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MOWI ASA (MHGVY) Earnings Quality Review/Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of MHGVY with a 4+ (Acceptable) rating.

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

We discontinue our BUY rating on MOWI and initiate earnings quality coverage with a 4+ (Acceptable) rating. We are moving all our buy/sell ratings to earnings quality coverage and will use our quarterly Focus List to communicate top long ideas and sell recommendations. Note that we do see more upside for MOWI with its new dividend policy and salmon pricing firming along with strong demand. 2021 looks like a solid year may be at hand.

Summary

MOWI's moving parts of harvest volume, fish pricing, and FX can create lumpy results, but trends appear to be moving in the right direction. For much of the quarter, weak sales to China hurt results by keeping high supply in other parts of the world and holding down pricing. What is key is by the end of 4Q, pricing recovered significantly and even the CEO noted on the call discussing results, *"Cost was down year-over-year, and volumes were up. So then the only missing factor in the equation is prices,"* as he pointed to pricing in the US at 2019 levels at the end of the quarter and even Norwegian prices had bounced up by more than one-third. He further noted that the China export issues appear to be resolved too. *"Consumption in China was impacted by uncertainties regarding import certificates, which should now, for the most part, be solved, and also confidence issues in imported food in general. But we see now that volumes are improving."*

We are pleased to see MOWI's confidence that 2020's COVID problems should be behind them as they reinstated the dividend at 50% of reported EPS and made that their policy going forward. It also guided to slightly higher harvest volume in 2021 and expects to see working capital investment increase due to higher salmon pricing. MOWI also saw their biomass inventory adjustment marked up in 3Q due to more fish in the pens and marked up again in 4Q due to improved pricing. That is a big swing from 1Q and 2Q.

The 4+ rating is based on MOWI still having a sizeable income statement and balance sheet item that tracks the value of live fish based on a number of management assumptions on future pricing, future costs, and mortality. Also, results are very lumpy even though MOWI has reduced costs and going to vertical integration further helps the situation. The movement in salmon pricing remains a powerful indication of results and assumptions on biomass.

What is strong?

- Guidance for 445,000 of salmon harvested in 2021 is only 1.2% more volume than 2020. However, in 2020, pricing in Euros was largely between €4-5 per kg from mid-March. Historically, pricing is above €6 per kg. Adding €1 per kg, would almost double EBITDA in 2020 from €505 million to over €900 million. MOWI is feeling so strongly about pricing in 2021 that it locked in a lower percentage of contract sales. According to the CEO on the 4Q call, *"Then over to contracts. As you can see from the graph here**, we are at the low end of our contract share policy, and that's deliberately. It's on purpose. We believe in a market recovery.** And therefore, we have decided to be light on contract."* For contracts from Norway, MOWI has about 15,000 tons contracted in 1Q and 16,000 tons in 2Q, vs. about 22,000 and 24,000 in the same periods of 2020. See Supply Forecast below under What to Watch?

- Cost-cutting is also evident. MOWI has been investing in more automation to reduce employees, improved its procurement programs, and has worked to lower biologic expenses. In 2020, it cut €35 million in costs like these and is targeting €25 million more in 2021. Even on higher volumes, its feed costs were basically flat or rose less than volumes in some regions. Lower price accounts for more than 100% of the drop in income for 4Q: EBIT down €116 million, pricing at farming was down €145 million. For 3Q, EBIT fell €67 million with pricing down about €84 million. We believe income can grow even faster given the lower cost base being leveraged by higher prices.

- **Free cash flow for 2020 was €187 million. Just on guidance for cash costs, 2021 free cash flow should rise by €76 million.** (For 2021, MOWI is forecasting CapEx to fall by €50 million, interest expense by €18 million, and taxes by €58 million, while working capital should rise by €50 million.) As noted after 2Q, **MOWI was looking to sell its stake in DESS and did so in 1Q21, which will boost cash flow by €114 million.** There was already €100 million in unrestricted cash on hand. A rise in salmon prices should further add to cash flow as noted above. It appears that cash and liquidity should rise noticeably in 2021.

- The dividend returned. Historically, MOWI paid a significant dividend > 6% as part of its way to reward shareholders. During COVID, the dividend was suspended to retain liquidity and also due to the disruptions in the normal pricing model and ability to sell into other foreign markets. MOWI announced a dividend based on 4Q EPS of 0.32 NOK.
    - The new dividend will be to pay 50% of underlying EPS as a dividend. Underlying EPS is EBIT less interest less taxes without accounting for new operating lease impacts on earnings.
    - When the company's debt is at €1.4 billion or below, it will consider paying additional extraordinary dividends or repurchasing stock as well.
    - Additional payments will likely also require a favorable outlook for future cash flows and future cash needs.
    - The payment of 0.32 NOK is only 4-cents per share in USD. It is worth remembering that under better salmon pricing scenarios, MOWI was paying essentially 30-cents per share or $1.20 in annual dividend in USD (it moved based on the NOK to USD exchange rate).

- Consumer Products continue to expand. We have noted that MOWI's goal is to get the US market to per capita levels of Germany in terms of people eating salmon products. The big roll-out was expected in 2020, but COVID delayed that. Consumer products continued to grow for MOWI even with COVID as many people bought salmon in grocery stores during lockdowns.

Consumer EBIT in €	**4Q**	**3Q**	**2Q**	**1Q**
2020	34.8	21.2	23.3	2.4
2019	17.3	13.8	7.5	6.8
Europe EBIT				
2020	21.9	8.1	11.0	-7.4
2019	10.1	5.0	1.1	1.6

    - Europe is the more established market and suffered early in COVID because flight restrictions stopped product from getting to Asia and a glut of salmon hit Europe early on. Asia saw declines in consumer EBIT from 1Q-3Q, and rose in 4Q

    - America saw higher consumer business in all four quarters and posted stronger margins.

When MOWI rolled out consumer products in Germany, per capita consumption was 1.1kg annually. That rose to 2.1g in eight years. The US is a much larger market and starting at 1.2kg per year now. What happens is people not only buy more salmon products in the store, they eat more salmon in other places too. We still see this as a big source of future growth for MOWI.

What is weak?

- The Canadian operations will see much of the western operations close due to Canadian government policy changes. This will cost MOWI about 10,000-12,000 tons of harvest volume. That is built into the forecast for 445,000 tons. This will emphasize production in Eastern Canada, which MOWI considers the toughest place to farm:

  > *"Bear in mind, we bought this [Canadian operation] back in 2018. It's not a long time ago, and then we run into a severe mass mortality from an algae bloom. Last year was also challenging. We had not a mass mortality, but we struggled with plankton. Lice is also an issue in the East.* ***<u>They have a very warm summer and a very cold winter, so you could say the worst of 2 worlds. That makes it even more challenging to be a farmer. So of all spots on the planet, I think, where you actually can do this, let me underpin that. I think Canada East is one of the most challenging areas. So it's much tougher to deliver results in this area than in other areas.</u>****"*

  There will be a €6.1 million charge in 2021 to restructure the Canadian operation and decommission operations on the west coast of Canada. The goal is to lower costs and grow Canada back going forward. This will be about 7% of MOWI's production. MOWI has improved health issues in other regions, but it sounds like this may remain a very lumpy source of profits/losses going forward.

- Foreign Exchange remains a wild card for MOWI. There are two primary exchanges to watch – NOK to USD. The stock trades in NOK and thus the ADR in the US is impacted by the exchange rate. Norway is an oil country so its currency tends to move up or down with oil prices. The exchange rate is currently 8.5 NOK to the dollar. That has improved considerably from early COVID and $13 oil when the NOK was almost 12 to the dollar and has fueled some of the stock price gain in 2020. Historically, the NOK trades closer to 5-to-1 but that has been a long time. So this may not be the same type of tailwind going forward.

MOWI's operations are reported in Euros. So there are some FX issues of the Euro vs the USD and Asian currencies for sales. The larger issue is much of the farmed salmon in the world comes from Norway. Many competitors report their feed costs in NOK and as the NOK depreciated, they effectively had lower feed costs and thus lower cost salmon and could afford the lower salmon prices better than MOWI in 2020. Going forward, those competitors would see future feed costs effectively rise faster and they will give back those incremental 2020 profits. The NOK/Euro relationship is returning to normal levels now. MOWI should see competitors needing better pricing in 2021 and help boost overall pricing too and MOWI does not have the feed cost headwind from FX.

What to watch

- Supply and Demand were largely in balance for 4Q. Chile on supply and China on demand were the wildcards last year. If China was merely flat in 4Q and 3Q, demand would have exceeded supply the last two quarters and likely spurred better prices before late 2020.

Market Balance	4Q	3Q	2Q	1Q
Supply Growth	10.8%	4.8%	3.3%	2.3%
Demand Growth	10.0%	4.8%	1.3%	0.4%
Chile Supply	20.4%	15.6%	9.7%	8.6%
China Demand	-48.5%	-51.5%	6.9%	-29.8%
y/y Demand with flat China	11.2%	7.1%	0.9%	2.0%

  - China had been about 5% of world demand and dropped to 2% in much of 2020. Early on, this was a lack of air travel making salmon shipping difficult. Later in the year, it was more paperwork and certificates to get salmon into China.
  - **MOWI's CEO says much of the certificate issues are behind them now. If China demand can now return toward more normal levels, it should absorb considerable supply.** This was the difference in 3Q and 4Q of having demand exceed supply growth and having it equal to or below supply growth. That would help pricing.

    - **Chile is about 28% of the world supply and rose 20% in 4Q, but that was only up 1% in December. Looking at salmon going from Chile to Miami in 4Q, the prices rose from $3 to over $5 per pound as Chile supply fell.**
    - More importantly, the biomass in Chile fell 12% y/y at the end of 4Q. Forecasts have Chile supply falling by 10%-15% vs 2020 levels in 2021. Total world supply is forecast to rise only 0%-4% in 2021.

- Foodservice continues to hurt salmon demand. Even with the growth in consumer products and people eating more salmon at home, that is not offsetting the closure and restrictions on restaurants. MOWI still estimates this as a net loss of demand of about 5%. As the world gets past COVID, MOWI should see a growing foodservice business and consumer products business and recapture the sales lost from food service in 2020. In some quarters of 2020, MOWI was estimating the net loss as about 10% of sales.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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