

# New Zealand King Salmon

## FY20 – Scaling Back Recovery Assumptions

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### OUTPERFORM

New Zealand King Salmon (NZK) experienced material disruption to sales channels in 2H20, weighing on earnings and leading to a build up in inventory. Although no explicit earnings guidance was provided, commentary suggests it is unlikely FY21 EBITDA will exceed FY20 (FY20 NZ\$25m, FY21E NZ\$22m). We have made significant downgrades to near-term earnings forecasts as we push out a recovery in sales into FY22. Our target price is unchanged at NZ\$2.65 as lower cost of capital assumptions offset earnings changes. We continue to have a positive view on the long term growth prospects for NZK, with current consents offering further volume uplifts and option value from positive outcomes on additional water space applications. However, investors should be cognisant that further short-term disruption is likely as the company navigates residual COVID-19 impacts. **OUTPERFORM.**

NZX Code	NZK	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$1.81	NPAT* (NZ\$m)	18.0	7.4	15.8	19.3	EV/EBITDA	10.1	12.7	8.1	7.1
Target price	NZ\$2.65	EPS* (NZc)	13.0	5.3	11.4	13.9	EV/EBIT	15.7	22.1	11.7	10.0
Risk rating	Medium	EPS growth* (%)	58.1	-58.8	n/a	21.9	PE	14.0	33.9	15.9	13.1
Issued shares	139.0m	DPS (NZc)	2.0	3.0	5.0	6.0	Price / NTA	1.8	1.9	1.5	1.4
Market cap	NZ\$252m	Imputation (%)	100	100	100	100	Cash div yld (%)	1.1	1.7	2.8	3.3
Avg daily turnover	42.4k (NZ\$86k)	*Based on normalised profits					Gross div yld (%)	1.5	2.3	3.8	4.6

### Navigating COVID-19 demand impacts

NZK reported operating EBITDA of NZ\$25m, broadly in line with expectations and partially supported by wage subsidies (NZ\$3.8m). With c. 75% of sales via foodservice, NZK experienced significant disruption as COVID-19 effectively closed the channel. In addition, air freight capacity became severely constrained, with freight rates surging. FY20 sales volume (6,331mt) fell -16% on the prior year as a result. Positively, fish performance saw marked improvements as mortality rates fell and the feed conversion ratio improved. Having been as low as 50% of normal levels in April, sales have since recovered to c. 80%. NZK has signalled further investment into sales and marketing to help drive adoption of its retail brand, Regal, in export markets and further establish new channels such as e-commerce and fish mongers.

### Higher inventory debt funded; balance sheet remains stable

Inventory levels surged as a result of lower sales, up +75% on the prior year. Due to fish quality considerations and feed discharge limits, NZK has had to harvest more product than it can sell in the COVID-19 impacted short term, with product being frozen. Higher debt (net debt NZ\$32m) has been used to fund working capital requirements. Having recently negotiated new facilities and covenants, NZK remains comfortable it has sufficient headroom, even in the event of a summer mortality event.

### Long-term value remains; short-term earnings challenged

In the short term NZK is facing 1) high levels of inventory to sell, 2) a significantly weaker foodservice channel, and 3) higher freight costs in FY21. Earnings guidance commentary suggests it may be challenging for FY21 EBITDA to exceed FY20. We expect sales will likely remain at subdued levels for another c. 12 months (time frames on recovery highly uncertain), and effectively push out our sales recovery assumptions. Looking through current disruption we maintain a positive view on the medium to long term growth prospects for NZK, and are attracted to its unique position as the world's largest producer of King salmon. In addition, NZK's Open Ocean and farm relocation applications provide potential upside to earnings not included in our forecasts.

## New Zealand King Salmon (NZK)

Priced as at 27 Aug 2020 (NZ\$)						1.81						
<b>12-month target price (NZ\$)*</b>						2.65	<b>Spot valuations (NZ\$)</b>					
Expected share price return						46.4%	1. DCF					2.72
Net dividend yield						1.8%	2. Comparative multiples					2.40
Estimated 12-month return						48.3%	3. Market multiple					n/a
<b>Key WACC assumptions</b>						<b>DCF valuation summary (NZ\$m)</b>						
Risk free rate						1.30%	Total firm value					433
Equity beta						1.01	(Net debt)/cash					(31)
WACC						6.4%	Less: Capitalised operating leases					
Terminal growth						2.0%	Value of equity					402
<b>Profit and Loss Account (NZ\$m)</b>						<b>Valuation Ratios</b>						
	2019A	2020A	2021E	2022E	2023E		2019A	2020A	2021E	2022E	2023E	
Sales revenue	172.6	155.3	160.9	204.4	219.2	EV/EBITDA (x)	10.0	10.1	12.7	8.1	7.1	
<b>Normalised EBITDA</b>	<b>25.2</b>	<b>26.5</b>	<b>22.0</b>	<b>34.2</b>	<b>39.0</b>	EV/EBIT (x)	13.3	15.7	22.1	11.7	10.0	
Depreciation and amortisation	(6.2)	(9.4)	(9.4)	(10.4)	(11.1)	PE (x)	22.1	14.0	33.9	15.9	13.1	
<b>Normalised EBIT</b>	<b>18.9</b>	<b>17.1</b>	<b>12.6</b>	<b>23.8</b>	<b>27.9</b>	Price/NTA (x)	2.1	1.8	1.9	1.5	1.4	
Net interest	(1.1)	(1.7)	(2.3)	(1.9)	(1.2)	Free cash flow yield (%)	-1.3	-4.7	2.4	4.8	8.8	
Associate income	0	0	0	0	0	Net dividend yield (%)	2.8	1.1	1.7	2.8	3.3	
Tax	4.4	6.9	2.9	6.1	7.5	Gross dividend yield (%)	3.8	1.5	2.3	3.8	4.6	
Minority interests	0	0	0	0	0	<b>Capital Structure</b>						
<b>Normalised NPAT</b>	<b>11.4</b>	<b>18.0</b>	<b>7.4</b>	<b>15.8</b>	<b>19.3</b>	Interest cover EBIT (x)	17.3	9.9	5.4	12.7	23.6	
Abnormals/other	0	0	0	0	0	Interest cover EBITDA (x)	23.0	15.3	9.4	18.2	32.9	
<b>Reported NPAT</b>	<b>11.4</b>	<b>18.0</b>	<b>7.4</b>	<b>15.8</b>	<b>19.3</b>	Net debt/ND+E (%)	5.2	14.4	14.2	10.9	5.5	
Normalised EPS (cps)	8.2	13.0	5.3	11.4	13.9	Net debt/EBITDA (x)	0.4	1.2	1.4	0.8	0.3	
DPS (cps)	5.0	2.0	3.0	5.0	6.0	<b>Key Ratios</b>						
<b>Growth Rates</b>							2019A	2020A	2021E	2022E	2023E	
Revenue (%)	7.7	-10.0	3.6	27.0	7.2	Return on assets (%)	8.5	6.2	4.6	7.8	9.0	
EBITDA (%)	-3.8	5.3	-17.1	55.7	14.0	Return on equity (%)	6.7	9.8	4.1	7.4	8.3	
EBIT (%)	-10.1	-9.6	-26.3	88.7	17.3	Return on funds employed (%)	9.5	7.0	5.2	8.8	10.1	
Normalised NPAT (%)	-30.5	58.6	-58.8	>100	21.9	EBITDA margin (%)	14.6	17.1	13.7	16.7	17.8	
Normalised EPS (%)	-30.6	58.1	-58.8	>100	21.9	EBIT margin (%)	11.0	11.0	7.8	11.7	12.7	
Ordinary DPS (%)	0.0	-60.0	50.0	66.7	20.0	Capex to sales (%)	8.2	10.4	6.4	8.5	6.9	
<b>Cash Flow (NZ\$m)</b>							2019A	2020A	2021E	2022E	2023E	
<b>EBITDA</b>	<b>25.2</b>	<b>26.5</b>	<b>22.0</b>	<b>34.2</b>	<b>39.0</b>	Capex to depreciation (%)	228	172	110	167	136	
Working capital change	(8.7)	(13.6)	(0.2)	3.3	7.0	Imputation (%)	100	100	100	100	100	
Interest & tax paid	(5.5)	(8.7)	(5.4)	(8.2)	(8.9)	Pay-out ratio (%)	61	15	56	44	43	
Other	0	0	0	0	0	<b>Operating Performance</b>						
<b>Operating cash flow</b>	<b>10.9</b>	<b>4.2</b>	<b>16.4</b>	<b>29.3</b>	<b>37.1</b>	<b>Revenue split by market (NZ\$m)</b>						
Capital expenditure	(14.2)	(16.1)	(10.3)	(17.3)	(15.0)	Domestic	79.8	66.7	69.1	88.1	94.2	
(Acquisitions)/divestments	0.0	0.0	0	0	0	Export	92.9	88.6	91.8	116.4	125.0	
Other	0	(1.4)	(1.0)	(1.0)	(1.0)	<b>Total</b>	<b>172.6</b>	<b>155.3</b>	<b>160.9</b>	<b>204.4</b>	<b>219.2</b>	
<b>Funding available/(required)</b>	<b>(3.2)</b>	<b>(13.3)</b>	<b>5.1</b>	<b>11.0</b>	<b>21.0</b>	<b>Revenue split by market (%)</b>						
Dividends paid	(7.1)	(6.9)	(4.2)	(6.9)	(8.3)	Domestic	46%	43%	43%	43%	43%	
Equity raised/(returned)	0.0	0.0	0	0	0	Export	54%	57%	57%	57%	57%	
<b>(Increase)/decrease in net debt</b>	<b>(10.4)</b>	<b>(20.2)</b>	<b>0.9</b>	<b>4.0</b>	<b>12.7</b>	<b>Revenue split by country (NZ\$m)</b>						
<b>Balance Sheet (NZ\$m)</b>							2019A	2020A	2021E	2022E	2023E	
Working capital	17.8	33.5	33.9	30.8	24.0	New Zealand	79.8	66.0	69.1	88.1	94.2	
Fixed assets	51.8	60.5	63.5	72.5	78.5	North America	58.5	58.4	58.9	77.7	83.3	
Intangibles	46.8	47.9	48.1	48.4	48.6	Australia	11.9	9.3	11.2	14.3	15.3	
Right of use asset	0	4.6	4.6	4.6	4.6	Japan	5.9	5.3	5.0	6.1	6.6	
Other assets	82.9	105.7	99.5	120.5	126.3	Europe	3.1	3.6	2.9	3.7	4.0	
<b>Total funds employed</b>	<b>199.3</b>	<b>252.2</b>	<b>249.7</b>	<b>276.7</b>	<b>282.0</b>	Other	13.5	12.7	13.7	14.5	15.9	
Net debt/(cash)	9.2	31.0	30.1	26.1	13.4	<b>Total</b>	<b>172.6</b>	<b>155.3</b>	<b>160.9</b>	<b>204.4</b>	<b>219.2</b>	
Lease liability	0	3.3	3.4	3.5	3.7	<b>Harvest volume (MT)</b>						
Other liabilities	21.4	33.6	33.6	33.6	33.6		7,931	7,336	8,500	8,500	9,000	
Shareholder's funds	168.8	184.3	182.5	213.5	231.4	<b>Average realised price (NZ\$/kg)</b>						
Minority interests	0	0	0	0	0		23.01	24.99	23.80	24.33	24.64	
<b>Total funding sources</b>	<b>199.3</b>	<b>252.2</b>	<b>249.7</b>	<b>276.7</b>	<b>282.0</b>							

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

## FY20 result summary

New Zealand King Salmon (NZK) reported a result in line with expectations, with FY20 Operating EBITDA of NZ\$25m vs. Forsyth Barr NZ\$26m. FY20 has been a challenging period for NZK as global lockdowns and social distancing requirements effectively closed the foodservice channel for a period of time. Although sales have recovered from lows, it still remains at ~80% of normal levels.

Unsurprisingly, NZK will not pay a final dividend, with dividends to be reviewed next year.

## Earnings changes and valuation

We have made significant downgrades to our FY21 forecasts as we assume continued channel disruption and push out a recovery in sales. Whilst there was no explicit earnings guidance provided, result commentary suggests it may be challenging for FY21 EBITDA to exceed FY20. We expect sales to remain at suppressed levels in FY21 as foodservice disruption washes through and NZK continues to explore alternative channels, in addition the company signalled sales investment and higher freight costs as weighing on margin. We have effectively pushed our sales recovery assumptions out 18 months.

The speed and quantum of a foodservice/sales recovery is the big question in our forecasts. Looking beyond COVID-19 disruption, NZK's brand strength and unique offering (produces c. 90% of the world's smoked King salmon product) underpins the value proposition.

Figure 1. Earnings changes (NZ\$m)

	FY21E			FY22E			FY23E		
	old	new	% chg	old	new	% chg	old	new	% chg
Revenue	221.3	160.9	-27.3%	220.9	204.4	-7.4%	233.1	219.2	-6.0%
Operating EBITDA	35.4	22.0	-38.0%	42.2	34.2	-19.0%	48.2	39.0	-19.1%
Operating NPAT	18.9	7.4	-60.8%	23.3	15.8	-32.2%	27.7	19.3	-30.5%
EPS (cps)	13.6	5.3	-60.9%	16.8	11.4	-32.5%	20.0	13.9	-30.8%
DPS (cps)	7.0	3.0	-57.1%	7.0	5.0	-28.6%	9.0	6.0	-33.3%

Source: Forsyth Barr analysis

## Target price NZ\$2.65, OUTPERFORM

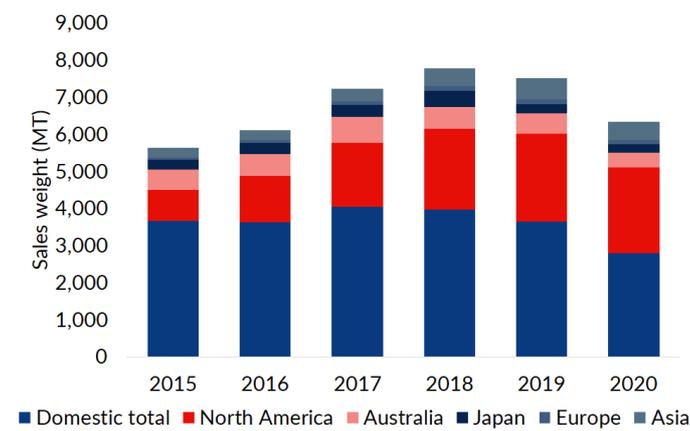
Our target price is unchanged at NZ\$2.65, despite taking a knife to near-term forecasts, as changes to our cost of capital assumptions offset. Our WACC estimate has fallen from 8.2% to 6.4% following changes to our risk free rate (from 2.0% to 1.3%) and market risk premium (from 7.5% to 6.0%), consistent with our strategy report, *The Cost of Capital Conundrum – When TINA Came to Our Shores*, published 7 August 2020.

We maintain a positive view on the long-term outlook for NZK. Whilst we expect earnings to get worse before they get better, we encourage investors to look beyond COVID-19. NZK has a strong track record of marketing a premium product and delivering continued price growth. Whilst fish performance has had its challenges in recent periods, we view investments into mitigation technologies and the change in operating model as moderating the summer risk to an extent. The aquaculture industry offers significant opportunity, with a government strategy to grow the industry +5x, and NZK actively pursuing additional water space (not included in forecasts). OUTPERFORM.

## FY20 result take outs and breakdown

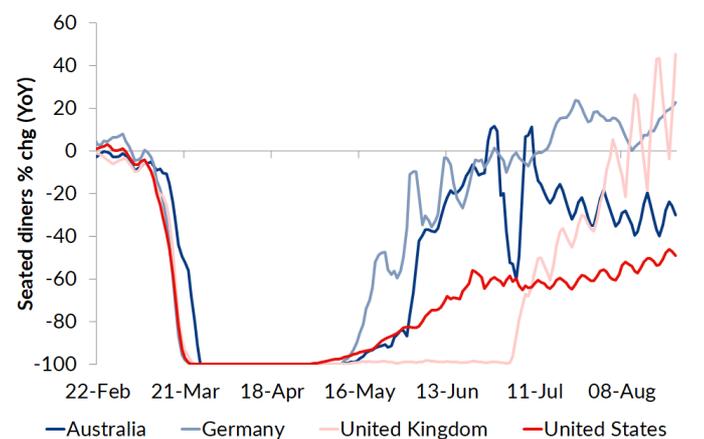
- Average realised price sees further improvement as country mix is optimised** – Continued market and product optimisation enabled NZK to deliver another period of price growth, up +7% to NZ\$24.5/kg.
  - We expect prices to soften in FY21 as NZK looks to sell through inventory (largely frozen gilled and gutted whole fish), negatively impacting mix.
- Diverging channel outcomes** – During Alert Level 4, sales fell to 50% of normal levels, and although activity has recovered slightly, volumes remain at suppressed levels (c. 80% of normal).
  - c. 75% of sales were previously into foodservice. NZK highlighted recent success with its Regal brand in the US and is adding additional sales resource in the US and Europe to help drive retail sales (marketing investment required). We expect to see an enduring swing in channel mix towards retail over the coming years.
- Inventory levels elevated** – NZ\$35.6m of inventory at balance date (FY19 NZ\$20.8m, up +71%). With foodservice challenged NZK has been freezing product. We expect inventory to continue to climb until sales return to pre COVID-19 levels.
- Balance sheet** – Increase in net debt associated with higher inventory (FY20 net debt NZ\$31m vs. FY19 NZ\$9m).
  - NZK is pursuing cash preservation measures, deciding not pay a final dividend and lowering FY21E capex to c. NZ\$10m (from c. NZ\$20m)
  - NZK has negotiated new facilities and covenants, and remains comfortable it has sufficient headroom to navigate further disruption.
- Fish performance** – On a positive note, fish performance experienced an improvement on the prior year, with NZK achieving an FY20 mortality rate of 15% (FY19 23%) and lower feed conversion rate (1.76x vs 1.80x).
  - Investments into farm technologies such as upwelling machines, and the shift to a single year class operating model, are providing performance benefits with scope to improve further.
- Open ocean** – NZK's Blue Endeavour open ocean site has seen a further delay when its hearing was pushed out as a result of New Zealand's lockdowns. A hearing is now expected towards the end of the year with an outcome expected mid-2021. Sticking to this time line, first harvest should occur in Q4 of CY2023 (previously Q1). We view open ocean as a significant opportunity for the aquaculture industry, however, time frames are long and uncertain, and at this stage we attribute no value to this application in our forecasts.
  - For additional detail on the open ocean opportunity for aquaculture companies refer to our report, *Open Ocean Optionality*, published 27 November 2019.

Figure 2. Annual sales volume by market

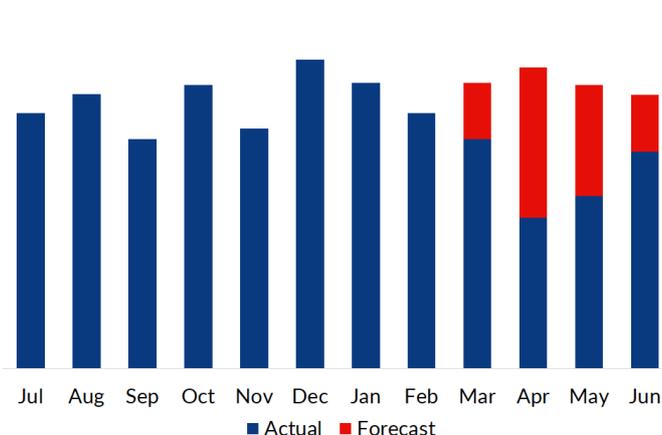


Source: Company reports, Forsyth Barr analysis

Figure 3. % change in restaurant table bookings (YoY)



Source: Opentable, Forsyth Barr analysis

**Figure 4. FY20 monthly sales volume**


Source: Company reports, Forsyth Barr analysis

**Figure 5. Mortality rates**


Source: Company reports, Forsyth Barr analysis

**Figure 6. FY20 result breakdown (NZ\$m)**

	FY19	FY20	% chg	Comment
Volume sold (MT)	7,520	6,331	-15.8%	Market accessibility impacted by COVID-19, August sales back at ~80% of normal levels
<b>Revenue</b>	<b>172.6</b>	<b>155.3</b>	<b>-10.0%</b>	<b>Average realised price up +7% to NZ\$24.5/kg</b>
COGS	(125.7)	(108.0)	-14.1%	Fish performance improvements, mortality 15% (FY19 23%)
<b>Gross profit</b>	<b>46.9</b>	<b>47.3</b>	<b>0.9%</b>	
Opex	(21.8)	(22.3)	2.4%	NZ\$3.8m wage subsidy benefit
<b>Operating EBITDA</b>	<b>25.2</b>	<b>25.1</b>	<b>-0.4%</b>	
Depreciation & amortisation	(6.2)	(7.9)	27.5%	FY21 expected capex lowered to NZ\$10m (from c. NZ\$20m)
<b>Operating EBIT</b>	<b>18.9</b>	<b>17.1</b>	<b>-9.6%</b>	
Interest and tax costs	(6.1)	(5.9)	-3.0%	
<b>Operating NPAT</b>	<b>12.9</b>	<b>11.2</b>	<b>-12.6%</b>	
<b>Reported NPAT</b>	<b>11.4</b>	<b>18.0</b>	<b>58.6%</b>	<b>Uplift relates to IFRS fair value gains</b>
Operating EPS (cps)	9.3	8.1	-12.6%	
Final DPS (cps)	3.0	-	n/a	Cash preservation, to be reviewed next year
<b>Balance sheet &amp; cashflow</b>				
Inventory	20.8	35.6	71.0%	Harvested fish to ensure optimal quality/size and to comply with feed discharge limits
Net working capital	17.8	33.5	88.1%	Inventory expected to remain elevated until sales return to 'normal' levels
Net debt (cash)	9.2	31.0	237.7%	Funding working capital increase, facilities and covenants negotiated
Operating cash flow	10.9	4.2	-61.4%	

Source: Company reports, Forsyth Barr analysis

## 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 2021.

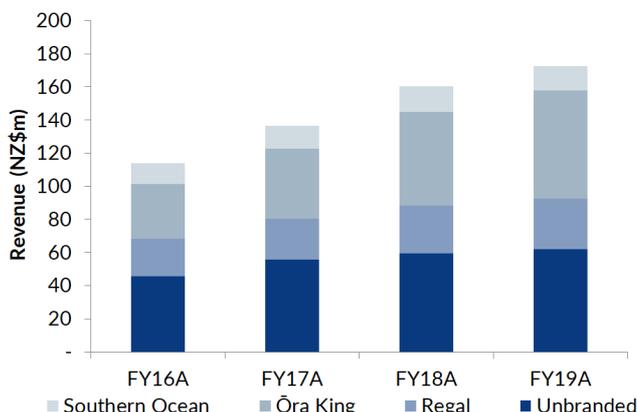
### Financial structure

- **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

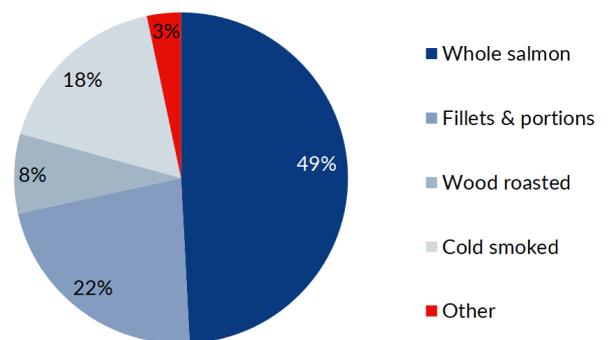
- **Summer mortalities:** Harvest volume is linked to fish mortalities, which is directly related to water temperatures.
- **Biosecurity and market access:** New Zealand currently holds disease free status for King salmon. Any biosecurity incursion could have a considerable impact on both operations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

Figure 7. Sales by brand (NZ\$m)



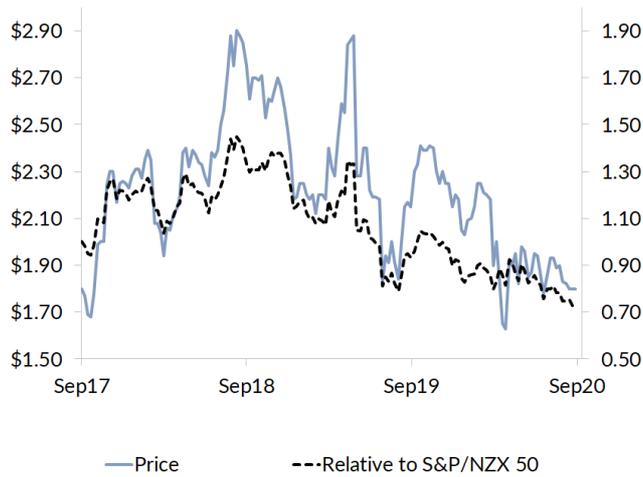
Source: Company reports, Forsyth Barr analysis

Figure 8. Sales split by product (FY19)



Source: Company reports, Forsyth Barr analysis

Figure 9. Price performance



Source: Forsyth Barr analysis

Figure 10. 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 SPH notices only

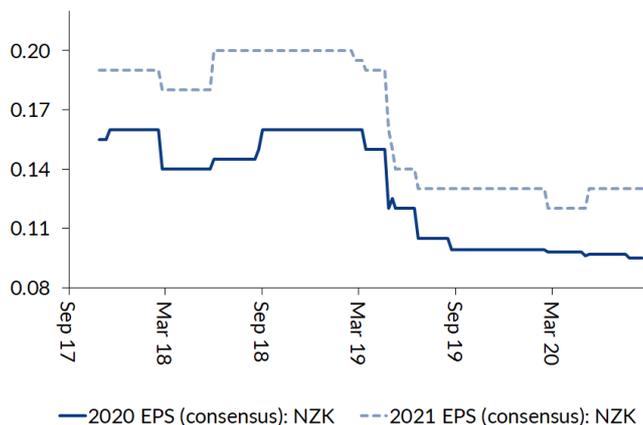
Figure 11. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2022E
				2021E	2022E	2021E	2022E	2021E	2022E	
New Zealand King Salmon	NZK NZ	NZ\$1.81	NZ\$252	33.9x	15.9x	12.9x	8.3x	22.4x	11.9x	2.8%
SANFORD *	SAN NZ	NZ\$5.57	NZ\$521	11.3x	8.9x	6.5x	5.3x	9.1x	7.3x	4.1%
HUON AQUACULTURE GROUP	HUO AT	A\$3.25	A\$285	>50x	10.0x	13.3x	6.4x	>75x	13.5x	2.1%
TASSAL GROUP	TGR AT	A\$3.65	A\$764	10.8x	9.7x	7.6x	6.8x	10.7x	9.5x	5.5%
MOWI ASA	MOWI NO	€173.50	€89,719	>50x	>50x	>75x	>75x	>75x	>75x	0.5%
SALMAR ASA	SALM NO	kr469.00	kr53,138	19.9x	16.8x	13.2x	11.4x	16.7x	13.7x	4.7%
DELEGAT GROUP *	DGL NZ	NZ\$13.20	NZ\$1,335	22.5x	20.8x	14.5x	13.6x	17.0x	15.8x	1.4%
SCALES *	SCL NZ	NZ\$4.91	NZ\$698	21.7x	19.5x	9.7x	8.9x	13.7x	12.2x	4.4%
COMVITA *	CVT NZ	NZ\$3.27	NZ\$233	21.3x	17.3x	11.8x	10.7x	21.1x	17.7x	1.5%
<b>Compco Average:</b>				<b>17.9x</b>	<b>14.7x</b>	<b>10.9x</b>	<b>9.0x</b>	<b>14.7x</b>	<b>12.8x</b>	<b>3.0%</b>
<b>NZK Relative:</b>				<b>89%</b>	<b>8%</b>	<b>18%</b>	<b>-8%</b>	<b>52%</b>	<b>-8%</b>	<b>-8%</b>

EV = Current Market Cap + Actual Net Debt

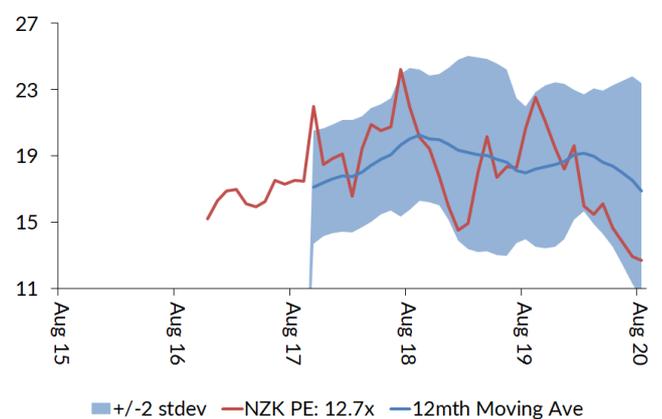
Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (NZK) companies fiscal year end

Figure 12. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 13. One year forward PE (x)



Source: Forsyth Barr analysis

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