Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

May 21, 2021

# Mowi ASA (MHGVY)
# Earnings Quality Update- 3/21 Qtr.

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

*We are maintaining our earnings quality rating of MHGVY at 4+ (Acceptable).*

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

## Summary

1Q21 results at MOWI showed good improvement sequentially and were flat with 1Q20 results at €109 million when pricing collapsed when COVID hit near the end of the period. The company had its largest harvest of salmon of any first quarter. Pricing has recovered from a very low starting point and that still had a negative impact on overall results. Thus in both first quarters, there was a wide swing in prices that impacted results. However, looking at the recent trends points to continued improvement going forward. Cash flow guidance remains the same on capital spending, working capital build, and interest with only tax guidance rising to €80 million from €20 million. Higher taxes implies some higher income. Also, MOWI reduced debt with the proceeds of its DESS sale and retains ample liquidity.

We think investors should note that the 32-NOK dividend introduced in 4Q20 was boosted to 77-NOK in 1Q21 based on the stronger pricing improving earnings – the goal is to pay a dividend of 50% of earnings. Also, one of the bigger earnings swings is marking biomass to reflect rising/falling valuations. During COVID, MOWI wrote down fish in sea pens by €200 million in 1Q20 and 2Q20. Since then, the valuation has recovered by €148 million with €92 million in Q21 based on higher period-end pricing. Also of note, the weight of fish in the pens is down 6%

from 1Q20 based on higher harvest volume this period, thus, MOWI has likely recovered nearly all of the COVID markdown.

## What is strong?

- Demand growth of 15.9% y/y exceeded supply growth even though supply grew at 14.4% as MOWI had the largest 1Q harvest ever. We take that as solid evidence that strong pricing seen as 1Q21 moved along could continue.

- Supply growth forecasts for the year remain subdued. The 1Q's 14.4% was higher than expected due to harvesting more large fish and early harvests in Chile. The full-year industry forecast remains low at 1%-4% vs. prior guidance of 0%-4%. This includes forecasts of -4%-0% in 2Q and -2%-1% in 2H21. Much of this is based on Chile seeing production fall by 15% in 2021 and given that harvesting happened earlier in 1Q for Chile, there simply isn't as much salmon ready for market coming from Chile in the rest of the year. MOWI should also benefit from this as its forecast is to see 5% y/y volume growth in 2Q.

- Pricing has already responded. We noted last quarter that under COVID pricing for salmon had been €4-5 per kg vs. the normal €6+ per kg. An extra €1 would almost double MOWI's EBITDA. For 1Q, MOWI posted flat operating income y/y of €109 million. That was due to salmon farming being down €34 million against consumer products being up €30 million. Salmon farming had lower costs and higher volumes but lower pricing for the quarter was about double the impact of the higher volumes. In 1Q20, MOWI had strong pricing for about 10 weeks and then saw it collapse. In 1Q21, MOWI had poor pricing early on, and then pricing strengthened at the end of the period. Salmon started the quarter at just over €4/kg and finished just under €7/kg.

- Consumer Products had another very strong quarter. It didn't quite match 4Q20's record of €34.8 million in EBIT but came in at €32.2 million. Dining restrictions have helped this unit post stronger sales and profits. However, MOWI delayed rolling out its brand name and all consumer products last year with COVID. Much of the consumer products results still come from Europe - €20 million of the €32 million total in 1Q21. On the call, MOWI noted it is launching into new stores in the UK and US, along with Belgium, Italy, Spain, and working on Chile, Brazil, and Columbia.

- Cost-cutting continues as MOWI is still targeting €25 million in lower structural costs for 2021 on top of €35 million realized after 2020. That level of cost savings would add about 10% to pre-COVID earnings and could help the dividend grow in the future. Biologic costs were down as well as operating costs for farming. Despite rising costs for many agricultural commodities and fish – MOWI still reported lower feed costs overall. That may increase in 2Q more and become more of a headwind.

## What to Watch?

- MOWI was betting on pricing increases and reduced the amount of its future sales tied to contracts to only 21% in 1Q and only 25% for the year. This will give it much more spot pricing, which is rising. Normally, MOWI has 2-3x these levels under contract which shaves off the highs and lows of spot price volatility – we would expect future contract sales to rise again as pricing nears higher levels.

- Foodservice in the US may be open, but much of Europe it was still closed during 1Q. The UK opened May 17. Sushi places in Japan have seen higher takeout orders, but there are still restrictions in many Asian countries. Foodservice consumes more salmon than the retail sector. When restaurants closed and retailer demand soared – it was still about a 10% loss of overall salmon demand. As more restaurants reopen for inside dining – it should further add to demand growth and possible drive pricing higher given the forecasts for supply growth to be essentially 0% the rest of 2021.

- China has had restrictions on foodservice and issues with supplying the market due to reduced airfreight capacity being available. There have also been trade issues. China had been a growth market for salmon and reached 4.8% of world demand in 2019. That dropped to only 3.1% in 2020 and even against a weak comp for 1Q, Chinese demand fell to only 2.3% of the world total. Having this market recover should further bolster salmon pricing.

- The NOK/Euro exchange rate can also help MOWI's earnings growth. Normally the exchange rate is just under 10 NOK to the Euro. Under COVID, it spiked to over 12 and remained higher for most of the year. Other salmon farmers function in NOK while MOWI functions in Euros. When the NOK lost strength, the other farmers could cut prices more easily and fish that were being harvested and that contributed to the pricing pressure in 2020. The weaker NOK also meant those farmers were paying more for feed costs during 2020 and have more cost invested in the current salmon. That will pressure the NOK farmers to hold pricing higher. At the same time, MOWI's own feed costs were cheaper with the stronger Euro so its embedded cost is lower. The NOK/Euro exchange is now at 10 to 1 – just a tad above normal at this point so these impacts should be muted in the near future. However, the market may see more pressure for higher pricing as the current fish are harvested and MOWI's cost to raise some of these fish should be lower.

- There may be less room for share appreciation from the USD/NOK ratio. MOWI's shares trade in NOK and its dividend is paid in NOK. For the US shares, that converts to dollars. Since the drop of $100 oil, the exchange rate has been about 8 NOK to the dollar. Under COVID, that spiked to over 11 to 1, and having it drop back to the mid-8s has helped MOWI's stock price in the US. Over a much longer timeframe, the exchange rate is closer to 5 to 1. But the COVID driving FX appreciation seen since last May has largely been realized.

- The dividend should rise with earnings with a goal to pay out about 50% of earnings. Historically, MOWI earned about $1.20-$1.40 per share in dollars before COVID, before some new capacity, before consumer products, and before some cost reduction efforts. We think the dividend could grow from the 4 cents in 4Q20 and 9 cents in 1Q21 toward 15-20-cents per quarter based on past results. And if the new products, pricing, and volumes grow – it could grow with those results too.

# 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.

# Disclosure

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