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## MOWI ASA (MHGVY) 2Q19 Update

### Maintain BUY

**We are maintaining our BUY recommendation on MHGVY.** The company beat on revenue and missed on EPS by €0.01. The stock is trading on what we still see as depressed EPS (19x) and depressed EBITDA (13x). The yield is 4.7%. The company is targeting an optimum debt level of €1.4 billion vs. the current €1.1 billion. So, it may still raise €300 million in external capital going forward and has the credit lines in place. This appears likely to support some higher working capital investment that the company is forecasting along with higher volumes and demand. If it does, the target level for Debt/EBITDA on current figures would only be 1.4x.

The company's dividend is €550 million per year and maintenance capital spending is about €180 million per year, so cash from operations needs to top €730 million. On a trailing twelve months, it is €738 million plus €21 million in dividends received on investments and that is after paying 84% of expected cash taxes for the year in the 1H19. We believe there are several levers to move cash from operations significantly above that figure. In looking at 2Q19 results, we see solid growth in volumes, some new operations have come online, and demand growth continues. There should be some pressure on pricing in some areas of the business during the 3Q. However, long-term growth in demand appears to set Mowi up for better pricing and volumes at the same time several new areas of growth investment are targeting better cost control.

In updating several of the catalysts and issues we highlighted in the original report, we see the following from 2Q19:

- **Demand growth continues in nearly all key places. The EU is the largest market and grew 3.6% y/y for the last 12 months. The US is the second-largest and half the size of the EU and grew at 5.3% for the last 12 months.** Russia and China are seeing growth slow – but in the case of Russia – it often loses out to higher bidders on price for salmon and China/Hong Kong issues appear to be impacting demand there now.

Also, China is a market that is tied to purchasing very large fish. **The net result appears to be that world demand is still growing faster than recent supply growth** and the increase in supply going to value-added product should also offset supply going to traditional fresh salmon markets.

- **Supply has been restrained for 2017 and 2018. 2019 is seeing some recovery, at 4%-7% growth and the industry is looking at 4% in 2020.**
- **Mowi is taking share with volume growth 26% in 2Q19, guidance for 3% growth in 3Q and 8% in 4Q.** Mowi has bought more licenses in Norway, enjoyed Norway's regulator boosting growth quotas on existing licenses, and is planning to develop more.
- **Pricing on salmon moves inversely with supply growth and in tandem with fish size, yet Mowi saw minimal pricing contraction in posting its highest 2Q EBIT ever. It is guiding to some areas of weaker pricing in 3Q** based on earlier harvesting, which means smaller fish. That is a common event in a few areas in any given quarter and seldom broad-based.
- **Mowi continues to invest in improving pricing and reducing costs.** Its new capacity for fish feed in Scotland opened in 2Q and boosted capacity at Mowi from 520 tons to 590 tons – that will control costs. It continues to invest in growth for more freshwater fish raising pens to reduce parasite issues, more seawater pens to boost volume, and more consumer product capacity to increase prices.
- **Cash flow should continue to improve.** This year, Mowi is expecting to invest €115 million in working capital to support growth, over €100 million in growth capital spending, higher volume should help, and of the forecast for €160 million in tax payments, it already paid €135 million in the 1H19.
- **The NOK is still almost 9-to-1-against the dollar, which remains a catalyst should it recover to 7-8 NOK-to-USD but still below the historic 5-to-1. The salmon market will always be volatile quarter to quarter and vary by region. However, the long-term growth remains well-founded.**

## Demand Growth Continues and Moves Up with Supply

Mowi has 20% of the world farmed-salmon market based on its 430,000 tons of volume against the industry's 2.2 million. Industry demand growth was over 6% for 2Q19 and just under 5% for the last twelve months. Salmon is still a luxury product and two years of poor industry supply growth caused the market to move supply away from less lucrative markets.

Demand Growth	% of Mrk	3m y/y	12m y/y 2Q19	12m y/y 2Q18	12m y/y 2Q17	12m y/y 2Q16
Eur. Union	44.0%	7.8%	3.6%	4.4%	-6.5%	2.0%
USA	20.0%	3.3%	5.3%	11.6%	-4.9%	10.4%
Asia	13.1%	4.7%	1.5%	16.0%	-3.5%	7.1%
World	100.0%	6.4%	4.7%	8.6%	-6.7%	2.6%

As the supply has recovered, many areas denied salmon have seen a surge in demand growth such as Eastern Europe moving from 3.5% growth in the last 12 months to 11% for 2Q or non-China/Japan/Korea Asia moving from -6.4% to 14.4% in the trailing 12 months to 2Q19.

	3m y/y 2Q19	3m y/y 2Q18	3m y/y 2Q17	3m y/y 2Q16
Supply Growth	8.3%	5.2%	3.9%	-8.8%

The supply growth is expected to be about 5.5% this year and 4% next year according to forecasts supplied by Mowi. It still looks like demand growth is stronger than supply increases.

## Mowi Is Taking More Share

As Chilean volume has recovered at Mowi, it has seen 2019 pick up much faster than the industry as a whole. Mowi volume is up 26% y/y in 1H19 and guidance is for 3% y/y in 3Q and 8% for 4Q19. We do not see the 3Q estimate as an issue. The 3Q18 was the highest volume quarter last year and Mowi's toughest comp:

Mowi Vol	4Q	3Q	2Q	1Q
2018	105.8	109.9	78.3	81.2
2019	114.4e	113.0e	98.0	104.1
y/y Growth	8.1%e	2.8%e	25.2%	28.2%

Even with the higher supply, pricing held strong compared to all-time highs in 2Q18. Market spot prices were only about 10% lower y/y. Plus, Mowi sells part of its supply with longer-term contracts that use average prices over time and smooth out spot price changes. Normally, when pricing is rising, the contract prices lag and vice versa. Plus, Mowi continues to produce a very high percentage of superior quality salmon which helps on pricing. The result is pricing against the market stays strong for Mowi and improved y/y:

Mowi 2Q Pricing	Norway	Scotland	Canada	Chile
2018	91%	97%	96%	91%
2019	100%	108%	99%	100%

It should still grow much faster than the industry. Mowi expanded its licenses in Norway in 2018, it also had Norway award higher biomass per pen that should add about 2% supply in Mowi's largest market. The company bought four more licenses in Norway during the 2Q that will add about 4% more its total there.

During the quarter, Mowi was awarded 5 of the 6 licenses for a new fish pen concept. Later, it sought to lower the cost by building it with steel and Norway's regulatory agency didn't approve the design change. That's in limbo now and the reason for the design change was to lower the total cost of the operation. We know nothing more than that from the call – but this doesn't sound like the biggest hurdle to overcome in our view. Plus, Norway is still forecasting that it will more than double its total supply over the next decade.

**The company did guide that it has harvested smaller fish in 3Q from parts of Norway. Smaller fish size normally means lower selling prices and the smaller fish didn't leverage the fixed costs as much as larger fish do. Thus, it guided to a higher cost/lower price situation for 3Q in Norway. That will impact volume in 3Q too.**

## Mowi Is Still Investing to Reduce Costs and Improve Volumes

Maintenance capital spending is €180 million and Mowi will spend €290 million this year. It completed the new feed operation in Scotland in 2Q which boosts feed volume capacity from 170,000 tons to 240,000. Mowi now has feed capacity of 590,000 tons. Producing its own feed helps control costs and also enables the company to show exactly what the fish ate

throughout its life. That helps boost selling prices and produce more contracts with customers.

It is also spending money this year to build more freshwater raising pens. This lets the fish grow larger and stronger before they face exposure to health issues like sea lice in salt water. That reduces the cost of treatment for lice, and treatment methods can also cause fish to eat less and grow more slowly.

Mowi is rebuilding a new smoked salmon facility too that will boost its supply of Value-Added consumer products. That should help on pricing and remove some more of the market swings from salmon pricing from the equation. With new licenses, new plants adding to volume, the company also anticipates growing its working capital to support more organic growth.

## Cash Flow Should Improve

Cash flow is largely a function of volume and pricing producing income. EBITDA is rising in 2019 as a result and that is helping drive Cash from Operations. As noted above, volume should come in higher in 3Q and 4Q both y/y and against 1Q and 2Q. Importantly, Mowi is guiding to €160 million in cash payments for taxes in 2019 – it has already paid €135 million in the first half.

Mowi Cash Flow	2Q19	2Q18	1Q19	1Q18	2018	y/y chg
EBITDA	€248.0	212.8	233.2	194.8	906.2	€73.6
taxes paid	-81.8	-53.3	-53.1	-50.5	n/a	n/a
CFO	€155.7	112.8	265.8	191.8	620.9	€116.9

Working capital typically rises considerably in 4Q and gets released in the 1Q. With the company pointing toward €115 million of increased working capital, that is a strong headwind after having working capital generate about €21 million in cash in the 1H19. It should boost EBITDA at the same time:

Seasonal W/C chg	4Q	3Q	2Q	1Q
2019			-29.6	51.0
2018	-124.9	-18.0	-43.2	38.5
2017	-99.9	-71.9	-3.0	59.6

In our view, the EBITDA is already growing and that should continue. Working capital normally rises in 3Q and 4Q and having most of the cash taxes already paid in 1Q and 2Q should also cushion that working capital growth as cash from operations has already risen in the 1H19 despite those higher payments.

## Other Issues Pressuring the Stock Should Eventually Ameliorate

We noted in the original report that the company does a large percentage of its business in Euros and US Dollars. Results are reported in Euros. However, the stock trades in Oslo in Norwegian Krone. The exchange ratio between the NOK and USD remains near the extreme low of 9 to 1 and actually has weakened a bit since July. We still see this as a function of forecasts of future oil prices as that is a large part of the Norway economy. We still believe given that oil prices are over \$20 off the lows – the pricing of the NOK remains out of line and it could appreciate a bit to help drive the stock price in dollar terms.

Mowi continues to move forward with its consumer products business. This is smoked salmon, pre-cut frozen filets, packaged fresh sushi as examples. There is pricing pressure in some of the European markets as supply has increased. We believe the market will absorb the supply increase and other markets in Europe also start to accept more product such as Russia. In the US, we still see consumer products as being very early in the roll-out stage for Mowi and it should become much larger than Europe overall. That could be a large source of growing demand for premium-priced products.

With the moving parts of new facilities coming online, the supply of salmon growing modestly faster or slower than demand at times – we’re more focused on the total rate of growth here and the fact that Mowi is the largest player in this industry and is well-capitalized to support its growth and efforts to reduce costs than we are on EPS of €0.29 or €0.28 in any given quarter. The larger trends should drive EPS for several years to come in our view and the forecasts show that health trends, the age of the world population with higher incomes, and the flat to down volumes for wild salmon – the demand for farmed raised salmon is expected to double or triple in the coming decade. Plus, it would remain a very modest part of overall diets. It doesn’t need to become coffee with the bulk of the

population having 5 servings per day. Boosting US per capita consumption by 0.5kg per year would be a huge surge in demand. (When other food companies are planning to put pot in food to fill higher demand – it shouldn't be that difficult to get more people to eat an extra piece of salmon.)

In the meantime, the company pays a 4.7% yield and expects to pay a minimum of 75% of free cash out to shareholders as dividends.

## Disclosure

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