Food and Beverage Sector Analysis

Stronger Activity Cannot Defend Falling Profitability

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Industry highlights

Food and beverage (further: F&B) industry is among top three largest industries in each economy in Adria region. Defined as both labour and capital-intensive industry, less cyclical and less sensitive to economic fluctuations relative to other industries. Generally characterized by a complex value-chain involving multiple players such as farmers, input suppliers, manufacturers, packagers, transporters, exporters, wholesalers, retailers and final consumers.

Even inter-sectoral dynamics between industry representatives are vastly diverse. As an example, beer producers are strongly dependent on tin prices and ability to sell final products at a relatively concentrated geographical market (beer is a bulky product best produced near consumers), while coffee producers are looking into supply and prices of raw inputs to determine their COGS.

Last couple of years have been demanding for all industries, bearing in mind that the COVID-19 environment is not something formerly experienced by any market participants. Even the F&B industry, which deals in basic foodstuffs and is less exposed to economic turbulences than other industries, was affected by certain headwinds across diverse branches. To best display inter-sectoral dynamics, our analysis focuses on forming peer subgroups (beverages, meat, bread and dairy) and addressing the principal trends and challenges they've encountered in the previous years and ultimately, providing a forward-looking expectation in these unprecedented times.

Taking the F&B producers' experiences and financial outcomes from the past years, we see the following elements still strongly influencing the undergoing production trends:

- Supply-chain disruptions started during the pandemic due to boosted consumer spending towards physical products (since many services were inaccessible), which created bottlenecks primarily within the transportation industry - a lifeblood for basically every other industry

- Spike in prices of commodities (i.e., raw materials) such as sugar, raw milk, cocoa, packaging materials, grains, etc., driven in-part by supply-chain issues.

Despite the challenges, financials for the sample of sector biggest players show that on average our F&B sector representatives have had an average sales decline of only 0.8% in 2020, mainly due to lockdown headwinds. Top-line drop resulted from difficult HORECA conditions in which hotels, restaurants and coffee bars have fallen victim to government-imposed civil protection measures. Therefore, demand for beverage products has been severely impacted and some of the players like Jamnica, Zagrebačka pivovara, or Atlantic's coffee segment have felt it in their top line results. The same negative effect is visible on the sales results of Dukat arising from their exposure to the "on the go" segment and HORECA. This was especially emphasized for companies dominantly operating in Croatia market due to the difficulties within tourist sector, which has high participation in the overall market demand.

Consumer necessities such as milk-based products, bread, edible oil, received less of a blow to demand, volumes produced and consequently their top line. Looking forward, raw material price hikes could result in less robust top line trends. However, these products still benefit from a strong retail presence and are integral to the basic consumer basket (these products have a virtually non-existent substitution or trade-down effect). To showcase their resilience to economic cycles, we could go back all the way to the last recession occurred in 2008/2009, when Atlantic has managed to increase their sales in both years, despite the obvious economic disaster on a global scale.

Going back to recent history, in the year following the pandemic spread, government-imposed measures were still active, but certainly less so. Tourism activity - of utmost importance primarily for the beverage producers - has slightly recovered in the summer months. Shoulder season was weak, almost non-existent, but strong July and August have resulted in better-than-expected numbers. That being the case, sales have on average increased by 8.6% and pushed margins north for up by 1pp.

To conclude, F&B producers have emerged stronger after the pandemic which is proven by the presented numbers in terms of indebtedness and profitability. Average industry EBIT in 2021 is 1.0pp higher compared to 2019, average ROIC 0.9pp higher and average net debt/EBITDA 0.7pp lower. As the slowdown of economic activity approaches, their resilience in the turbulent covid times can be used as a quality indicator for future predictions and expectations.

Industry highlights - continued

Growing market share of discount retailers in Eastern Europe can be considered as a negative trend and a major threat to the F&B sector due to its high percentage of private label reliance.

According to GFK research, private label accounts for 63% share of merchandise in discount retailers, while in general, average share of private label was 34% (2020) in Eurozone countries and is expected to keep rising. For the sake of comparability, back in 2013 share of private label was 22% in Croatia, while in 2020 it stands at 29%.

Of course, the threat is less severe for Adria countries that are yet to enter the European Union, nevertheless, growing share of private label results in less visible positioning of F&B sector products and even stronger negotiating power of retailers, which eventually manifests in margin compression.

Source: www.gfk.com

Macroeconomic highlights

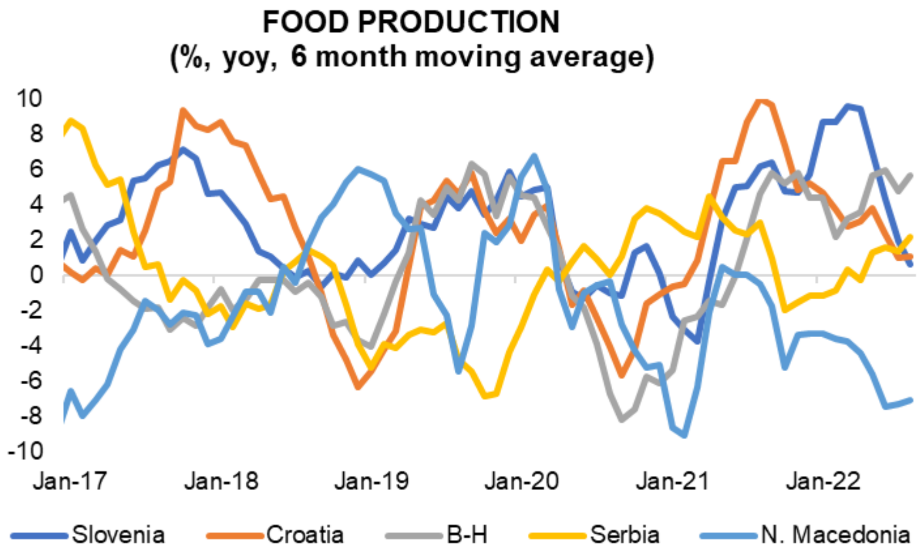
Bloomberg Adria

Official hard data display a mixed picture of manufacture of food products between countries in Adria region for 2021, with Croatia outperforming at 5.9% yoy growth pace on average and North Macedonia marking the weakest numbers with a -1.6% yoy footing on average. Performance in 2021 was dominantly driven by the general activity rebound from COVID-19-created turmoil.

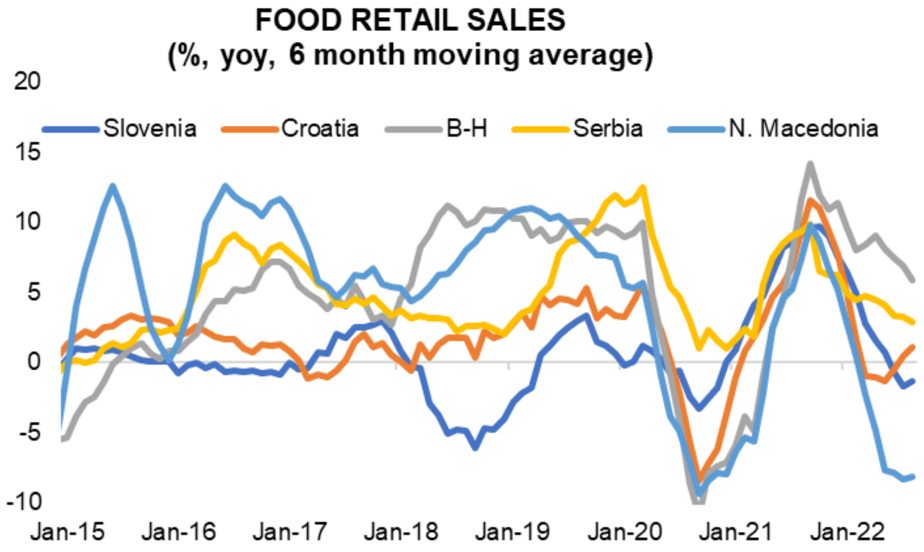
Although food production is less sensitive to economic cycles, we nevertheless see the named output rebound in 2021 coming on the heels of low base effects from 2020, but also receiving strong support from favourable labour market developments including employment growth and real wage growth across the whole region. Indeed, the number of employed was in 2021 higher by low single-digit % figure than in 2019.

Real net wages marked single digit annual growth rates in 2021 as well, ranging between 2.2% yoy in B-H to 5.6% yoy in Serbia. Our view of strong support from spending fundamentals is further corroborated by real retail trade figures for food, beverages and tobacco, which showed annual growth rates for the named retail sale categories in the area of 5% yoy in North Macedonia to 7.9% yoy apiece in Slovenia and Serbia. What's more, the magnitude of retail sale volume rebound is the best displayed by the fact that on average volumes were up by 3.6% (B-H) to 10.8% (Serbia) compared to 2019, while only in North Macedonia retail sale volumes were still down by 1.3% against 2019 average.

Furthermore, data on stocks of produced goods is available for Slovenia, Croatia and North Macedonia, with mixed outcomes for 2021 as there was a spike of 23% yoy in Croatia, followed by 13% yoy in Slovenia and a small increase in North Macedonia of 5%. Results for North Macedonia must be observed on a multi-year period as there was a regional-strongest performance in 2020 (+26% yoy), which helped that stocks are in the recent months at almost 50% higher level than in 2019. Bottom line is that stock replenishment is not surprising in any country given the economic activity recovery and in smaller case frontloading of production of some specific products which carry longer expiration dates and are highly affected by increased input prices.



Source: National statistics offices, Bloomberg Adria analysis



Source: National statistics offices, Bloomberg Adria analysis

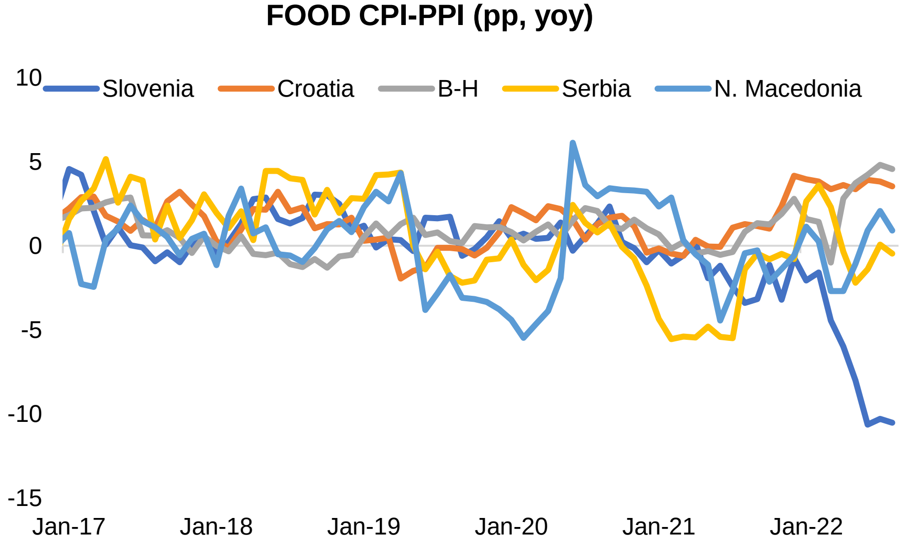
Inflation and commodity price trends

Bloomberg Adria

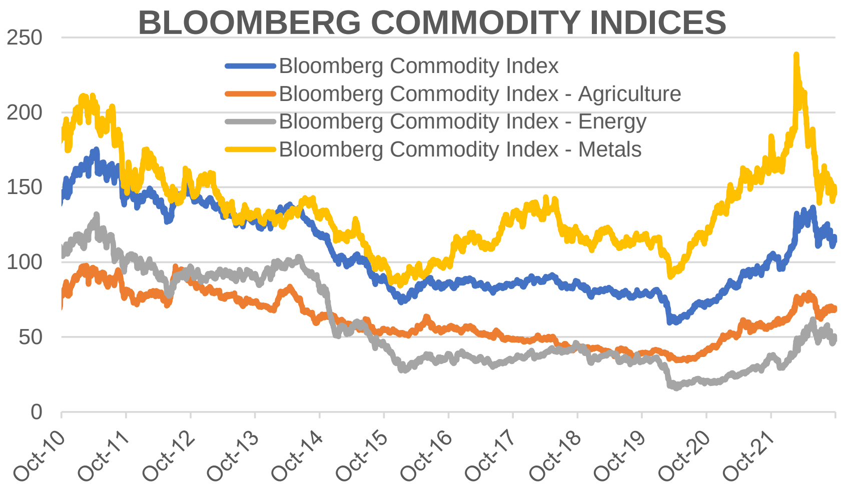
Aside from the very increase in headline inflation rates, we are focusing on the difference between consumer and producers' price trends, which also displays mixed outcome in 2021, with Croatia and B-H displaying figures of 0.8pp and 0.6pp (respectively) hence suggesting margin improvements among retailers. On the other hand, margin compressions at the level of retailers were implied in other Adria region countries, with CPI-PPI negative in the area of -0.7pp in North Macedonia up to -3.4pp in Serbia. Given the above-mentioned improvements in household spending fundamentals, we see the named CPI-PPI for food reduction dominantly reflecting more intensive price competitiveness among the key market players. Also of interest is the recent drop in the CPI-PPI for food deep into the negative area, reflecting material margin compression in Slovenian retail market.

Going into 2022, with spikes in headline inflation, official statistics show that only in Slovenia retailers are struggling to transfer increased input costs onto end consumers, with the CPI-PPI differential falling to -6.7pp on average over first eight months in 2022. Elsewhere in Adria region, we have seen retailers managing to fully transfer elevated input costs onto consumers, with high elasticity of consumer food prices to input costs, suggesting hefty barganing power by retailers as households spend a lot of their overall expenditures on food. This has also come on the heels of swift economic recovery after the lift-off of COVID-19 measures and this especially in tourism activity over 3Q 2022.

Rise in inflation rates has a lot to thank to spikes in commodity prices given supply shortage effects following a surge in geopolitical crisis in 1Q 2022, coupled by an upswing in global economy after the COVID-19 activity downturn. Rise in commodity prices has also come on the back of multi-year money printing practices by many key central banks, pushing now commodity prices for various products towards or even beyond historical highs. The most recent months have already seen a cool-down in commodity price upside pressures, as the global economic slowdown and key central banks' aggressive tightening have mixed with some commodity supply reliefs (e.g., openning of some Ukraine ship harbours allowing for a revival in agri commodity routes).



Source: National statistics offices, Bloomberg Adria analysis



Source: Bloomberg

Inflation and commodity price trends

Bloomberg Adria

We see headline inflation peak in 2H 2022, followed by a slow reduction in yoy inflation rates in 2023. Inflation cool-down will be dominantly driven by high base effects and results from central bank's tightening. Another element pulling inflation rates lower would be weaker household spending fundamentals, courtesy of elevated energy costs and generally ailing economic activity after this year's economic rebound. In 2023, the annual average inflation will still remain at multi-year highs given the prolonged spillover effects from this year's upwsings of agri and energy commodity prices onto core inflation categories. Also keeping inflation rates relatively high is the fact that many producers have by now not fully transfered increased input costs onto end product prices, having used previously pilled stocks for sales towards retailers and thus kicked the can down the road for the complete transition of input cost hikes onto selling prices.

Looking ahead, we see commodity prices going slowly downward as a result of the global economic cool-down, coming in as a product of the key central bank's rate hikes. Global money supply is the key factor here, being in a sharp downtrend and thus implying that commodity prices, as a global element, cannot escape unscathed from this pull effect. Indeed, global money supply is hitting multi-decade lows and draws strong links to results similar as in the Global Financial Crisis 2008-2009 when global commodity prices slumped alongside the recession-related contraction in money supply, Another important element is that the key global central banks are nowadays very much aware what created upside pressures to the commodity prices in 2020-2021 and it was the side-effect of multi-year money-printing, which means that the key central banks can be pretty reluctant to restart monetary easing after the current tightening cycle – global investors could take this into their anticipation, which would mean anything but an upside pressure to commodity prices. Interconnections between different commodity categories are also not to be ignored, with reduced demand for gasoline implying a drop in corn prices as well. Our graphic below shows that we expect a gradual reduction in commodity prices (vs. average prices in first nine months of 2022) to take place over the upcoming quarters.

Commodity	2016	2017	2018	2019	2020	2021	2022YTD
Sugar	27%	-16%	-27%	-8%	-4%	37%	4%
Cocoa	-9%	-30%	10%	-2%	6%	2%	-8%
Coffee	-8%	-11%	-23%	-22%	-3%	38%	30%
Wheat	-19%	-16%	-6%	-9%	8%	21%	26%
Soybean	5%	-4%	-10%	-12%	-1%	46%	20%
Tin	13%	13%	2%	-6%	-7%	103%	15%
Aluminium	-9%	20%	6%	-16%	-9%	39%	13%

FORECASTS - DISPLAYED AS % CHANGE VS. YTD AVERAGE

Commodity	Q4 22	Q1 23	Q2 23	Q3 23
Sugar	-4%	-4%	-4%	-6%
Cocoa	0%	-1%	0%	-9%
Coffee	-2%	-3%	-7%	-12%
Wheat	-5%	-6%	-4%	-7%
Soybean	-10%	-6%	-9%	-16%
Tin	-36%	-39%	-36%	-33%
Aluminium	-21%	-20%	-19%	-16%

Source: Bloomberg terminal; Bloomberg subindex; Bloomberg Adria analysis

Peer group comparison

Bloomberg Adria

Selected F&B producers delivered 8.6% average yoy sales growth in 2021. Aggregated sales for 2021 amounted 3,523 mEUR and was 7.7% higher than aggregated sales in 2019 - pre-pandemic period. That alone indicates the sector resilience to market turbulences and economic cycles in general. At the moment when monetary tightning is stretching across the globe, that is an important indicator stakeholders should bear in mind.

Despite HORECA channel being cardinal distribution line for many industry players - especially in Croatia due to its significant exposure to tourism sector (~20% of GDP) – negative consequences were successfully eschewed. Even better indicator of the successful navigating throughout the pandemic is the net debt/EBITDA indicator. In the presence of government-imposed measures which resulted in HORECA closures and reduced gatherings, one would expect financial distress and increased indebtedness. However, surprisingly average net debt/EBITDA is 0.7pp lower at the end of 2021, compared to end of 2019.

Industry margins are double-digit, nevertheless, it is impossible to neglect the fact that some industry players have completely different unit economics, despite being part of the same sector. To illustrate, Zagrebačka pivovara (brewing industry) has an EBITDA margin of 29.2%, while Dukat (dairy producer) with the lowest remains at 1.3%. Zagrebačka pivovara generates a major share of their revenue by selling to HORECA, while in Dukat's case it is the other way around. Since HORECA is highly dispersed market – unlike retail, which is highly consolidated – F&B producers have better negotiating power and can generate better margins. In addition, HORECA can obtain better selling prices, compared to retail, hence they are willing to pay higher purchasing price.

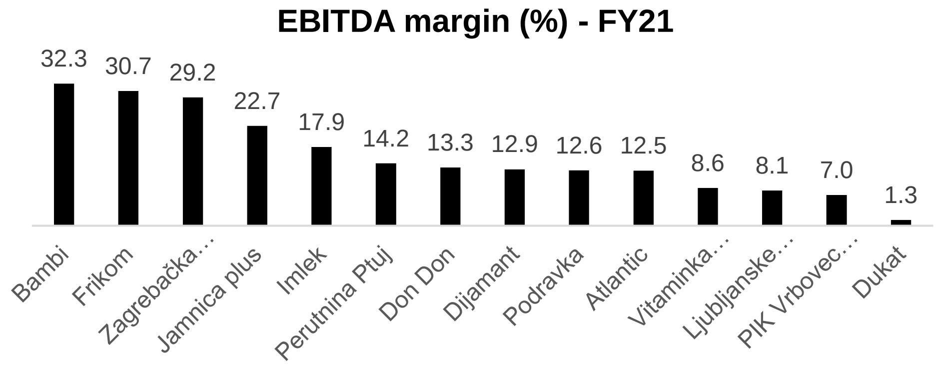
Company name	Sales EUR in millions			Sales growth %			EBITDA margin %			EBIT margin %			ROE %			ROIC %			Net debt/EBITDA			CCC in days		
	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021
Bambi	82.3	88.1	93.8	4.8	7.0	6.4	20.0	35.3	32.3	15.6	32.0	29.6	13.3	18.6	18.4	6.9	18.8	18.1	(0.8)	(0.4)	(0.3)	162.1	129.4	101.1
Zagrebačka pivovara	139.7	117.1	131.6	(3.7)	(16.1)	12.4	31.5	28.9	29.2	21.8	18.5	20.3	71.8	68.5	84.3	53.8	39.2	44.0	(0.6)	(1.7)	(1.3)	15.0	17.0	(7.0)
Vitaminka Prilep	37.1	38.2	45.8	6.5	3.0	20.1	6.9	7.7	8.6	2.2	2.8	4.2	2.1	3.0	8.2	2.5	3.0	4.8	7.3	7.0	6.2	155.7	142.4	114.7
Podravka	594.5	597.4	615.2	4.2	0.5	3.0	11.3	12.2	12.6	6.4	7.4	7.9	7.2	7.6	8.8	5.9	6.4	7.6	1.6	1.3	0.8	168.6	186.5	185.6
Atlantic	742.4	706.9	768.5	3.3	(4.8)	8.7	14.1	13.4	12.5	9.1	8.3	7.6	15.4	12.2	11.3	10.6	9.2	8.8	1.2	1.0	0.6	54.3	61.4	56.8
Perutnina Ptuj	285.0	293.7	342.0	5.3	3.1	16.4	14.6	16.1	14.2	10.8	12.3	10.7	19.8	20.1	16.7	13.9	14.5	11.6	0.8	0.5	0.1	38.1	44.1	51.8
Don Don	108.2	111.5	130.7	15.5	3.0	17.2	12.6	15.4	13.3	5.2	8.4	7.2	6.6	15.5	13.8	6.1	9.3	9.0	2.5	2.0	1.9	22.7	13.2	4.5
PIK Vrbovec plus	207.0	243.0	239.8	(15.1)	17.3	(1.3)	6.5	8.0	7.0	3.2	4.3	3.2	0.6	12.5	5.7	3.6	4.9	3.6	1.6	0.8	1.0	76.6	53.8	44.3
Frikom	117.9	107.9	115.7	7.7	(8.7)	7.2	14.7	15.5	30.7	11.4	12.0	25.2	14.3	10.1	31.0	11.8	11.0	30.0	0.1	(1.0)	(0.2)	153.4	149.1	146.5
Imlek	270.3	273.2	281.1	(16.4)	1.0	2.9	28.9	16.6	17.9	23.7	9.8	9.6	58.4	12.0	10.6	14.8	6.0	6.0	3.4	5.9	4.7	45.5	49.2	51.0
Ljubljanske mlekarne	175.6	176.3	180.8	4.2	0.4	2.6	8.6	9.6	8.1	5.4	6.2	5.0	10.5	10.7	8.2	10.3	10.5	7.8	0.1	0.0	0.1	13.1	12.0	16.0
Dukat	246.6	225.7	246.6	(1.4)	(8.5)	9.2	3.7	2.6	1.3	1.8	0.4	(0.8)	1.9	0.5	15.6	1.7	0.3	(1.4)	(2.6)	(4.4)	(5.0)	29.7	29.8	27.6
Jamnica plus	142.8	131.4	148.6	(16.8)*	(8.0)	13.1	24.3	21.9	22.7	19.2	14.1	15.4	23.0	5.8	9.8	9.8	3.6	4.8	10.4	10.7	8.5	39.3	75.0	48.7
Dijamant	121.5	135.0	183.6	15.3	11.2	35.9	9.1	11.1	12.9	6.6	8.9	11.5	13.3	18.5	27.6	9.2	12.6	19.3	3.0	1.4	0.8	126.0	129.0	111.0
Median	**159.2**	**155.7**	**182.2**	**n.a.**	**(2.2)**	**17.0**	**13.4**	**14.4**	**13.1**	**7.8**	**8.6**	**8.7**	**13.3**	**12.1**	**12.6**	**9.5**	**9.2**	**8.3**	**1.4**	**0.9**	**0.7**	**49.9**	**57.6**	**51.4**
Average	**233.6**	**231.8**	**251.7**	**n.a.**	**(0.8)**	**8.6**	**14.8**	**15.3**	**15.9**	**10.2**	**10.4**	**11.2**	**18.5**	**15.4**	**19.3**	**11.5**	**10.7**	**12.4**	**2.0**	**1.7**	**1.3**	**78.6**	**78.0**	**68.0**

Source: Company financial statements, Bloomberg Adria analysis

*Please note that numbers for sales growth of Jamnica plus are not fully representative due to organizational restructuring that occured in 2019. Jamnica d.d. had a different organizational structure than its successor Jamnica plus d.o.o.

Peer group comparison – continued

Bloomberg Adria



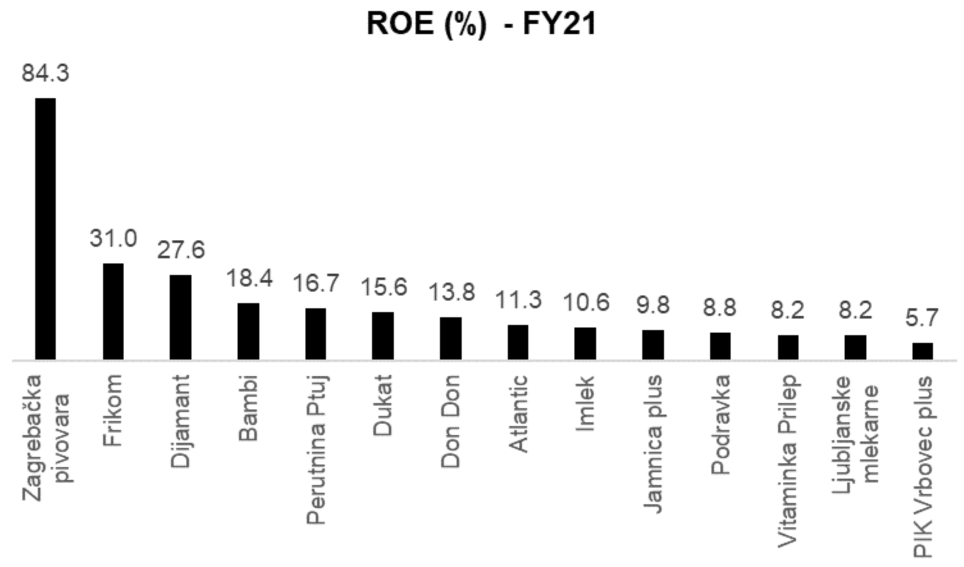
Source: Company financial statements, Bloomberg Adria analysis

Nevertheless, comparing Dukat to other dairy products producers does not show a brighter picture. In particular, Ljubljanske mlekarne and Imlek are generating better operating margins as well due to different market dynamics in regard to milk prices. To be more precise, Serbia imposes a cap on milk prices and export in order to assure supply in the domestic market - unlike Slovenia and Croatia - which brings us to „laissez faire“ and serves as a great example how markets regulates itself and reduces the chance of money flows going into just one direction. Unlike Imlek, who, leveraging their dominant market share, significantly influences the purchase price of milk (by purchasing large volumes from a vast array of farms), Ljubljanske mlekarne seem to harbour a comparatively lax approach regarding their raw milk suppliers. In 2022 alone there was a 35% increase in the purchase price of raw milk in Slovenia (in a bilateral agreement with farmers), compared to previous year.

On the other hand, meat producers have their own set of challenges. To illustrate, Pik Vrbovec has had issues in 2019 due to swine fever in China (major world supplier of hog) which resulted in significant price increase and consequent drop in demand. Pricing recovered in 2020, hence the results have stabilized as well. Perutnina Ptuj could be hit in the same way in case of bird flu. Noteworthy in the given circumstances is the fact that Perutnina Ptuj is owned by the Ukrainian MHP group, however, in their financials it is stated that raw materials are not purchased from Ukraine and they do not foresee material disruptions to the business in that regard. Nevertheless, global uncertainties regarding the prices of food, primarily wheat and soy beans, could pose a material threat to the meat producers. This particularly goes on account of hog and beef producers, as poultry is generally seen as the most economic option in the meat line and first choice of the customers when price competitiveness is in question.

In our opinion, most important indicators of the business quality are returns on equity or returns on invested capital in case of excessive leverage. In that regard, selected industry peers are delivering outstanding results. Both average ROE and ROIC are double-digit, with Zagrebačka pivovara delivering best returns by far. Remarkably high returns are result of high margins and high inventory turnover. A proof of that is negative cash conversion cycle, meaning that Zagrebačka pivovara manages to sell its inventory, collect cash from its customers and only then pay its dues to suppliers. Consequently, that results in lower invested capital number and better returns.

On the other hand, Dijamant and Frikom levered their high stock levels (and consequently high CCC) purchased in previous period at lower prices and sold them at currently higher prices to deliver outstandingly high returns. In the short term they've benefited from unusually high inventory levels, however, in the long term it is not healthy since a lot of cash is being tied up in their inventory. Overall healthiness of the industry proven by high returns is additionally seen in the low indebtedness, with average net debt/EBITDA standing at 1.3x.

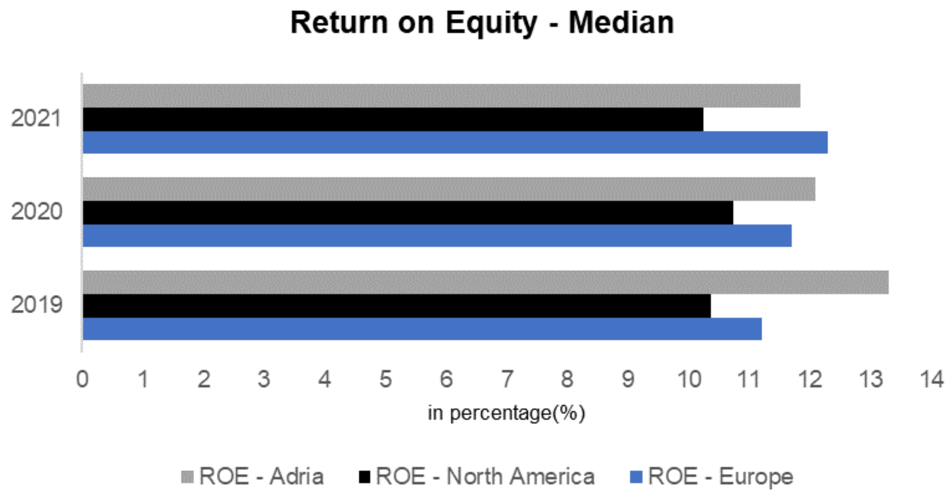


Source: Company financial statements, Bloomberg Adria analysis

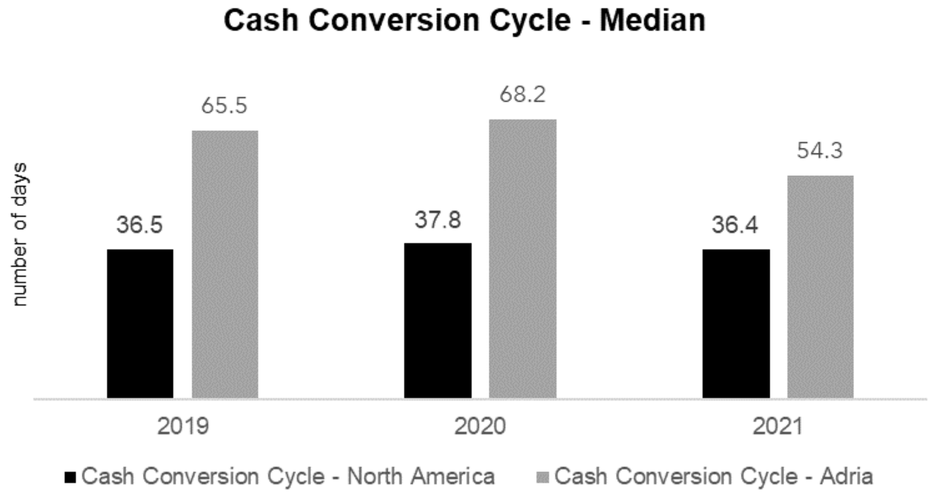
Comparison to western peers

It may come as a surprise to some that F&B producers in our region are in front of its western peers when looking at certain financial indicators. In our opinion, this could be explained by the customers' commitment and loyalty towards locally produced food. Global players such as Danone, Nestle, Bonduelle, to name a few cannot count on that, while economies of scale bring benefits up to certain point.

More importantly, regional producers can count on the proximity and lower cost of raw materials such as grains, milk, water, sugar, etc. In addition, labor rates are still way below EU average, which makes regional players cost competitive. In our opinion, above stated facts are the key competitive advantage of regional producers on which they could base their future success. Where they lag their western peers is cash conversion cycle. Although, gap of Adria players in CCC has significantly decreased in 2021 and it falls behind 18 days, whereas in 2020 it was lagging 30 days, compared to North American peers. Explanation could be found in the fact that western peers have operations and distribution across the globe and their negotiating power with suppliers, customers and distributors is greater, thus impacting their payables days, receivables days and inventory days.



Source: Company financial statements, Bloomberg Terminal, Bloomberg Adria analysis



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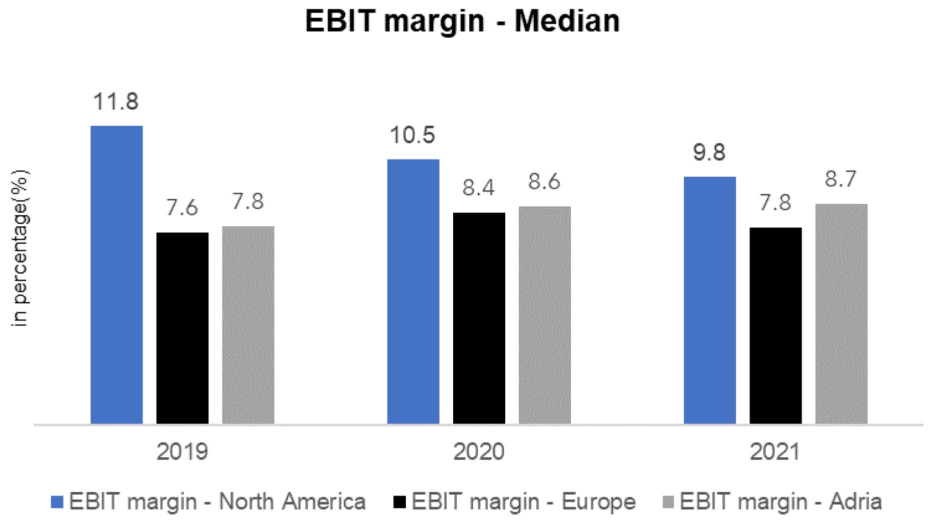


Source: Company financial statements, Bloomberg Terminal, Bloomberg Adria analysis

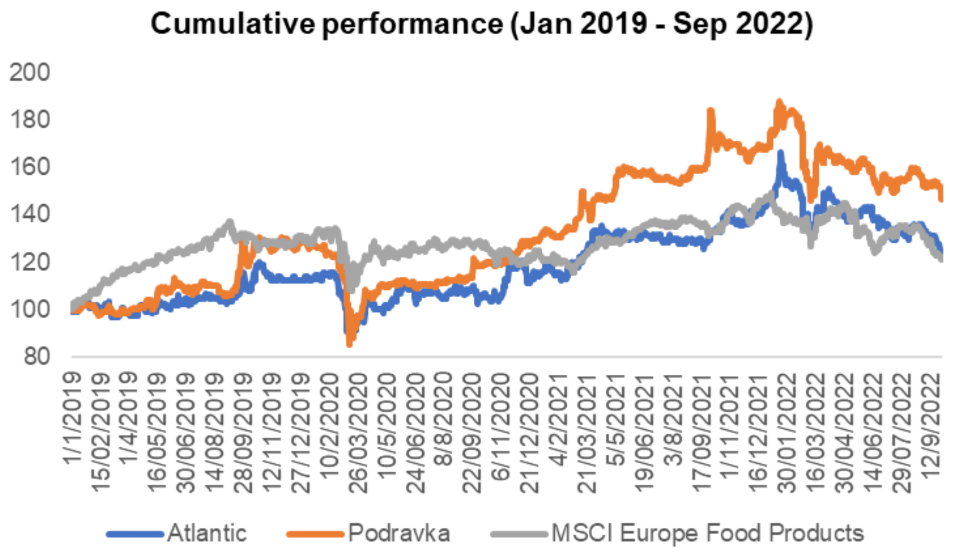
Stock price movement

Movements in stock prices of Adria companies and MSCI European food products index were characterized by a steep drop in March of 2020. That was the result of pandemic-related hysterical reaction of market participants across the globe. By looking at the fundamentals of chosen companies, it is hard to explain such a steep fall and it serves as a great example how market participants diferently anticipate company financials driving features.

In general, over the observed periods, selected peers had a positive stock price direction, led by Podravka whose stock price increased 48%, followed by Atlantic with 22% and lastly MSCI European food products index also with 22%. CAGR for the period was 11.1% for Podravka, 5.5% for Atlantic and 5.5% for the index. Unlike Atlantic whose returns on sales and invested capital have decreased in the period 2019-2021, Podravka has demonstrated certain improvements, and hence the largest CAGR for their stock price. In this case, it serves as a great example how in the long-term markets often reflect the movement in fundamentals.

Rising input costs have already been reflected in quarterly financial statements for selected companies in terms of higher sales, but also lower profitability. Consequently, stock prices have dropped from their 52-weeks high.
In the following 12 months, we see a further drop in stock prices as a result of monetary tightening and continued hustling with rising input costs that is hurting their bottom-line.

In respect of long-term horizon (which we certainly advise), investment returns - in our opinion - are not expected to enter double-digit territory, as it is generally the case for blue chip companies, especially during bear markets. Outstanding growth which normally drives double-digit investment returns is certainly difficult to accomplish for companies of this size. Nevertheless, they have a history of regularly paying dividends, with yields of up to 3% on average, and they may represent a decent investment choice for risk-averse investors.



Source: Bloomberg Terminal, Bloomberg Adria analysis

Dividend yields	2019	2020	2021	2019	2020	2021
in percentage(%)		Podravka			Atlantic	
Close	1.9	1.9	1.4	1.9	1.9	2.4
Average	2.2	2.1	1.6	2.6	2.0	1.7
High	2.5	2.8	1.9	2.9	2.4	2.4
Low	1.8	1.9	1.3	1.9	1.8	1.5

Source: Bloomberg Terminal, Bloomberg Adria analysis

M&A activity

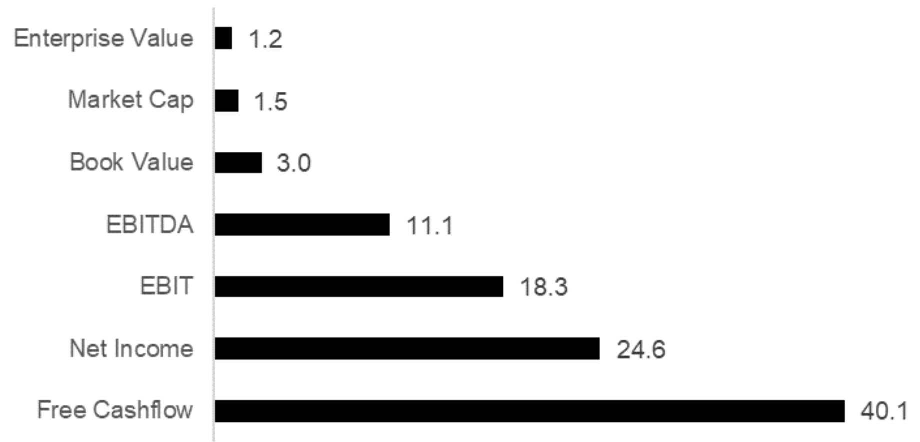
We have witnessed in the recent years a relatively idle F&B sector in terms of mergers and acquisitions within the Adria region. Industry players were attempting to grow organically by penetrating international markets, innovating products and expanding existing production lines. Invested capital numbers support our statement since the absolute amount has remained relatively stable over the observed periods. Stable invested capital numbers indicate that shareholders were not able to enjoy compounding effects, albeit inability to find attractive deals has resulted in decreased indebtedness, thus, average net debt/EBITDA has decreased from 2x in 2019 to 1.3x in 2021 - another indicator of the players' readiness and weaponry for future acquisitions.

A sizable acquisition could change that, although, one needs to be aware that takeovers rarely bring double digit IRR due to control premiums which exacerbate acquisition prices being paid. Good timing could certainly help boost the returns. As the slowdown of economic activity is expected to arrive later this year, and valuations on the market are to cool down following the increase in interest rates, industry players could possibly make a sizable acquisition.

Having said that, the timing of precedent major acquisition by Atlantic should be noted in this case. Droga Kolinska was acquired by Atlantic amid severe financial crises - 2010. Size of the acquisition was approx. half of their current invested capital amount – approx. EUR 240m. Additionally, in their latest annual report Atlantic mentions one-off due diligence costs for failed acquisition, meaning that they have already commenced making moves. Furthermore, Podravka could also be a major contributor to the M&A activity, with their CEO confirming for Bloomberg Adria that Supervisory Board has given a green light to the Management Board for potential future acquisitions.

To improve their negotiating power, of the utmost importance for the industry players is to try and build their brands and presence outside regional borders. However, we don't see much potential for organic growth of market share due to strong competitiveness of the industry and presence of international players who fiercely defend their market shares with higher marketing budgets and better negotiating power with distributors. That being said, Podravka and Atlantic with Vegeta and Argeta respectively, were the most successful ones within the peer group in penetrating international markets and building their brands outside the local markets. Nevertheless, their numbers still don't show whether their negotiating power has improved and that itself manifests industry competitiveness. Brand loyalty from consumers is important, although, not as strong as towards cigarette labels or towards Coca-Cola branded products, to use an industry example. In light of that, Atlantic has felt on their own how difficult it is to grow internationally and defend their market share domestically. While they managed to grow sales of their savoury spread segment for 6%, EBITDA of the segment has in the meantime contracted 7% in 2021.

Median multiples - European food sector (2017-2022)



Source: Bloomberg Terminal, Bloomberg Adria analysis

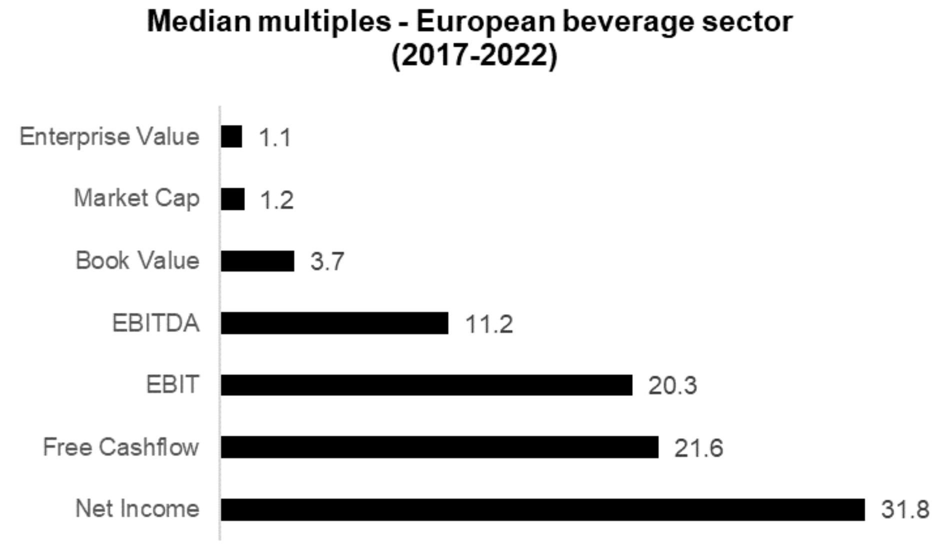
M&A activity - continued

Fortenova group subsidiaries such as Dijamant, Pik Vrbovec or Jamnica are not in a position to make sizable acquisition due to the status of group's consolidated indebtedness, which doesn't leave much maneuvering space for anorganic growth. Nevertheless, they could represent a potential target for any of the other industry players as Fortenova group is currently working on de-leveraging its balance sheet for the purposes of refinancing and easing an excessive debt burden. Frikom and Ledo could be used as examples since they were recently sold by Fortenova as a frozen segment package in a deal which allowed struggling group to temporarily stabilize its financial position after stormy 2020. Taking into consideration what is being said, we predict a more active M&A market in the following periods, despite rising interest rates.

In terms of historical transactions, frozen segment sale was the most recent and largest deal in terms of enterprise value within the region, over the observed period. Nomad foods has acquired frozen segment (i.e., Ledo plus, Ledo Čitluk, Frikom) for a purchase price of EUR 615m. Transaction allowed New York-listed Nomad Foods (NOMD) to obtain presence in our region, whereas Fortenova group used the proceeds in the amount of EUR 501m to de-leverage its balance sheet and remain in line with the creditor's covenants. On top of de-leveraging, transaction resulted in net gain in their P&L, in the amount of approx. EUR 121m. Deal was completed as of 30 September 2021 and Nomad financed it by issuing new bond in the amount of EUR 553.2m, maturing in 2028.

Another important deal completed in our region was the exit of private equity fund Mid Europa from the Serbian beverage producer Knjaz Milos in a deal valued EUR 224.7m. Knjaz Milos was acquired by a consortium of PepsiCo and Mattoni 1873 in 2019. Apart from the sale of Knjaz Milos in 2019, Mid Europa also sold its stake in Bambi to Coca Cola for an enterprise value of EUR 260m. While Mid Europa was liquidating some of its positions, Mesna industrija brace Pivac was active on the buy-side, with acquisition of a majority stake in the Croatian confectionary producer Kras for approx. EUR 32m.

Historically looking at European level, acquisition multiples realized in the past 5 years are double-digit, both for EBIT and EBITDA, and in case of listed companies, sale premium is 50% and 20% in relation to market cap, for food and beverage sector respectively.



Source: Bloomberg Terminal, Bloomberg Adria analysis

Investment activity

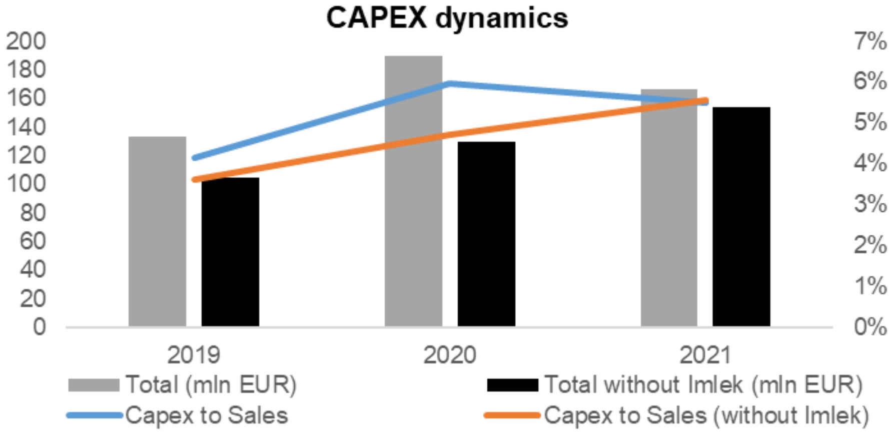
Period of past 3 years was marked with intensified capital expenditures within F&B Adria industry, with an average capex/sales ratio growing from 3.4% in 2019 to 4.7% in 2021. Capital investments were predominantly intended to boost efficiency and cost savings. The need for capacity to more appropriately respond to market demand was also a driver for investment.

In 2020-2021 Bambi has invested EUR 12mln toward a new production plant with the aim to increase production of its iconic Plazma keks by 50%, intended for sales abroad. Zagrebacka pivovara invested in a new can filling line totalling EUR 8.5mln in order to provide a four times higher capacity than at present. Dijamant Zrenjanin is yet to enter into construction of a new plant for pressing and extracting oil with an estimated investment value of EUR 30mln. Atlantic's investments in the upgrade and modernization of production lines within each principal brand segment amounted more than EUR 90mln during the past three years. Even more, EUR 50mln is earmarked for a new plant for Argeta savoury spread in Croatia. Preparation works are completed (land has been purchased and building permits are approved) but the building process is postponed in light of the current economic situation. With invested EUR 101mln in past 3 years and Capex/Sales ratio reaching 22% vs. 6% industry average in 2020, Imlek appears an apparent outlier with exceptionally high capital expenditures. Investments into rebuilding factory that was destroyed by the fire - at the end of 2018 - resulted in inflated CAPEX. Thus, in the following graph we present the selected peers with and without Imlek, for the sake of comparability.

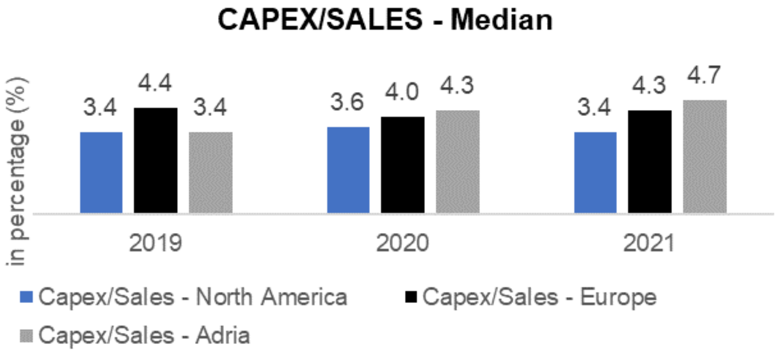
Majority of companies in the industry are still not investing above depreciation level which is perceived as a negative as it is a necessary step to provide stronger competitiveness in the market and provide higher yields to its owners. With increasing ratio Cap Exp to Dep at 1.1 in 2021 as compared to previous years, Adria F&B companies are still below its peers in Europe and North America.

Poorer investment dynamic can be expected for the following period due to increasing costs of investments (inflated prices of construction materials) and costlier borrowings (growing interest rates). Still, it is not expected to completely halt, having in mind the recent supply chains issues arising from the Covid pandemic and Ukraine-Russian crisis. These circumstances made investments in additional production and warehouse capacities in order to hedge against operational risks (both from the demand and supply side) - a necessity to preserve stability in the placement of goods.

Median capex/sales ratio in Adria F&B market is above average in relation to European peers and North American peers in past 2 years. This data speaks in favor of the potential for modernization and upgrades which should ultimately result in higher returns to owners.



Source: Company financial statements, Bloomberg Adria analysis



Source: Company financial statements, Bloomberg Terminal, Bloomberg Adria analysis

Median indicator	2019	2020	2021
Cap Exp to Dep Exp - North America	1.3	1.3	1.6
Cap Exp to Dep Exp - Adria	0.8	0.7	1.1
Cap Exp to Dep Exp - Europe	1.2	1.1	1.2

Source: Company financial statements, Bloomberg Terminal, Bloomberg Adria analysis

Outlook

Given the circumstances which include negative effects from micro and macro point of view (i.e., rising raw material prices, rising interest rates, rising energy prices and rising labour wages), we predict a challenging outcome of 2022 for the F&B sector.

In our view, the FY2022 financial statements will print sales figures that follow the trend from the previous years and keep growing (our prediction 9-12%), while margins will be under immense pressure, mainly gross margins given the fact that cost of materials is accounting for 40-50% of sales on average. As an example, Podravka had a 21.6% rise in the prices of raw materials and supplies in the first half of this year. It sounds even worse the fact that procurement prices obtained during the period, and which are to be reflected in the financials for the second half of the year, are 5-30% higher compared to year-end 2021.

On the other hand, rising energy prices should not have a meaningful impact on operating margins since historically they've accounted for just the fraction of sales (i.e.,1-2%). Employee expenses are expected to increase for 5-7%, although, it should be highlighted that certain industry players have exposure to employee unions (e.g., Podravka), therefore, in that case it could result in even greater increase. In total, according to our analysis, operating expenses for F&B Adria representatives will increase 12-15%, which could result in a decrease of EBIT of 15-20% on average for the financial year 2022. It means that EBIT margins could drop up to 2% on average.

In the short-term, players with exposure to Croatian tourism sector will have significant tailwind in navigating the current market environment due to strong tourist arrival and spending, both in shoulder season and high season. However, that on its own won't be enough to absorb rising input costs given the highly competitive industry environment and pressures from media and customers towards food producers to take a partial hit and not pass on these rising costs.

As a negative consequence of current economy trend, it can be expected inventory balances increase (>10% on average) in 2022 that will negatively impact operating cash flows. In order to circumvent anticipated shortages driven by delays in transportation, higher transportation costs and ever-rising input costs, companies will be incentivized to order greater batches of inventory. Higher quantity with a combination of higher prices will inevitably lead to significantly higher inventory amount. Presented chain of events could end-up being cumbersome for the industry, given the expected consumer spending slowdown in the first quarter of 2023. In those circumstance, companies tend to aggressively discount their products, which could then lead to additional margin pressures in the following year. On the other side, damage that could arise with deficit of their products in the market could be prevailing factor for long term perspective.

Looking into 2023, macro-outlook looks weak in general, with mixed real GDP profiles highlighted by GDP contraction in Slovenia, stagnation in Croatia and only a small positive figures elsewhere in Adria region. Private spending will be one of the key drags to the overall economic activity outcome as a result of aggravated household spending habits courtesy of high inflation. Household spending shares on food run high in some Adria region countries, like in Serbia (26%), North Macedonia (36%) and B-H (29%) vs. the EU average of 16%, which will offset some of the negative macro factors. Competition pressure will, on the other hand, only add to margin pressures in Croatia and Slovenia where household spending on food (19% and 16%, respectively) is close to the EU average. Case of the latter two countries is a bad omen for food producers' margins given the transitory effects of retailers' price wars, and this especially in environment of inflation remaining persistent above multi-year averages in 2023 as well.

Also, (i) retailers' shift towards private labels and (ii) retailers' consolidation of market share, represent a severe threat to the already competitive market environment. All in all, we see potential for further pressure on the local producers' market shares as local products are substituted for imported cheaper replacements. We anticipate private spending recovery to gain traction only in 2024, when a more favourable environment for food producers' profitability will arise. On stock building, we see the upcoming dynamics in 2023 as a balance of two opposite forces – on one hand, producers have learned the best in this year that stock pilling could ease margin pressures from rising input costs and positioning on the market could advocate for stock increases. On the other hand, theory says that in economic downswings stocks are reduced and some producers (dependent on their product mix) will certainly avoid unnecessary stock pilling.

Another challenge, in particular for dairy producers, lies in the carbon footprint of the industry. With more and more firms from western countries focusing on reducing carbon emissions, it remains to be seen how these policies will affect output and whether producers in the region will proactively turn to emission reduction.

Glossary

Term	Definition	Formula
ROE	Return on Equity	Net income/average total shareholder's equity
ROA	Return on Assets	Net income/average total assets
ROIC	Return on Invested Capital	(EBIT - income tax)/ average invested capital
INVESTED CAPITAL	Invested Capital	Short-term debt + long-term debt + provisions + long-term payables + deffered tax liabilities
AR DAYS	Accounts receivables days	Average accounts receivables/Sales revenues*365
AP DAYS	Accounts payables days	Average accounts payables/(cost of materials + cost of services)*365
INVENTORY DAYS	Inventory days	Average inventory/cost of materials*365
CCC	Cash Conversion Cycle	AR days + Inventory days - AP days
INTEREST COVERAGE RATIO	Interest coverage ratio	EBIT/interest paid
CURRENT RATIO	Current ratio	Current assets/current liabilities
NET DEBT/EBITDA	Net debt/EBITDA	(Long-term debt + short-term debt - cash)/EBITDA
NET DEBT/EBIT	Net debt/EBIT	(Long-term debt + short-term debt - cash)/EBIT

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