NEW ZEALAND EQUITY RESEARCH | FOOD, BEVS, & AGRI | AQUACULTURE
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New Zealand King Salmon
1H20 Result — Channelling Value

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OUTPERFORM

New Zealand King Salmon (NZK) delivered a 1H20 result with few surprises and remains on track to hit full year guidance. However, we note the importance of the coming month in terms of water temperature risk. NZK is facing a period of subdued volume growth following the FY19 mortality event, combined with a change to its operating model. However, medium-term growth, underpinned by current consents, remains attractive in our view. Although not captured in our forecasts, we see significant upside should NZK be successful in gaining additional water space, particularly offshore, where volume uplifts could be meaningful. Reiterate OUTPERFORM.

NZX Code	NZK
Share price	NZ$2.01
Target price	NZ$2.65
Risk rating	Medium
Issued shares	138.5m
Market cap	NZ$278m
Avg daily turnover	54.2k (NZ$123k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	11.4	13.8	17.3	23.3
EPS* (NZc)	8.2	9.9	12.5	16.8
EPS growth* (%)	-30.6	21.4	25.8	34.4
DPS (NZc)	5.0	5.0	6.0	7.0
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	11.1	10.6	8.8	6.9
EV/EBIT	14.7	14.3	11.6	8.8
PE	24.5	20.2	16.1	12.0
Price / NTA	2.3	2.1	1.8	1.6
Cash div yld (%)	2.5	2.5	3.0	3.5
Gross div yld (%)	3.5	3.5	4.1	4.8

Price momentum continues

NZK has been successful in delivering further price increases as it rationalises its market exposure and utilises price as a demand lever. The weighted average price increased +6.6% on the prior comparable period, with underlying price improvements across markets combined with favourable geographic mix changes. We expect further price increases will be tougher to achieve going forward and currently forecast inflation type growth. NZK has been steadily addressing brand positioning and price by market, reducing volume and lifting price in traditionally lower margin markets such as Japan and Australia. The company now suggests that the margin differential by market is minimal, providing additional flexibility in the event of trade disruption. As such, NZK has seen no material impact as a result of the coronavirus.

Open ocean update in June, farm relocation decision pushed out again

Applications for additional/more suitable water space offer a source of significant earnings upside not captured in our forecasts. NZK's application to farm additional water space in the Cook Strait is in the public consultation stage, with a public hearing scheduled for mid-2020 and a decision expected within the calendar year. A decision on the company's application to relocate a number of its lower performing Marlborough Sounds sites to better suited areas has been kicked further down the road, with no outcome expected this side of the New Zealand election.

On track to hit full year guidance

NZK has reaffirmed its FY20E Operating EBITDA guidance range of NZ$25.0m to NZ$28.5m (FB NZ$27m), and reiterated its medium-term volume forecasts (~8,000mt in FY21 and ~9,200mt in FY22). We have left our forecasts unchanged. It is worth noting that February/March is an important time for salmon farmers, given water temperature risk (sustained temperatures above 17^{o}c can negatively impact fish health). To date temperatures have been behind recent years and closer to average levels. In addition, upwelling devices recently installed at all NZK farms provide a form of mitigation against temperature increases.

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New Zealand King Salmon (NZK)

Priced as at 27 Feb 2020 (NZ$)	2.01

12-month target price (NZ$)*	**2.65**
Expected share price return	31.8%
Net dividend yield	2.8%
Estimated 12-month return	34.7%

Spot valuations (NZ$)	
1. DCF	2.72
2. Comparative multiples	2.40
3. Market multiple	n/a

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	1.01
WACC	8.2%
Terminal growth	2.0%

DCF valuation summary (NZ$m)	
Total firm value	389
(Net debt)/cash	(9)
Less: Capitalised operating leases	
Value of equity	380

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	160.3	172.6	180.7	187.9	220.9
Normalised EBITDA	**26.2**	**25.2**	**27.4**	**33.5**	**42.2**
Depreciation and amortisation	(5.1)	(6.2)	(7.2)	(8.2)	(8.9)
Normalised EBIT	**21.1**	**18.9**	**20.2**	**25.3**	**33.3**
Net interest	(0.7)	(1.1)	(1.1)	(1.2)	(1.0)
Associate income	0	0	0	0	0
Tax	6.6	4.4	5.4	6.7	9.1
Minority interests	0	0	0	0	0
Normalised NPAT	**16.3**	**11.4**	**13.8**	**17.3**	**23.3**
Abnormals/other	0.2	0	0	0	0
Reported NPAT	**16.4**	**11.4**	**13.8**	**17.3**	**23.3**
Normalised EPS (cps)	11.8	8.2	9.9	12.5	16.8
DPS (cps)	5.0	5.0	5.0	6.0	7.0

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	10.5	11.1	10.6	8.8	6.9
EV/EBIT (x)	13.0	14.7	14.3	11.6	8.8
PE (x)	17.0	24.5	20.2	16.1	12.0
Price/NTA (x)	2.3	2.3	2.1	1.8	1.6
Free cash flow yield (%)	3.9	-1.2	-0.5	2.8	4.8
Net dividend yield (%)	2.5	2.5	2.5	3.0	3.5
Gross dividend yield (%)	3.5	3.5	3.5	4.1	4.8

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	30.5	17.3	18.9	20.3	34.0
Interest cover EBITDA (x)	37.9	23.0	25.7	26.8	43.0
Net debt/ND+E (%)	-2.4	5.2	8.8	8.3	6.1
Net debt/EBITDA (x)	n/a	0.4	0.6	0.5	0.3

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
Revenue (%)	17.5	7.7	4.7	4.0	17.5
EBITDA (%)	21.1	-3.8	8.9	22.2	26.1
EBIT (%)	22.2	-10.1	6.8	25.3	31.7
Normalised NPAT (%)	-29.9	-30.5	21.4	25.8	34.4
Normalised EPS (%)	-30.0	-30.6	21.4	25.8	34.4
Ordinary DPS (%)	>100	0.0	0.0	20.0	16.7

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	9.8	8.5	8.1	9.4	11.3
Return on equity (%)	9.8	6.7	7.6	8.6	10.3
Return on funds employed (%)	11.0	9.5	9.0	10.3	12.5
EBITDA margin (%)	16.3	14.6	15.2	17.8	19.1
EBIT margin (%)	13.1	11.0	11.2	13.5	15.1
Capex to sales (%)	8.7	8.2	11.3	9.1	6.9
Capex to depreciation (%)	275	228	284	208	172
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	42	61	50	48	42

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**26.2**	**25.2**	**27.4**	**33.5**	**42.2**
Working capital change	(0.0)	(8.8)	(2.0)	(0.8)	(3.6)
Interest & tax paid	(7.3)	(5.5)	(6.4)	(8.0)	(10.0)
Other	5.9	0	0	0	0
Operating cash flow	**24.8**	**10.8**	**19.0**	**24.7**	**28.6**
Capital expenditure	(14.0)	(14.2)	(20.4)	(17.0)	(15.3)
(Acquisitions)/divestments	0.0	0.0	0	0	0
Other	0	0	0	0	0
Funding available/(required)	**10.8**	**(3.3)**	**(1.4)**	**7.7**	**13.2**
Dividends paid	(7.1)	(7.1)	(6.9)	(8.3)	(9.7)
Equity raised/(returned)	(0.0)	0.0	0	0	0
(Increase)/decrease in net debt	**3.7**	**(10.5)**	**(8.3)**	**(0.6)**	**3.6**

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue split by market (NZ$m)					
New Zealand Retail	41.4	40.6	42.2	43.1	49.5
New Zealand Foodservice	37.8	39.2	40.0	40.4	45.8
Domestic	79.2	79.8	82.1	83.5	95.3
Export	81.0	92.9	98.5	104.4	125.5
Total	**160.3**	**172.6**	**180.7**	**187.9**	**220.9**
Revenue split by market (%)					
Domestic	49%	46%	45%	44%	43%
Export	51%	54%	55%	56%	57%
Revenue split by country (NZ$m)					
New Zealand	79.2	79.8	82.1	83.5	95.3
North America	48.4	58.5	63.7	68.8	83.9
Australia	11.5	11.9	12.5	13.1	15.5
Japan	8.3	5.9	5.9	5.9	6.6
Europe	2.9	3.1	3.3	3.4	4.0
Other	10.0	13.5	13.1	13.2	15.5
Total	**160.3**	**172.6**	**180.7**	**187.9**	**220.9**
Sales volume (MT)	**8,018**	**7,931**	**8,000**	**8,000**	**9,200**
Average realised price (NZ$/kg)	19.99	21.76	22.58	23.49	24.01

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	15.1	17.8	19.8	20.6	24.2
Fixed assets	43.7	51.8	64.8	73.4	79.6
Intangibles	44.4	46.8	47.0	47.2	47.5
Right of use asset	0	0	5.0	5.0	5.0
Other assets	84.4	82.9	88.2	99.5	110.4
Total funds employed	**187.6**	**199.3**	**224.8**	**245.8**	**266.7**
Net debt/(cash)	(4.0)	9.2	17.5	18.1	14.6
Lease liability	0	0	5.0	5.0	5.0
Other liabilities	25.3	21.4	21.4	21.4	21.4
Shareholder's funds	166.3	168.8	180.9	201.2	225.7
Minority interests	0	0	0	0	0
Total funding sources	**187.6**	**199.3**	**224.8**	**245.8**	**266.7**

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

1H20 result summary

New Zealand King Salmon (NZK) reported 1H20 Operating EBITDA of NZ$16.5m, behind the prior comparable period and our expectations, although predominantly reflects sales volume timing rather than operational underperformance. Key highlights in the result include (1) another step up in weighted average price, up +6.6% on the prior period, (2) a low feed conversion ratio achieved, lifting gross margin and biomass for the half, and (3) early positive indicators that operational changes are delivering improvements.

Figure 1. 1H20 result summary (NZ$m)

	1H19A	1H20A	% chg
Revenue	**87.7**	**84.2**	**-4.0%**
Expenses	(70.4)	(67.7)	-3.7%
Pro-forma EBITDA	**17.3**	**16.5**	**-5.0%**
Depreciation & ammortisation	(3.0)	(3.8)	27.6%
Pro-forma EBIT	**14.4**	**12.7**	**-11.7%**
Interest & tax expense	(4.7)	(4.0)	-15.1%
Pro-forma Operating NPAT	**9.7**	**8.7**	**-10.0%**
Adjustments	5.4	12.0	124%
Reported NPAT	**15.1**	**20.8**	**37.7%**

Source: Company reports, Forsyth Barr analysis

Target price NZ$2.65; OUTPERFORM

NZK reaffirmed FY20E Operating EBITDA guidance of NZ$25.0m to NZ$28.5m (FB NZ$27m). We remain comfortable with our earnings forecasts and make no changes to current assumptions, although note the importance of the current period for meeting expectations.

We see the New Zealand aquaculture sector as being on the right side of sustainable farming trends and have a positive view on the sector. We are attracted to NZK's medium-term growth underpinned by volume uplifts enabled by current consents, with longer-term upside should the company progress with open ocean opportunities or receive a favourable outcome from its farm relocation application. OUTPERFORM.

Key result highlights

Achieving premium prices

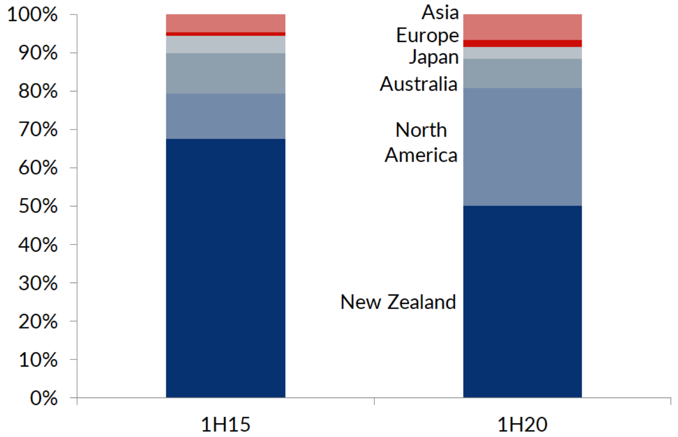
NZK has delivered a meaningful increase in weighted average price in 1H20, with commentary suggesting possible upside for full year estimates. 1H20 weighted average price increased +6.6% to NZ$24.5/kg. Following a difficult FY19, NZK successfully used price increases as a mechanism to manage customer demand. The price increase represents a mixture of underlying price growth and favourable market mix.

Prices for Ōra King are capped by restaurant menu prices, in our opinion, where clearer premium food substitutes exist. The company has previously noted that it is seeing its products moved from main to starter across Australasia, suggesting there is limited scope for further increases. We currently forecast inflation type (low single digit) price growth.

Other incremental opportunities to drive value include:

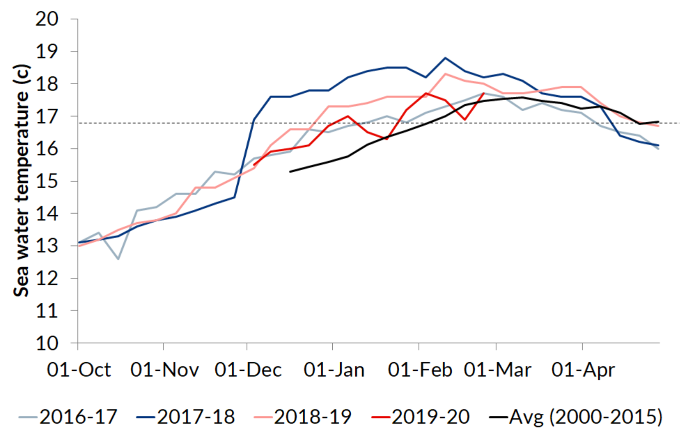
- **Atlantic salmon —** NZK is importing and selling Atlantic salmon in the domestic market, under the brand Regal — Epicurean. Early indications are positive for the brand, with initial market share at a major retailer of ~2%.
- **Pet food —** NZK is growing its Omega Plus pet food range, with a particular focus on the Chinese e-commerce market.

Figure 2. NZK sales by geography



Source: NZK, Forsyth Barr analysis

Figure 3. Sea surface temperature — Pelorus Sound



Source: NZK, Forsyth Barr analysis

Navigating tricky summer waters

The next two months represent a critical time on NZK's calendar, with summer waters potentially leading to fish performance challenges. Sustained temperatures above 17^{o}c can lead to fish mortalities, representing a large cost to the business but also impacting sales volumes in future periods. Temperatures to date have been below prior periods and closer to long-term averages (Figure 3), as such, we are cautiously optimistic at this stage that NZK can navigate the summer period unscathed.

Following two difficult summer periods, NZK has made operational changes and invested into fish health. Although early days, initial feedback on initiatives is positive.

- **Upwelling systems —** These devices, which NZK has installed at all of its farms, are designed to churn the water under the farms, oxygenating the water column and redistributing cooler water towards the surface. At some farms the systems have delivered a -1^{o}c difference to surface temperature.
- **Single year class (all salmon reared at a site are from the same year class) —** Single year class is global best practice and serves as a biological reset of the farm between re-stocking. This limits cross infection of disease that can occur between salmon.
- **Vaccinations —** NZK has been vaccinating smolt ahead of release, which appears to be mitigating impacts from common marine bacteria NZ-RLO.

Open ocean optionality

Open ocean salmon farming represents a significant opportunity for NZK, offering meaningful upside in the event water space is granted. NZK has identified 13 potential open ocean sites around the southern (mostly eastern) coast line, and has made a resource consent application to farm in the Cook Strait.

If approved, the possible site, referred to as Blue Endeavour, could produce ~4,000mt per 18 month cycle. This would represent a +50% lift to NZK's current production. At this stage the application is awaiting a public hearing in June with a decision expected in 2020. Should the application be approved, the current timeline would suggest the first harvest could be 2H23. We estimate a positive outcome from Blue Endeavour adds ~NZ$0.40 per share or +15% upside to our NZK valuation. Refer to our report *Open Ocean Optionality* — published 27 November 2019, for additional background on open ocean farming and a breakdown of our valuation assumptions made.

Investment Summary

New Zealand King Salmon (NZK) is the world's largest producer of King salmon, a luxury food item sold predominantly into the foodservice channel. NZK sells products through a suite of well established brands which have a strong track record of achieving premium pricing over alternatives. We expect NZK to maintain its market positioning but see the path for further price growth ahead of inflation as more challenging. Significant volume uplift is unlikely in the near-term although provides optionality. OUTPERFORM.

Business quality

- **Competition:** New Zealand is one of the few countries where King salmon is produced commercially and therefore we see little direct competition to NZK with considerable barriers to entry.
- **Industry leader:** NZK produces the majority of the world's King salmon and has illustrated both operational and price leadership.

Earnings and cashflow outlook

- **Harvest volume:** Volume growth is dictated by incremental consent increases (~+4,000mt by FY33). Additional new water space is considered unlikely in the medium-term, though could add considerable upside.
- **Price:** Underlying prices are likely to experience inflation like growth; however, improved product utilisation/sales mix could provide further upside to realised average price growth.
- **Decision on farm relocations:** NZK has applied to MPI to relocate a number of its marine farm sites to sites better suited for farming salmon which could result in both a better environmental and economic outcome. A decision from the Minister of Fisheries is expected in 2020.

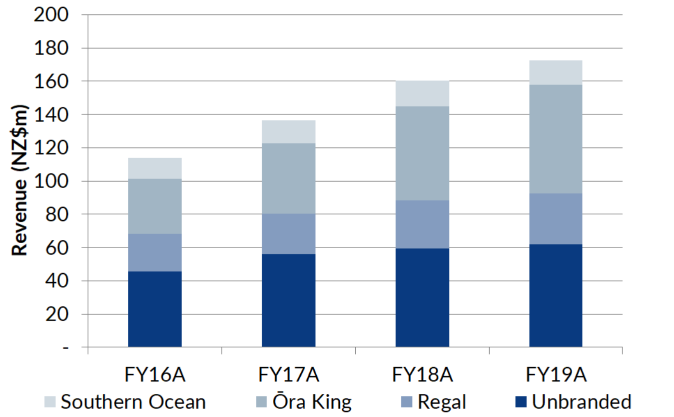
Financial structure

- **Balance sheet headroom:** NZK has headroom on its balance sheet. In the event of a positive outcome from its farm relocation application or approval of its open ocean consent capital will be required to invest in additional farm assets (e.g. new pens/nets).

Risk factors

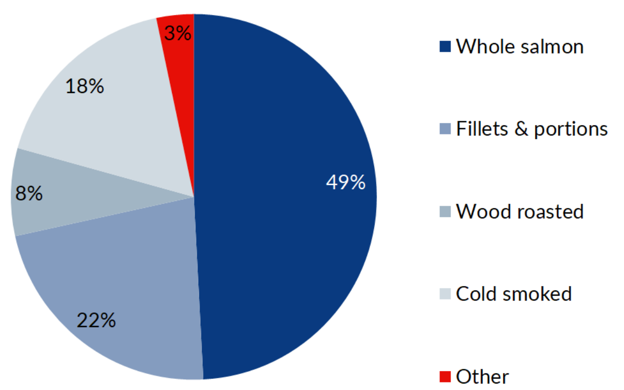
- **Summer mortalities:** Harvest volume is linked to fish mortalities, which is directly related to water temperatures.
- **Biosecurity and market access:** New Zealand currently holds disease free status for King salmon. Any biosecurity incursion could have a considerable impact on both operations but also market access.

Figure 4. Sales by brand (NZ$m)



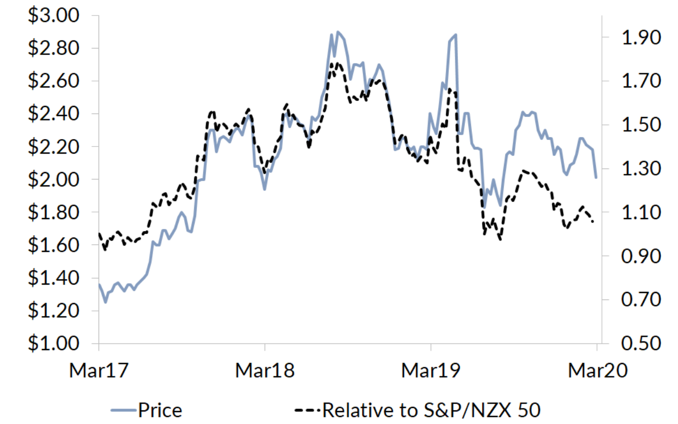
Source: Company reports, Forsyth Barr analysis

Figure 5. Sales split by product (FY19)



Source: Company reports, Forsyth Barr analysis

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. Substantial shareholders

Shareholder	Latest Holding
Oregon Group	40.2%
China Resources	10.0%
New Zealand Superannuation Fund	6.5%

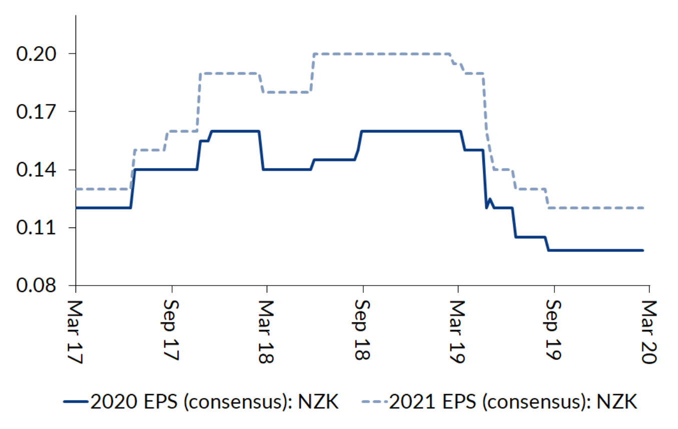
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 8. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect NZK's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
New Zealand King Salmon	**NZK NZ**	**NZ$2.01**	**NZ$278**	**20.2x**	**16.1x**	**10.5x**	**8.6x**	**14.2x**	**11.4x**	**3.0%**
Sanford *	SAN NZ	NZ$7.10	NZ$664	14.3x	12.0x	8.0x	6.8x	10.9x	9.3x	3.2%
HUON AQUACULTURE GROUP	HUO AT	A$4.19	A$366	28.5x	12.9x	9.2x	5.8x	30.4x	10.2x	1.8%
TASSAL GROUP	TGR AT	A$3.98	A$825	12.3x	11.2x	8.0x	6.9x	11.0x	9.6x	4.8%
MOWI ASA	MOWI NO	€214.70	€111,024	>50x	>50x	>75x	>75x	>75x	>75x	0.5%
SALMAR ASA	SALM NO	kr448.60	kr50,826	18.5x	16.0x	13.1x	11.3x	15.9x	13.4x	5.2%
Delegat Group *	DGL NZ	NZ$10.52	NZ$1,064	20.0x	17.3x	13.0x	11.6x	15.4x	13.5x	1.7%
Scales *	SCL NZ	NZ$4.37	NZ$619	15.8x	18.3x	7.8x	8.2x	10.1x	11.5x	4.9%
Comvita *	CVT NZ	NZ$2.60	NZ$129	14.5x	10.0x	10.6x	8.7x	15.7x	11.9x	2.5%
			Compco Average:	**17.7x**	**14.0x**	**10.0x**	**8.5x**	**15.6x**	**11.3x**	**3.1%**
EV = Current Market Cap + Actual Net Debt			**NZK Relative:**	**14%**	**15%**	**5%**	**1%**	**-9%**	**0%**	**-3%**

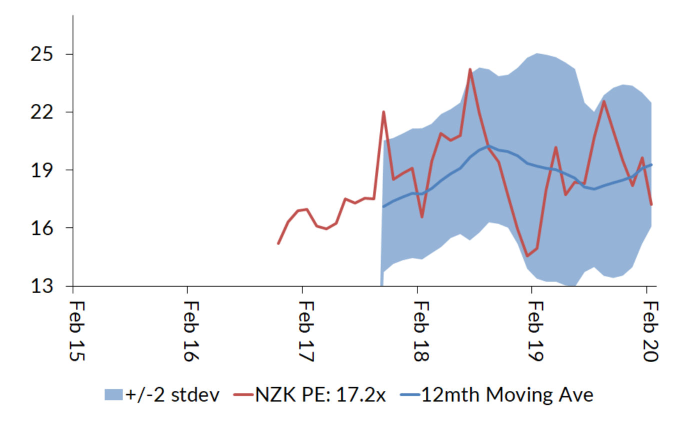
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (NZK) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)



—Source: Forsyth Barr analysis

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