

# Etika's acquisition spree eats into margins

BY GWYNETH YEO |

Investors looking at F&B company Etika International may be wondering if the company has bitten off more than it can chew. The Malaysian dairy company, which is listed on the Mainboard, has been on an expansion spree, adding a noodle maker, milk and beverage manufacturer and a PET bottling plant to its stable in two years. However, paying for those acquisitions at a time of rising raw-material costs has eaten into its once-fat pre-tax margins, bringing them down to 21% for FY2011 ended September.

Indeed, Etika's FY2011 fell well short of the expectations of analysts such as NRA Capital's Angelia Phua, who was caught off-guard by the company's higher-than-expected cost of sales. Revenue rose 30% y-o-y to RM879.6 million (\$362.1 million) for the F&B company, which is benefiting from fast-growing consumption of liquid and dairy products in tandem with the region's growing middle-income class. However, net profit tumbled 57% y-o-y to RM28.8 million, largely because of a jump in operating expenses, which rose 58% as a whole. Finance costs spiked 147%, as the company had taken on more debt to fund its acquisitions and expansion.

These borrowings have helped push the company's gearing ratio to a high 1.8 times as at end-FY2011. However, CEO Dato' Kamal Tan isn't losing too much sleep over Etika's leveraged balance sheet. "We are not too concerned. Previously, our gearing went up to as

high as 2.3 times and we brought it down," he tells *The Edge Singapore*. The company is operating well below the three times gearing limit its banks have imposed on it, he adds. Additionally, cash flow is still very strong and Kamal points out that Etika was able to pay out a dividend of 0.7 cents a share last fiscal year because of this. He is confident he will be able to bring the company's gearing level down.

In the meantime, Kamal and his team have their hands full turning their recent acquisitions into profit-generating assets. In 2010, Etika acquired **PT Sentra Group**, an instant noodle company in Indonesia; and **Family Group**, which supplies bread to major chains such as Subway Malaysia. More recently, it acquired a pasteurised milk and beverage manufacturer and distributor in Malaysia called **Susu Lembu Asli** and is setting up a UHT aseptic PET filling plant in New Zealand.

## Sweet spot

PT Sentra is expected to boost sales of Etika's dairy products in Indonesia, a market that Kamal predicts could one day be larger than Malaysia, where Etika derives the bulk of its revenue. PT Sentra has two facilities, one in Jakarta and the other in Surabaya. The latter is being converted into a sweetened condensed milk production facility and will become operational by August. "The population in Indonesia is large and the market is much bigger than Malaysia. Eventually, it might overtake Malaysia as No 1 in consumption of our con-



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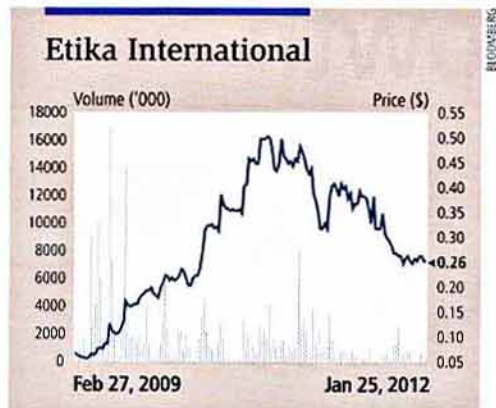
Kamal says he is confident he will be able to bring the company's gearing level down

densed milk," says Kamal, whose family owns 52.2% of Etika.

The acquisition of **Susu Lembu Asli**, meanwhile, has expanded Etika's dairy product offerings through the "Goodday" milk brand. The Malaysian dairy and beverage company

has also increased Etika's distribution channels to hypermarkets, supermarkets, dealers, wholesalers and restaurants.

Etika's venture in New Zealand, however, may take longer to filter down to the bottom line. It has 60% in a joint venture for a NZ\$7



milk powder, palm oil, flour and sugar. Sugar prices, in particular, ran up after the Malaysian government withdrew its subsidy for the commodity. Kamal expects to be able to pass on some of these raw-material price increases to consumers. "We have been doing that. The prices of our products have gone up in tandem with commodity price increases... [but] at the end of the day, how fast can we pass costs on? And how much?"

In the view of NRA Capital's Phua, Eti-

ka's ability to pass on rising raw material costs to consumers will be a challenge due to price resistance faced in its exports markets, particularly if the US dollar strengthens against the domestic currency in the export market. She expects "stubbornly high raw material costs" as well as higher operating costs for the expansion of its distribution network in existing and new markets to pressure gross profit margins in the short to medium term.

Following the release of the FY2011 results, Phua has revised her valuation of the company's shares to 28 cents from 41 cents previously. The stock closed on Jan 25 at 25.5 cents, giving it a PER of 11.3 times trailing 12-month earnings. While the outlook for dairy and beverage consumption in the region remains compelling for Etika, its management will have to show investors the company can digest its recent acquisitions without too much damage to its profitability. **E**

million (\$7.2 million) UHT aseptic PET filling plant in Hawkes Bay.

Once operational in 2H2012, the plant will enable the company to fill PET bottles with beverages such as infant milk in a clean environment. This will give Etika's dairy products a longer shelf life and reduce the use of preservatives. It could also result in 30% savings in packaging cost. Kamal says the plant will start with products such as water and juices, then graduate to more sensitive products such as milk. "If the plant is successful, we can duplicate it in Malaysia, Indonesia, Vietnam, wherever we have a presence," he adds.

### Challenge passing on costs

As he builds on these growth platforms, Kamal faces the challenge of keeping costs in check. Last year, Etika took a hit from a steep increase in the cost of raw materials such as