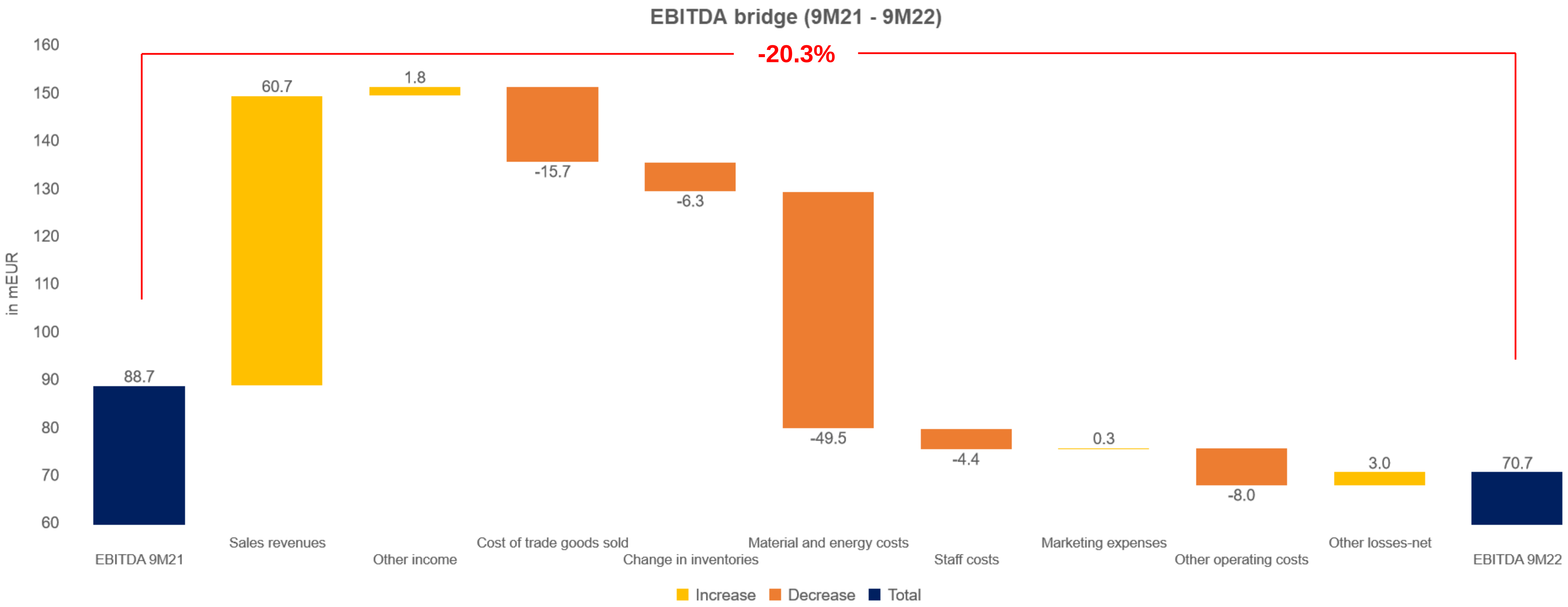
Depreciation and amortization increased slightly in 9M22 as a result of significant capital investment cycle (also during COVID-19 period!), however D&A are broadly stable on a multi-year basis. **Significant investments are expected to continue**, primarily due to low investments earlier in the past decade, proven by average capex to sales of 2.3% for the period 2011-2018. On the back of a deleveraged balance sheet, Atlantic has increased its capital investments, exceeding 4% of sales starting from 2019.

Outlook

In the remaining quarter of this year, we expect further aggravation in profitability, since historically the fourth quarter has always been the least profitable one.

Full recovery of margins is not expected in the short-term, but rather in 2024-2025, on the back of expected easing of inflationary pressures. As inflationary pressures are the main driver of profitability decline, weaker inflation will be helpful for purchasing power recovery, lower input prices and thus, gradual recovery of profitability, albeit matching levels achieved in 2021, not the ones realized in 2019.

Negative incremental gross margin driving lower EBITDA



Source: Financial statements; Bloomberg Adria analysis

This year's growth in sales has been achieved with negative incremental gross margin, given the fact that increase in cost of materials and cost of trade goods exceeded the increase in sales to a fair extent (4.5m EUR). Obviously, largest negative effect can be attributed to the coffee segment due to its high share of sales and significant price increase of raw coffee. Cost of production materials have increased 30.7% yoy, while cost of energy has increased 78.2% yoy. Those factors are out of the Management's control and are common to all industry participants.

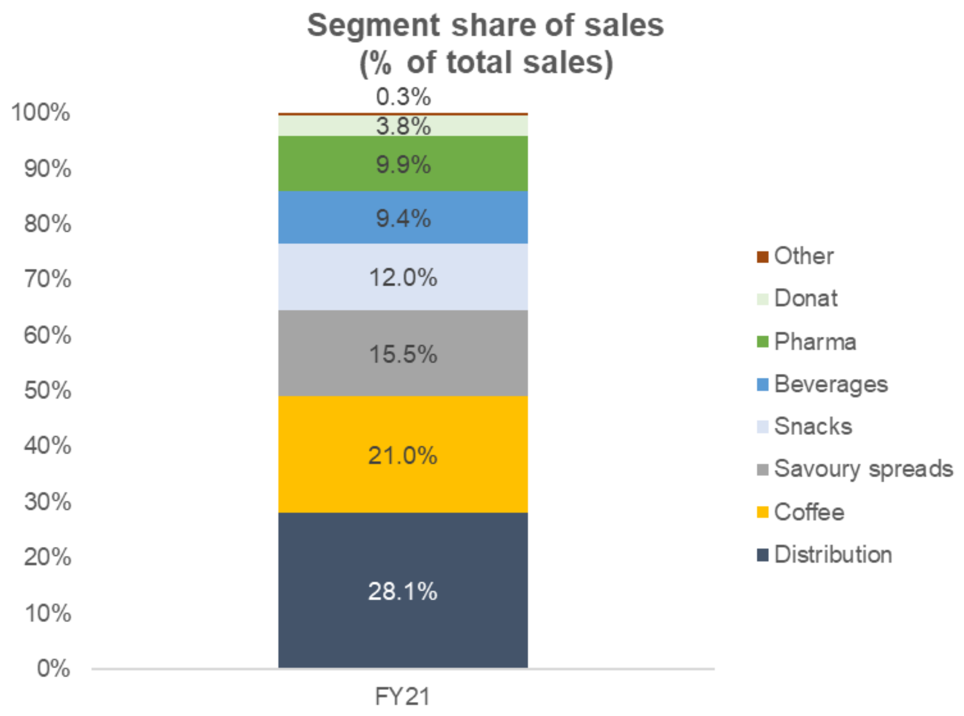
Clearly, Atlantic Group decided to go against the herd and not make significant price modifications due to stable financial position and hence, an ability to absorb majority of the rising costs. Bearing in mind the aggressive price modifications by many market participants, such practice could result in reap of some additional market share. However, in our opinion, gaining or protecting market share by lowering or not increasing prices demonstrates highly competitive environment and company's vulnerability to a certain degree. In addition, resilient inflation will compel ATGR's Management to make upward price modifications in the following periods.

Distribution share of sales not easing

Brands such as Ferrero, Mars, Rauch, Durex, distributed over the Adria region contribute approx. 200m EUR yearly to the top line**. The importance of the distribution segment lies in the fact that it gives Atlantic greater negotiating power towards retailers in placing its own brands and obtaining better financial conditions**. Atlantic has a long-term relationship with some of the key FMCG producers and the segment serves as a perfect extension of its own brands and thanks to which incremental costs of distribution are significantly lower. Thanks to low incremental costs, Atlantic is a cheap middleman for the global producers and clearly their cost-benefit calculations indicate that it is financially more lucrative having Atlantic as a partner, instead of opening a local subsidiary.

Coffee has the largest share of sales among Atlantic's own brands and the largest share of profitability. Key markets for the segment are Serbia (Grand kafa) accounting for nearly 50% of segment sales and Slovenia (Barcaffe) with nearly 30%. Sales of **espresso coffee** have accounted for 7.1% of sales in 2021 and – in our opinion – **represents a subsegment on which Atlantic will predominantly focus in the following years**. Sales of the espresso subsegment has grown its share compared to 2020 (5.3%), but it is still below 2019 (7.3%). Having said that, we presume a low single-digit (1-2%) CAGR for the whole coffee segment, in the upcoming 3-5 years.

Savoury spreads segment thanks to, primarily Argeta, has managed to increase significantly its share by 2.6 pp back from 2019. Argeta is no doubt the most prominent brand due to its international potential and sales in countries such as France, USA, Austria, Germany, Switzerland, etc. In view of strong volume increase during pandemic lockdowns, Atlantic has initiated a process of building a new Argeta plant near Varaždin. The land has already been purchased, however, this process is now postponed indefinitely, since the growth did not keep pace in recent months.



Source: Financial statements; Bloomberg Adria analysis

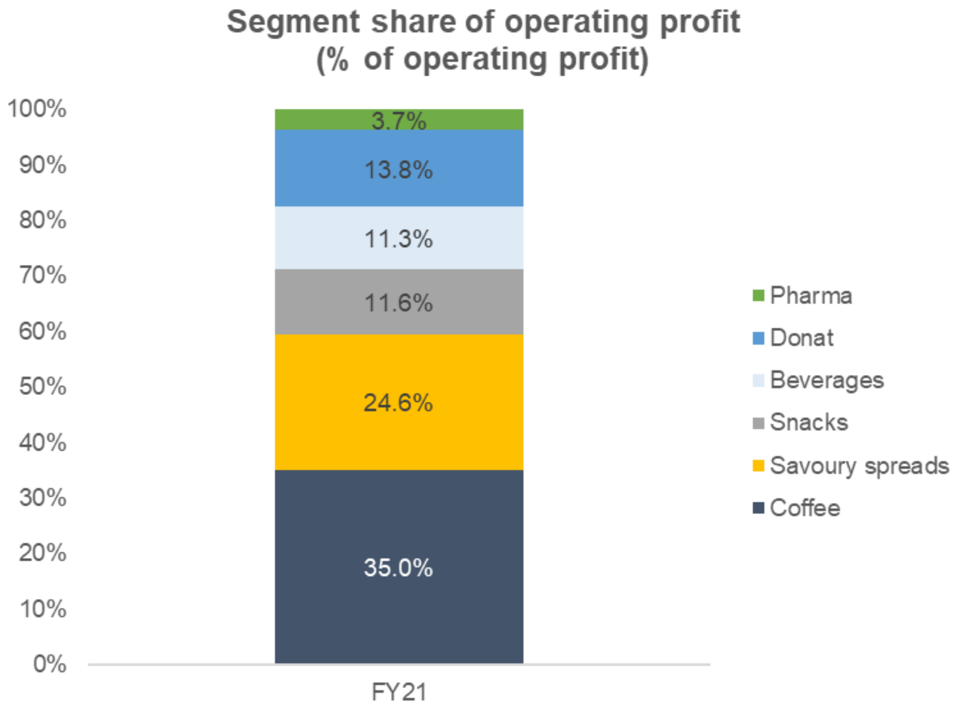
Donat is the most profitable segment/product

Beverages segment was particularly hit by the pandemic-related restrictions in HoReCa and spike in prices of raw sugar. According to Bloomberg subindex, sugar prices have increased 37% yoy in 2021. Segment operating margins were marked down to ~ 14% in 2021, compared to ~ 18% in 2019. In the light of reduced margins, its share of operating profit shrank to 11.3%, from the 21.5% in 2019.

Sugar was also the main cause of shrinking profitability in the **snacks** segment, since confectionery products (high sugar ratio) account for over half of the sales**. In terms of top line, this segment is not delivering any sales growth in the past 4-5 years and given the highly competitive environment, we don't anticipate any changes going forward in that respect.**

Donat is the most profitable business segment with the EBIT margin exceeding 40%. Despite Donat being the least lucrative segment in terms of sales, it is delivering a higher share of operating profit than Snacks segment (10.6% of sales), Bevereges segment (11.1% of sales) and Pharma segment (9.2% of sales) individually. In our opinion, Donat's success is based on successful promotion of Donat as a niche product due to its high magnesium content, which then distinguished it from other carbonated waters (e.g., Jamnica, Radenska) and set the path for hefty margins (i.e., product premiumisation).

Pharma segment is an outlier in Atlantic's portfolio. It is a non-core business segment with the lowest margins, alongside distribution. It generates EBIT margin inferior to 5%, unlike other segments with double-digit margins. By selling their Pharma segment and investing those proceeds in the core business segments, Atlantic would probably cause some top-line damage, however, it would lead to material improvement in their bottom-line. Over the last decade Atlantic has been active in divesting their non-core business segments, and we believe Pharma has remained intact due to its top-line impact. In our opinion, it is a matter of time when offer attractive enough will make them pull the trigger and divest Pharma retail as well.

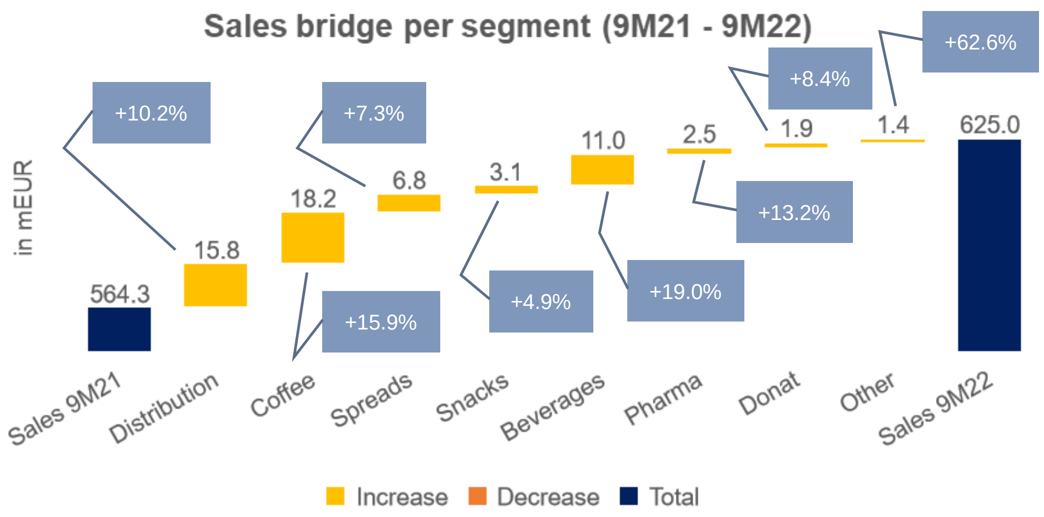


Source: Financial statements; Bloomberg Adria analysis

Disclaimer: ATGR discloses EBIT margins of its business segments prior to certain cost allocations. Additionally, ATGR does not disclose operating profitability of Distribution segment, hence these numbers serve for indicative purposes only

Coffee and beverages have recovered on the back of HoReCa

Bloomberg Adria



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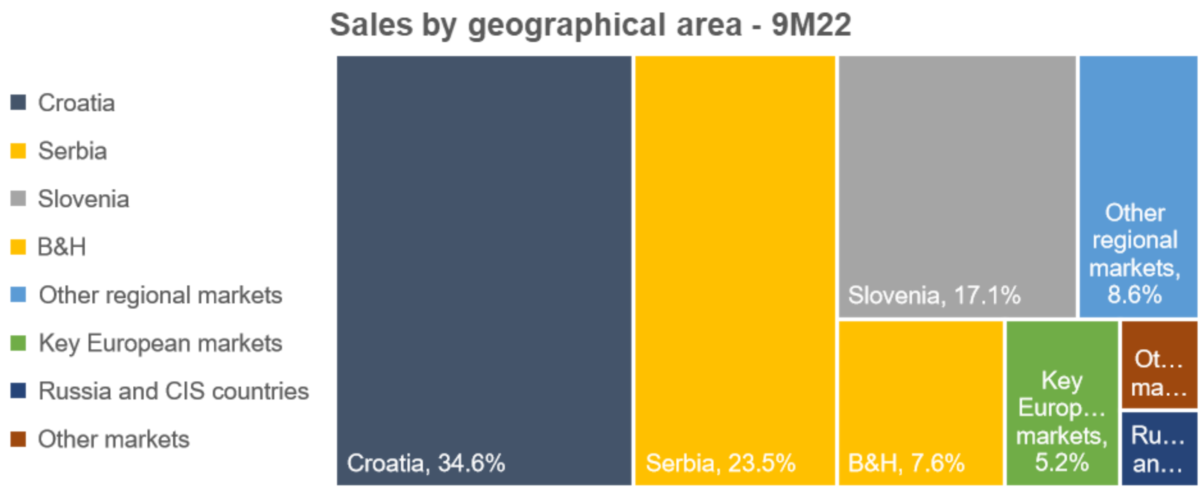


Source: Financial statements; Bloomberg Adria analysis

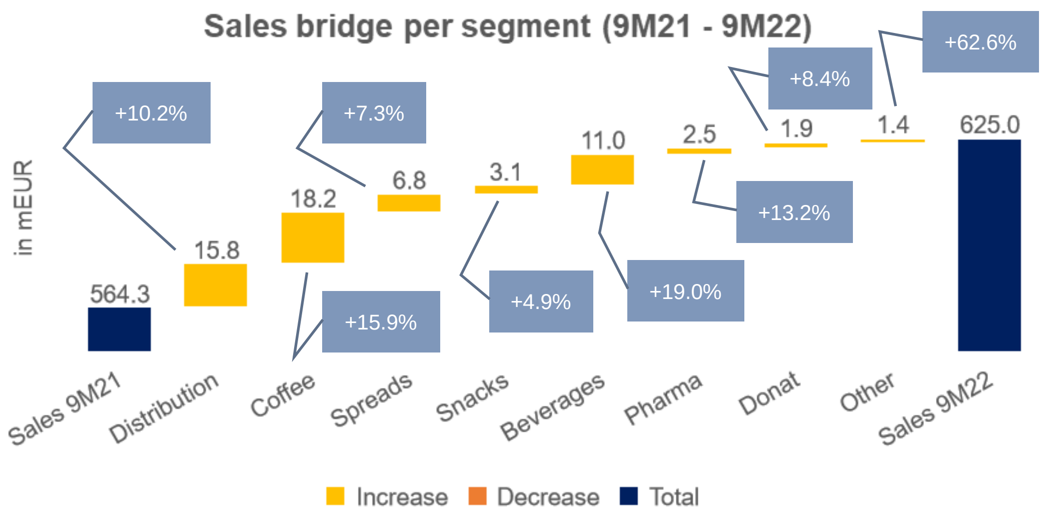
The coffee segment was a major contributor to the top line increase in 9M22, thanks to lifted pandemic restrictions in HoReCa and thus, strong tourism activity in both shoulder and high season. Roast and ground coffee have managed to achieve sales growth on the back of increased prices (Grand kafa and Bonito), while **espresso coffee under the Barcaffe brand delivered volume growth** as well. The coffee segment is of overly importance for Atlantic not just due to its significant share of revenue, but also due to healthy EBIT margins, that were historically placed around 20%. During 2022, margins in the segment were under significant pressure **of increased coffee prices resulting from drought in Brazil and overall economic conditions**. Prices of coffee, according to Bloomberg subindex had increased on average by 30% yoy, on top of already high prices that have risen 38% yoy in 2021. Though, Atlantic uses forward contracts to hedge coffee prices and in that context, impact is somewhat lower. In addition**, the strength of US dollar is also having an adverse effect on purchasing prices**. In order to maintain its market share, Atlantic was unable to fully pass through these costs to its customers. **Goong forward**, despite the aforementioned low contribution of espresso coffee sales (i.e., 7.1% in 2021), **we don't envisage a long runway ahead due to vigorous competition** from brands such as Lavazza, Illy, Julius Meinl, Costa coffee, Franck, etc. Future margins of the segment will depend on the Management's choice between gaining a few extra percentage points in market share by offering lower prices or retaining healthy margins and, of course, the **unpredictable weather conditions impacting harvest season and coffee supply**.

Distribution has delivered an important sales growth of 10.2% yoy, thanks to increased sales of Ferrero, Rauch, Hipp and Red Bull. **Going forward, we expect a continuation of growth – though, mid-single-digit – due to extended product range with Intersnack products (e.g., Chio chips) in Serbia and Red Bull in North Macedonia**.

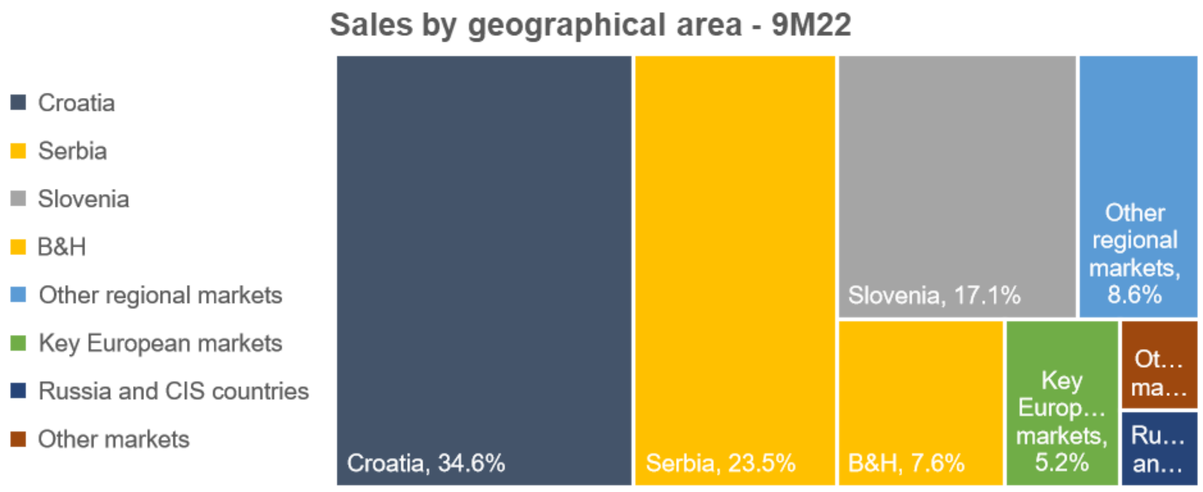
Double-digit sales growth for Pharma segment is Covid-related. Sales of disinfectants, drugs, tests and protective equipment were the key contributors to sales growth. We sense the focus is more on core business, with pharma contribution to sales falling from 11.9% in 2019 to 9.2% in 9M22. **Going forward we see a deterioration in pharma segment like-for-like sales due to lower contribution of covid-related sales**. **Non-LFL sales will be impacted by the Management's decision on further expansion of Farmacia locations**. Given that Atlantic has 99 locations that on average contribute 775k EUR (annualised 9M22 sales) to the top line, each additional location could result in approx. 1% increase to the segment's sales. Although, it is unreasonable to expect that new locations would maintain the average achieved by prior stores given the ramp-up period and store cannibalization, hence a more conservative expectation of 0.8 - 0.9% contribution to the segment's top line would be more rational.

Beverages segment had the strongest recovery in percentage terms, with growth just shy of 20%. Growth of the segment was driven by the same drivers that have impacted growth of coffee segment, i.e. strong tourist season, and lifted pandemic restrictions. **Such a significant growth cannot be expected going forward**, and this year is an outlier due to low base in 2021, still influenced by the pandemic.

Atlantic has done miracles with Argeta



Source: Financial statements; Bloomberg Adria analysis



Source: Financial statements; Bloomberg Adria analysis

More on **beverages**, we believe Atlantic will have a hard time competing with likes of Coca Cola due to Cola's immense brand and negotiating power, low unit cost and low price products. Cockta is perceived as a cheaper version of Coca-Cola, without the cheaper price attached to it. Even if Atlantic manages to lower production costs of Cockta and offer some discount pricing, the difference would still be too small to move the needle for the end consumers. On the other hand, Cedevita is an example of how innovation allows to attach a premium price to the product (over 60% of segment sales and market leader in instant drinks). In Cedevita's case it was innovation in packaging. Sadly, **in our opinion, expected recession in 2023 will prevent rise in real tourist spending and lead to negative growth rates for the segment. Looking into next couple of years, we don't see Atlantic materially exceeding strong results achieved in 2022.**

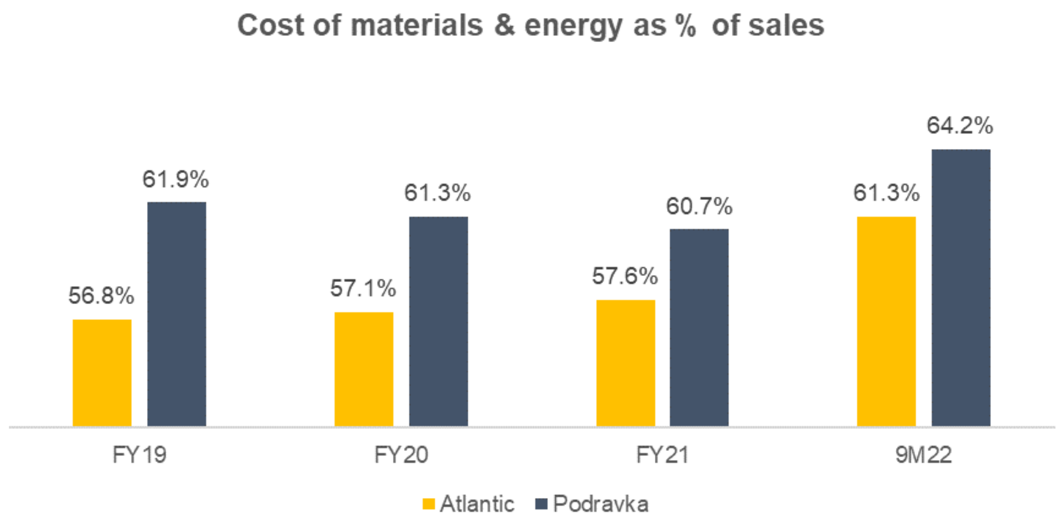
Spreads sales have increased in almost all markets, aside from France and USA. Apart from being a market leader in Adria region, Argeta is also a market leader in markets such as Switzerland, Germany and Austria. **Argeta contributes with over 100m EUR annually (109.5m in 2021) to Atlantic's top line**. That being said, it is one of **the top 5 FMCG brands in the Adria region** and according to Nielsen, No.1 meat and fish pate in Europe. **Argeta alone contributes more to Atlantic's sales than any other business segment except distribution and coffee**. Given those remarkable results, we believe Argeta can keep delivering steady low to mid-single-digit (3-4%) CAGR in sales for the following 3-year period, on the back of growing penetration in international markets.

High single-digit sales growth of Donat was driven by sales in the markets of Russia, Austria, Slovenia and B&H. Considering the increased consumer awareness regarding their health and wellbeing, fueled by Donat's exorbitant pricing power, **we expect Donat segment to keep delivering 3-4% CAGR in sales over the 5-year period**.

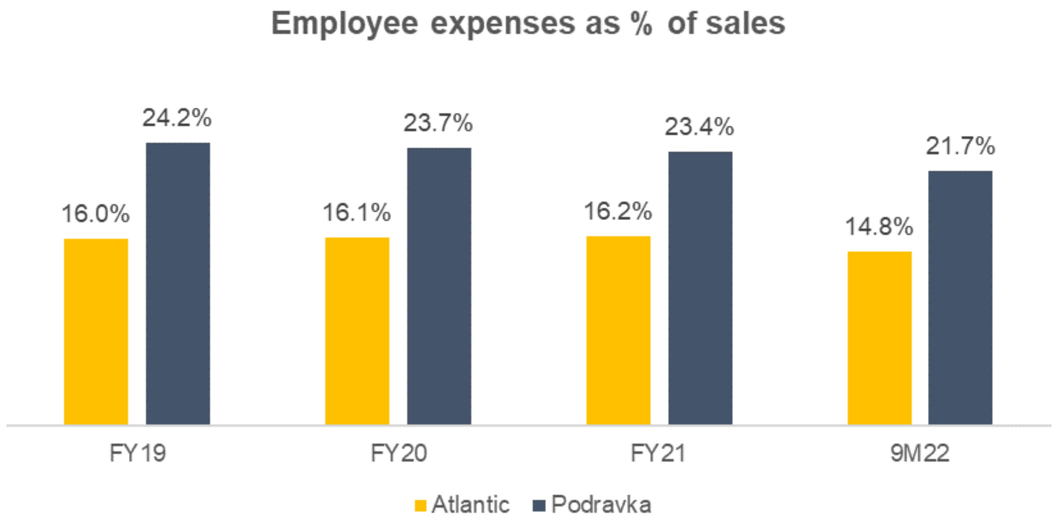
Snacks segment was the worst performer within sales growth. Atlantic's brands such as Najlepše želje, Smoki and Bananica have an important market share in the Adria region, particularly in Serbia which accounts for over 60% of segment sales. However, most of these brands have low international penetration and potential, while domestic market is being pressured by global competitors. **Going forward, we envisage a reduction in market share locally, which in our opinion cannot be offset by the increased international penetration**. Additionally, **segment sales in Serbia will be influenced by the growing market share of discount retailers and hence, private label products**. In our view, snacks segment is the most exposed one to detrimental effects.

Although still immaterial with less than 1% of sales, **Other "segment" delivered double-digit growth on the back of new Atlantic brands such as Boom Box and Jimmy Fantastic**. ATGR is heavily investing in marketing of mentioned products and given their low regional and almost non-existent international penetration, **we presume upward of 20% CAGR for the 5-year period**. New brands are yet to become profitable, however, Management learned from its past mistakes (e.g., Multipower) and has taken a cautious approach by outsourcing production of these products until obtaining a proof of concept.

Size does matter...



Source: Financial statements, Bloomberg, Bloomberg Adria analysis

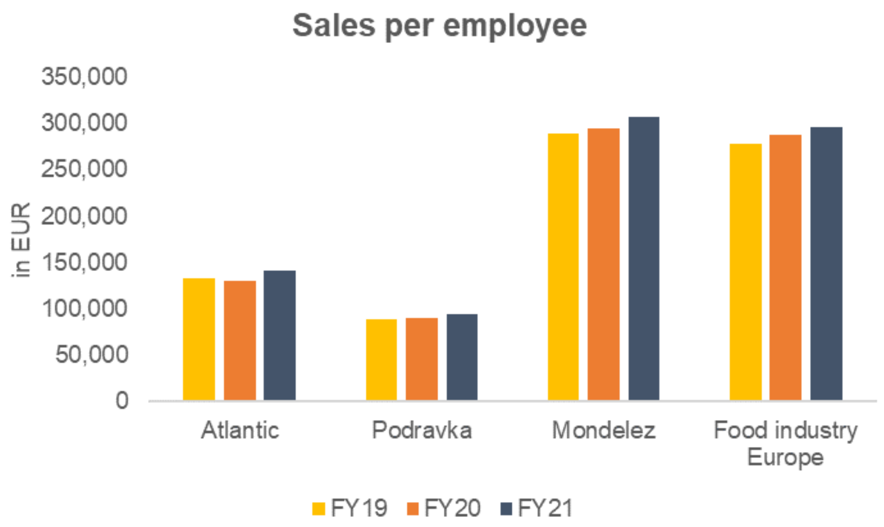


Source: Financial statements, Bloomberg, Bloomberg Adria analysis

The fact that share of cost of materials & energy was quite stable in years before does not signal procrastination in managing capacity utilization, if anything because the biggest market peer i.e. Podravka is the one with much higher ratio and in fact the need for adjustment laid therein. For Atlantic Group, this year is an outlier due to significant cost inflation. Notwithstanding our prediction that inflation will stay above historical averages during the next year as well - **we do expect gradual reversion to the mean and presume cost of materials and energy in 2024 will reach the level achieved in 2021.**

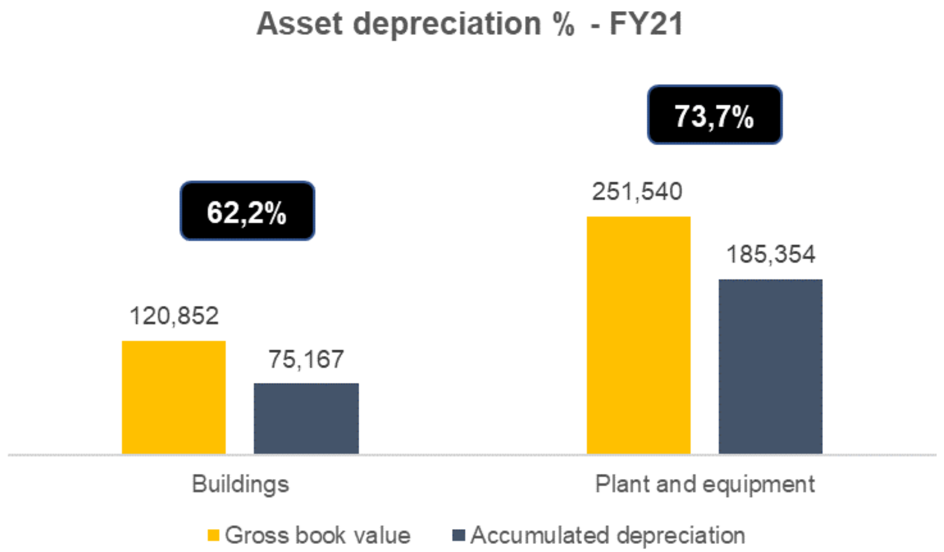
Despite Atlantic and Podravka having their own set of characteristics, they are still both food conglomerates. Seeing such an advantage in staff productivity is uplifting for the Atlantic's stakeholders. This difference is driven primarily by a share of distribution sales in Atlantic, which is just an extension to their F&B production and does not require extra people, aside from probably a few more in logistics. For the sake of more direct comparison, **when excluding the distribution arm (171 mEUR in sales), ATGR's sales per employee amounts to 83,398 EUR for the 9M22**, which is still 10% higher compared to Podravka's. **This shapes ATGR's employee expenses (% of sales) of 20.7%, which is still 1pp below Podravka's 21.7% and confirms ATGR's high productivity tag.**

Global presence in case of Mondelez and European peers allows them to achieve economies of scale and to have production facilities in countries with cheaper labour, hence the material difference. **Looking at it as a glass half full, Atlantic still has a low international penetration (Adria region contributes >90% of sales) and potential further international expansion may increase their economies of scale** and, to some extent, add operating leverage to their bottom line.



Source: Financial statements, Bloomberg, Bloomberg Adria analysis

You can run, but you can't hide...



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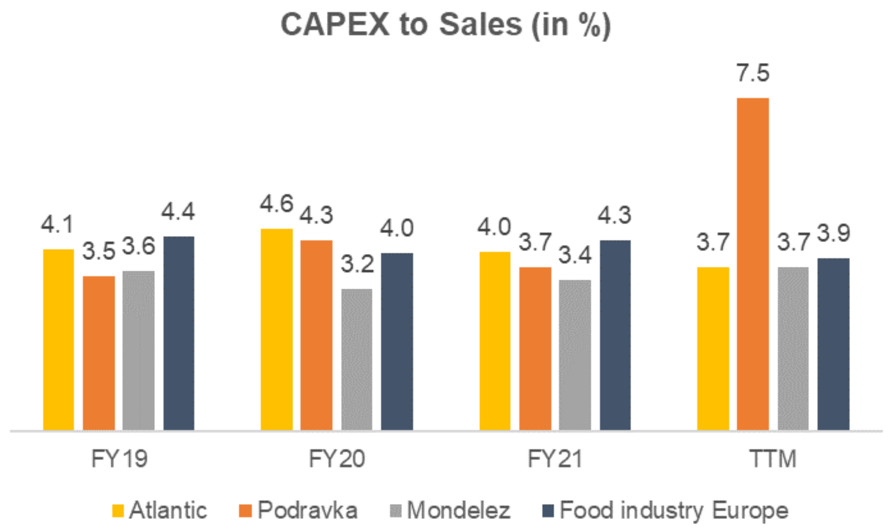


Source: Financial statements, Bloomberg, Bloomberg Adria analysis

As mentioned on the previous slides, **Atlantic had been underinvesting in its plants and equipment historically, with an average capex to sales of 2.3% for the period 2011-2018**. Reasons may be found in the slow recovery of the Adria region economy from the financial crisis in 2008-2009 and highly leveraged balance sheet due to acquisition of Droga Kolinska back in 2010-2011. Acquisition of Droga Kolinska in the amount of 240m EUR represented approx. ½ of the current invested capital number and was executed on the back of significant leverage. The timing of the acquisition could be a hint for what is expected going forward. As interest rates are increasing, obtaining cheap financing becomes difficult. However**, increased rates affect company valuations given the higher discount rate for future cash flows, and finding bargain deals becomes more facile**. **Atlantic has managed to significantly unlever its balance sheet**, with interest coverage ratios exceeding 40x, and with net debt/EBITDA below 1x. Having said that**,** Atlantic **is fully prepared for another significant takeover.** One-off due diligence cost disclosed in their latest annual report indicates that Atlantic is being active in respect of M&A, however, their prudent financial management demonstrated in the past serves as a consoling fact to the shareholders that ATGR will not make sizable acquisitions with low IRR. Thus, acquisition will materialize in case of target price being in the vicinity of 8-12x EV/EBITDA.

Given the period of low historical investments, plants and equipment are severely depreciated. If we take the most common useful life for plants and equipment, which approximates 10 years - data shows that on average remaining useful life would be 2.6 years. That being said**, future maintenance CAPEX will be elevated and should be taken into consideration when performing valuation**. Substantial investments of up to 50m EUR are planned for a new Smoki plant in Serbia at existing location, in the upcoming three years. Furthermore, previously planned investment in Argeta factory near Varaždin (now postponed indefinitely) may also come to life with projected investment in range of 40-45m EUR – though, it would be considered as a growth CAPEX. Maintenance CAPEX can undeniably be covered out of operating cashflows and out of existing cash balance (47m EUR as of September 30). Current production capacity is not fully utilised, thus we don't anticipate significant growth CAPEX in the upcoming periods.

We can see that starting from 2019, in the light of low leverage**, Atlantic has increased its capital investments**. **Average capex to sales for the period 2019-2021 equaled 4.2%.** This number is in line with the food industry in Europe and way higher than 3.8 for Podravka and 3.4 for Mondelez. Although, Mondelez had an average of 4.6% for the period 2011-2018. **Going forward, anything below 3.5% on average, for the successive 3-year period would surprise us in Atlantic's case.**

Top-notch inventory management

Working capital - Atlantic

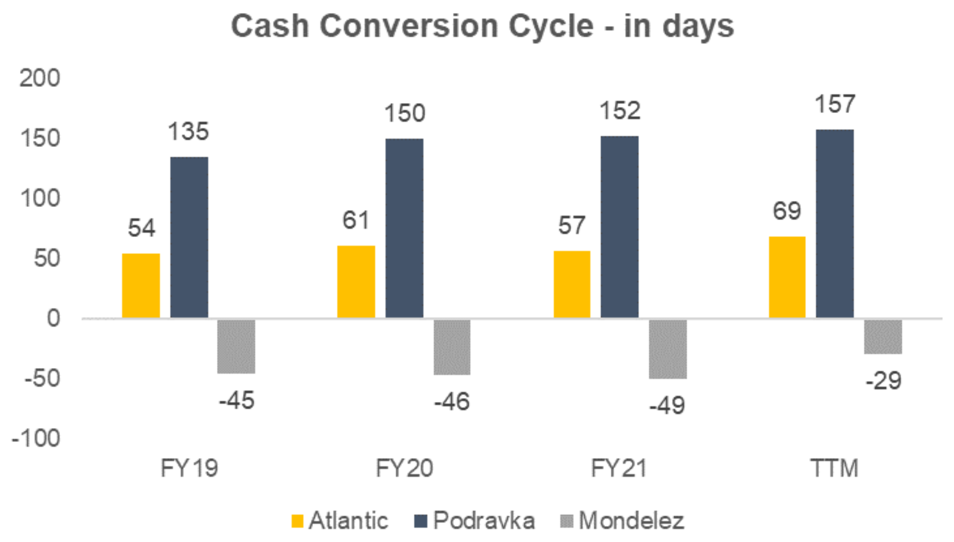
in days	FY19	FY20	FY21	TTM
Days Sales Out.	72	75	68	71
Days Inventory Out.	59	66	67	68
Days Payable Out.	77	79	79	71

Working capital - Podravka

in days	FY19	FY20	FY21	TTM
Days Sales Out.	73	74	75	74
Days Inventory Out.	118	124	118	123
Days Payable Out.	56	47	41	41

Working capital - Mondelez

in days	FY19	FY20	FY21	TTM
Days Sales Out.	32	31	29	33
Days Inventory Out.	60	59	56	59
Days Payable Out.	137	136	135	121



Source: Financial statements, Bloomberg, Bloomberg Adria analysis

The exhibit shows that **Atlantic has done an outstanding job managing their inventory and logistics**. Average inventory days for the period 2019-2022(TTM) stands at 64, which is almost at par with Mondelez's 59 and far superior to Podravka's 120 days. In that sense, Atlantic is “par excellence” and we are not of the opinion that inventory management and hence, inventory days could be improved.

A negative trend, i.e., **growing inventory days** - our best guess **- is coming as a result of supply-chain issues** and thus, longer lead time which then forces companies to order larger batches of inventory "just in case". Also, for the TTM period it is a matter of formula calculation since 4Q21 COGS is included in the TTM formula. Due to procurement prices being higher this year and hence, the current inventory amount being higher, we expect that 4Q22 COGS will also be higher yoy and positively affect inventory days. The same thing applies to days of sales outstanding and days of payable outstanding. That being said, we see no signs of deterioration in the cash conversion cycle.

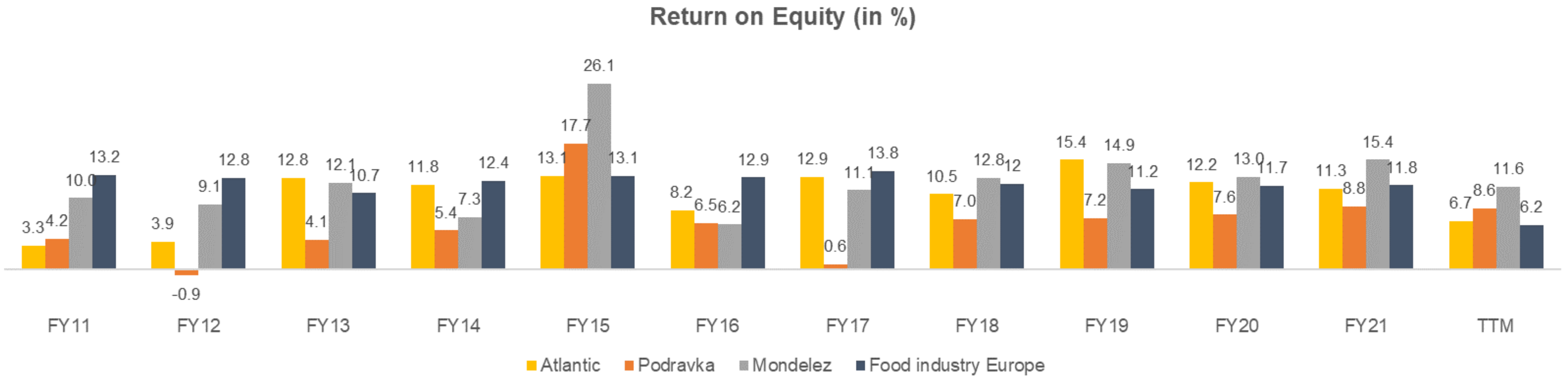
Regarding cash collection, **it is highly unlikely that cash collection can be ameliorated. Highly consolidated retail market and their immense focus on working capital management does not leave plenty of maneuvering space**. Atlantic has high customer concetration with the top 5 retailers accounting for a third of Atlantic’s turnover, among which the largest one accounts for approx. 10% of total turnover. Growing market share of discount retailers (world-wide trend) results in growing private label share, which then further reduces negotiating power of F&B producers. On the bright side, categories with largest private label share on a global scale are cooking ingredients/meals, tissue&hygiene and staple foods, meaning that Atlantic has been successful so far in navigating its portfolio of products around these obstacles.

There is, perhaps, some room for further extension of payment days when we look at practice Mondelez is executing. Mondelez, due to its negotiating power, is able to collect cash 38 days sooner than Atlantic, and pay its suppliers 51 days later.

The current ratio formula is becoming more and more outdated. Nowadays, **low current ratio or negative cash conversion cycle is a reflection (in most cases) of ample negotiating power** and results in companies being able to grow their sales on the back of interest-free financing by its suppliers. Also, it results in a high free cashflow margin. Though, it is of equal importance to have inventory that is flying off-the-shelf and timely collect cash from customers.

Atlantic’s low cash conversion cycle is manifested in high FCF margin, which has averaged 7.2% for the period 2019-2021. When compared to Podravka’s average of 4.8%, it proves that Atlantic has done an outstanding job historically. During 9M22, we have witnessed a significant deterioration in FCF margin, which has amounted to 1.6% due to significant drop in profitability and increased inventory amount – both factors being driven by double-digit inflation in Adria region.

What is driving ROE?



Source: Financial statements, Bloomberg, Bloomberg Adria analysis

ROE disaggregation

Indicators	FY19	FY20	FY21	TTM
Net income margin	7.1	6.4	6.0	3.5
Asset turnover	1.1	1.0	1.1	1.1
Leverage ratio	2.0	1.9	1.8	1.8
ROE	**15.3**	**12.2**	**11.4**	**6.7**

Source: Financial statements, Bloomberg, Bloomberg Adria analysis

After the acquisition of Droga Kolinska back in 2011, Atlantic's return on equity has risen significantly on the back of leveraged balance sheet and increased profitability given the higher share of own brands sales. Since then, ROE has been mostly stagnant, with minor changes over the years and reached its peak in 2019. After 2019, it went downhill. **This year Atlantic will deliver a record-low ROE (~ ½ of FY19) due to depressed margins amid high cost inflation and low leverage ratio**, which has been steadily decreasing over the course of last decade.

On a positive note, **Atlantic is still in line with the most prominent European food companies**, which is something that should be used as a rule of thumb. Despite our scepticism regarding the material growth (precisely, anything over 5%) of their existing business segments, weakening inflation will ease pressure on their cost structure and, therefore – in our opinion – operating margins will partially recover starting from 2024.

Increased interest rates, followed by expected recession (affecting purchasing power in general) **will not leave notable scars on Atlantic due to low cyclicality of their business segments**. Above average inflation will allow Management to maintain a slight modification of prices without losing market share. On the other hand, increased interest rates will partially offset the positive effect on net profit margin from previously mentioned partial recovery of operating margins, given the increase of net debt of approx. 30% during 2022, expected continuation of high capital investments and potential acquisition. Vis-a-vis acquisition, it is more likely than not that it will occur in a somewhat short time frame (1-2 years). We doubt the acquisition itself would be ROE accretive since they rarely are due to prices being paid for goodwill (premium over net book value). However, in case of acquisition price being somewhat reasonable, increased leverage may squeeze ROE up by few percentage points, though, below the record high of 15.4%, staying in a zone of 11-13%.

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