Nordic Credit Rating

CORPORATE

Norway
2 Jul. 2021

Lerøy Seafood Group ASA

Full Rating Report

LONG-TERM RATING

BBB

OUTLOOK

Stable

SHORT-TERM RATING

N-1+

PRIMARY ANALYST
Geir Kristiansen
+4790784593
geir.kristiansen@nordiccreditrating.com

SECONDARY ANALYST
Mille O. Fjeldstad
+4799038916
mille.fjeldstad@nordiccreditrating.com

RATING RATIONALE

Our 'BBB' long-term issuer credit rating on Norway-based Lerøy Seafood Group ASA (Lerøy) reflects the company's relatively strong market position in the profitable salmon farming industry. It also reflects the breadth of its operations as a fully integrated seafood producer with significant wildcatch, processing and distribution capabilities. The rating further reflects the company's moderate financial leverage and strong cash flow, which should allow it to maintain a high level of investment, if necessary, to keep up with technological developments and create revenue growth.

The rating is constrained by the seafood sector's historical earnings volatility due to unstable prices, primarily as a result of variable supply, although reduced demand since the outbreak of the COVID-19 pandemic has also had an impact. The sector also faces environmental and disease-related challenges, with Lerøy particularly impacted by higher costs for sea lice and winter wounds, which we expect will trigger investment in new farming technology. These factors have contributed to volatile EBITDA margins despite strong credit metrics. However, we note that salmon is a healthy food product, with a significantly lower environmental footprint than many other sources of protein.

STABLE OUTLOOK

The outlook is stable, reflecting our view that the COVID-19 pandemic will subside, increasing demand for seafood and so support salmon prices. We also expect lower supplies from Chilean producers to support prices globally over the next three years. We also believe that Lerøy will keep adverse biological factors under control. Although we expect the seafood sector to face high investment requirements, we think that the company will maintain a prudent approach to acquisitions.

POTENTIAL POSITIVE RATING DRIVERS

- More stability in supply leading to reduced price uncertainty.
- Lower dividends and/or investments leading to debt/EBITDA below 1x.
- Reduced costs and improved margin stability due to reduction of biological problems.

POTENTIAL NEGATIVE RATING DRIVERS

- Increased biological problems such as disease and sea lice.
- Higher financial leverage leading to debt/EBITDA above 2.5x.
- Lower demand for Norwegian and Atlantic salmon in general.

Figure 1. Lerøy key credit metrics, 2018–2023e

NOKm	2018	2019	2020	2021e	2022e	2023e
Revenue	19,838	20,427	19,960	22,537	23,889	24,606
NCR-adjusted EBITDA	4,455	3,997	3,123	3,856	4,145	4,273
NCR-adjusted net debt	4,136	4,015	4,740	5,792	6,406	6,978
Total assets	28,373	30,189	30,163	31,869	32,943	34,410
NCR-adjusted net debt/EBITDA (x)	0.9	1.0	1.5	1.5	1.5	1.6
NCR-adjusted EBITDA/interest (x)	27.2	19.9	14.9	15.8	15.0	14.2
NCR-adjusted FFO/net debt (%)	86.7	83.1	54.0	45.7	44.6	42.4

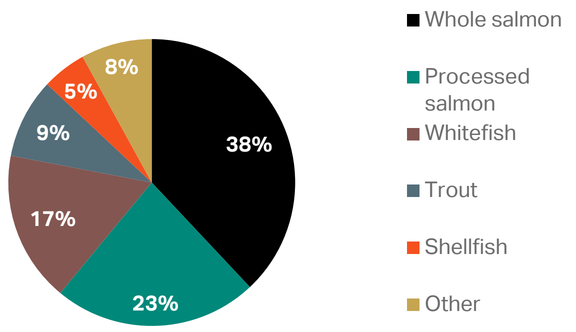
Based on NCR estimates and company data. e–estimate. FFO–funds from operations. All metrics adjusted in line with NCR methodology.

ISSUER PROFILE

Lerøy traces its roots back to 1939 as a seafood wholesaler and exporter. It bought its first wholly owned salmon farming operation in 2003 and has developed into a fully integrated international seafood supplier with three business segments; Farming, Value Added Processing, Sales and Distribution (VAPSD), and Wildcatch. Farming is the largest business segment in terms of contribution to profit (Figure 3) and is divided into three geographic regions; Lerøy Sjøtroll in western Norway (40% of production), Lerøy Midt in central Norway (40%), and Lerøy Aurora in northern Norway (20%). Lerøy also owns 50% of UK salmon farmer Scottish Sea Farms Ltd. through a joint venture with SalMar ASA. VAPSD is the largest segment in terms of revenues and mainly processes, sell and distributes the company's own production. It is among the largest seafood processors in Europe and its processing facilities are located in Norway, Sweden, Finland, the Netherlands, Spain, France, Portugal, Italy and Turkey. The Wildcatch segment comprises Norway's largest fishing company, Lerøy Havfisk (Havfisk), which owns and operates 10 trawlers, and whitefish processor and distributor Lerøy Norway Seafood, which takes deliveries from more than 600 fishing vessels. These businesses were acquired in 2016.

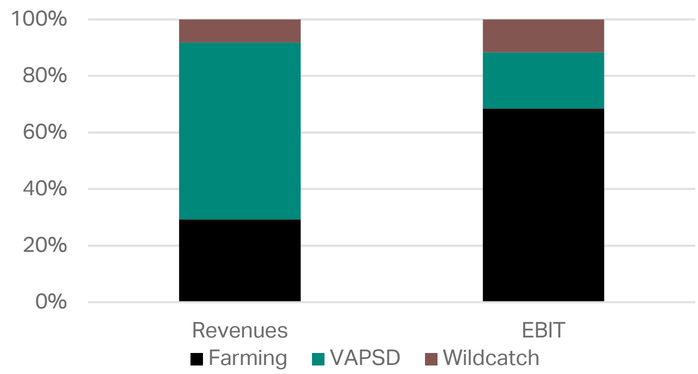
Austevoll Seafood ASA, a pelagic fishery company, became Lerøy's majority owner in 2008 and currently holds 52.7% of the shares. Some 55.6% of the shares in Austevoll Seafood are owned by Laco AS, an investment company owned by the Møgster family. Both Lerøy and Austevoll Seafood are listed on the Oslo Stock Exchange.

Figure 2. Lerøy operating revenue by product, 2020



Source: company.

Figure 3. Lerøy revenue and EBIT by segment*, 2020



Source: company. *Before eliminations.

BUSINESS RISK ASSESSMENT

Business risk assessment is 'bbb-'

Lerøy generates most of its profit from salmon farming, where it is among the world's largest operators. The market for salmon is characterised by increasing demand and limited, albeit volatile, supply growth. Historically, this has led to volatile but generally strong margins in the sector. The company is Norway's largest seafood processor and distributor and a major operator in European terms. Seafood processing and distribution is characterised by low but relatively stable margins. The company's Wildcatch segment is small but generates good margins and provides products for the company's sales platform. Overall, Lerøy has margins close to the industry average.

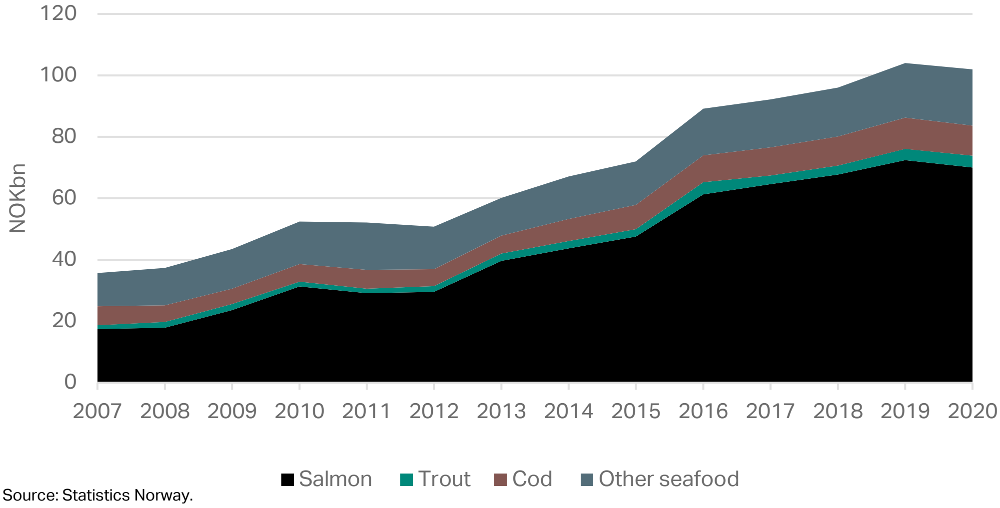
Volatile prices and costs driven by biological challenges

Operating environment scores 'bb'

Demand for fish in general and Atlantic salmon in particular is growing, helped by rising demand for healthy food worldwide and a growing middle class in developing countries. Salmon is sold both to the hotel, restaurant and catering industries (the HoReCa market) and to households as fresh, frozen or processed products. The HoReCa market, which primarily buys whole, fresh salmon, has been strongly affected by the COVID-19 pandemic. In Europe, this has meant that greater volumes are being sold to secondary processors which distribute salmon products to the retail market, or directly to retailers.

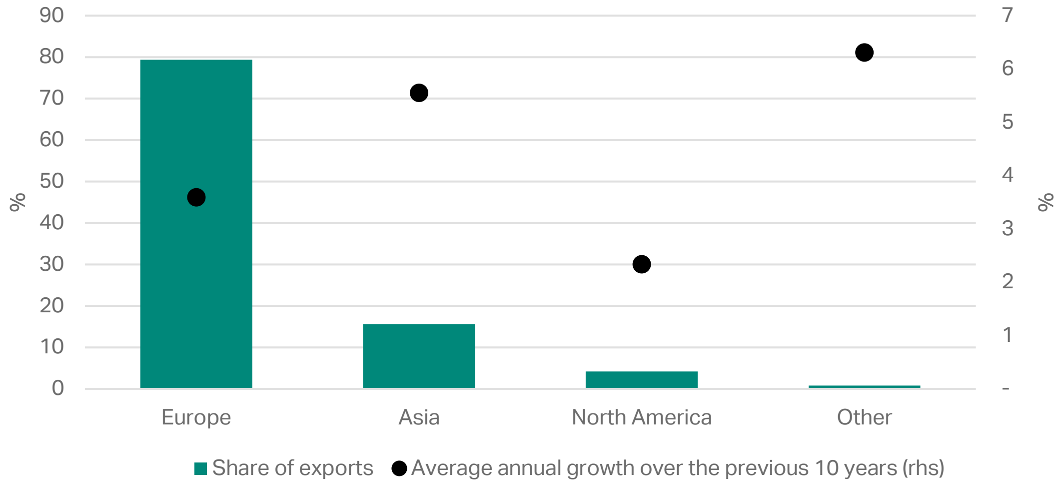
Negative media reports on biological issues (disease, sea lice), pollution, and escapes by farmed salmon leading to genetic changes in wild salmon, have had only a limited effect on demand. However, such problems could force fish farmers to develop new farming methods and technologies. About 40% of Lerøy's salmon farming operations are located on the western coast of Norway, which has made it more susceptible to such risks in recent year. Environmental factors are also an issue for Lerøy's trawler operations and impact our assessment of the operating environment (see Environmental, social and governance factors below).

Figure 4. Norwegian fish and seafood exports, 2007-2020



Source: Statistics Norway.

Figure 5. Norwegian salmon exports, 2020

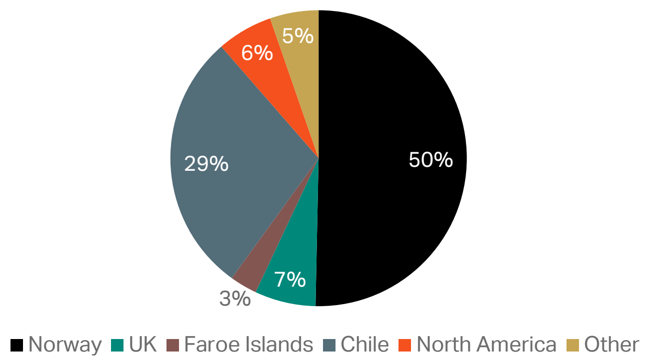


Source: Statistics Norway.

Supply of farmed Atlantic salmon underwent average annual growth of 8% in the 1995-2020 period and 6% since 2010. Availability of licences and sites are the main constraints on industry growth, and fish farmers consequently seek to optimize their licences to the full extent. We expect average annual supply growth of 4% globally in the 2020-2023 period. Lerøy targets ambitious 12% volume growth in 2021. Prices of Atlantic salmon have historically been volatile, mainly driven by changes in supply, particularly from the Chilean farming industry, because of biological challenges. Price vs volume regression for the period 2001-2020 (see Figure 9) indicates that a 7% annual increase in supply has meant a zero effect on prices. In 2020, worldwide supply of salmon increased by about 4%, which should have had a positive impact on prices. However, prices for Norwegian salmon were down by 14% year on year, which can be explained by the impact of the COVID-19 pandemic. Consequently, in our price forecasts we are more conservative than the regression model (see Figure 8). Lerøy generates 9% of its revenues from trout. Trout prices have been negatively affected by trade restrictions in the important Russian market since 2014 but are now close to those of Atlantic salmon.

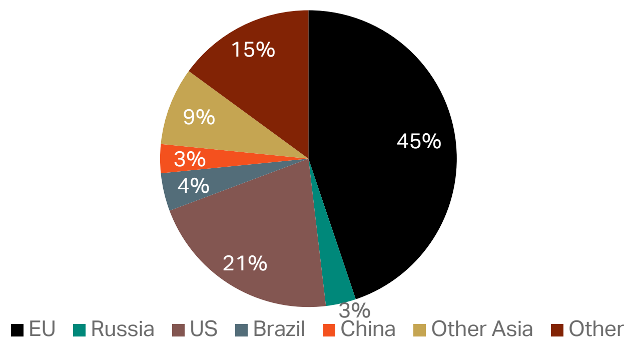
Supply of wildcatch is mainly dependent on licence rights and quotas. While the wider fishing industry have shown good profitability in recent years, the fish processing industry has struggled with low profitability due to regulatory challenges and seasonality of supply. The price of cod, which we estimate to be about half of that of wildcatch, was higher on average in 2020 than in 2019 but has also been impacted by COVID-19 and is currently 26% lower than 12 months ago.

Figure 6. Global salmon supply, 2020



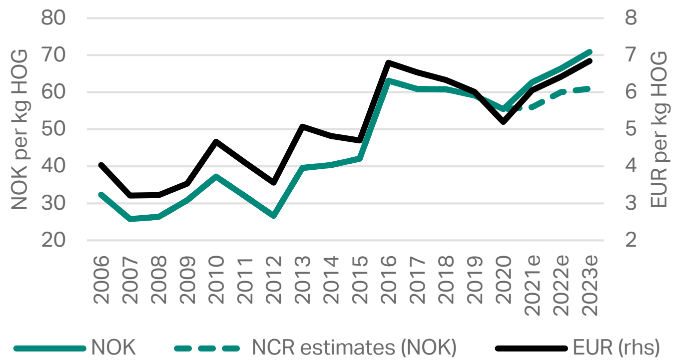
Source: Mowi.

Figure 7. Global salmon demand, 2020



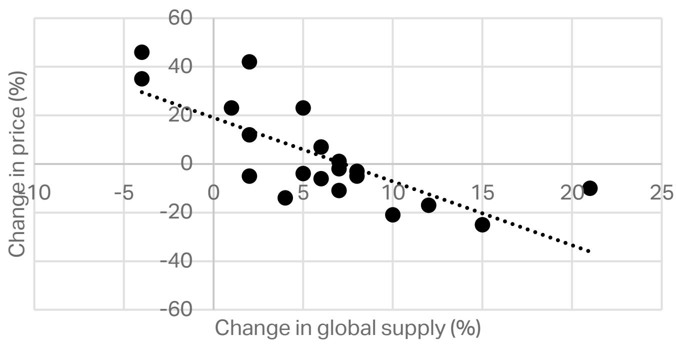
Source: Mowi.

Figure 8. Norwegian salmon prices, 2006–2023e



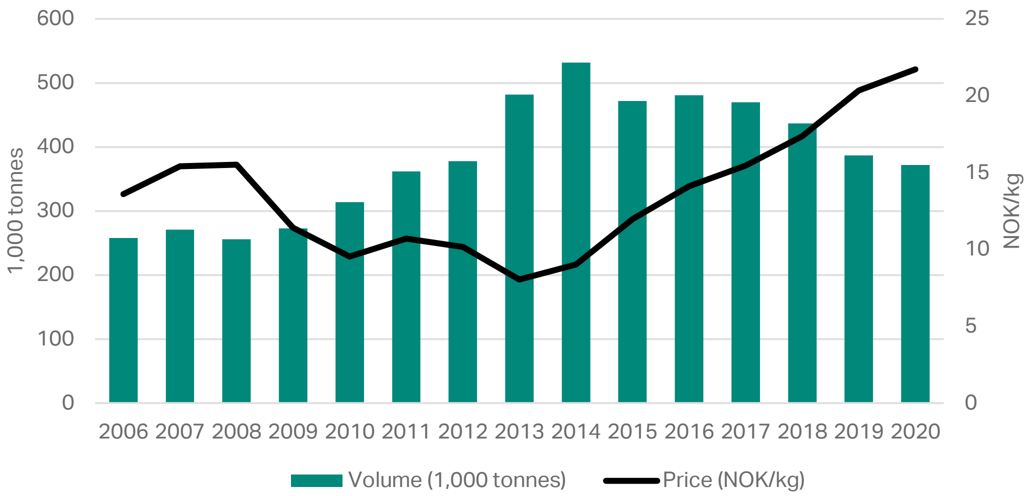
Based on data from Fish Pool and NCR estimates. *Head on gutted.

Figure 9. Regression changes in salmon volume and price*



Based on data from Mowi and Fish Pool. *The coefficient of determination is 56%.

Figure 10. Cod catch volumes and annual average price per kg, Norway 2006-2020



Source: The Norwegian Fishermen's Sales Organization.

The world's second largest farmer of salmonids

Market position scores 'bbb'

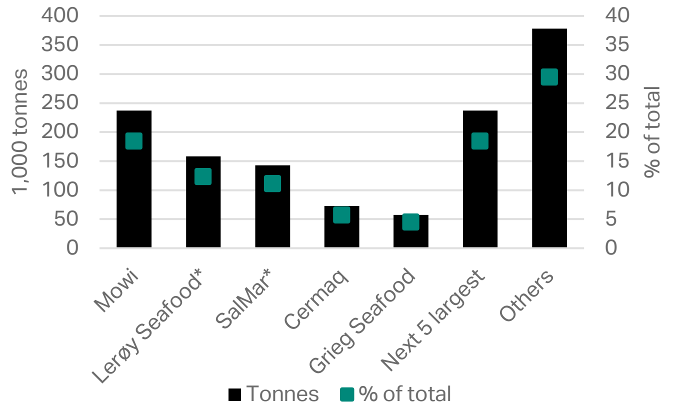
Lerøy harvested 128,699 tonnes (all weights gutted) of salmon and 29,479 tonnes of trout in Norway in 2020, 8% more than in 2019. Of this, 40% came from western Norway, 40% from central Norway, and 20% from northern Norway. Including 50% of Scottish Sea Farms' production (12,000 tonnes), Lerøy is the largest trout farmer and second-largest farmer of salmon and trout both in Norway and globally.

Mowi is the largest producer in the industry with about 20% of both Norwegian and global salmon harvesting volumes.

Lerøy Seafood is the leading distributor of seafood to the Norwegian market and supplies key grocery markets in Europe. VAPSD handled close to 400,000 tonnes of seafood in 2020, of which about 70% was from the company's own farming and fishing operations. The European and global seafood processing industry is extremely fragmented. According to the EU fish processing sector economic report 2020, there were about 3,500 seafood processors in the EU in 2020 with a total of EUR 32.5bn in turnover. Although VAPSD's revenues in 2017 were 200x larger than those of the average EU processor, they accounted for only 5.8% of the total EU market (3.3% if only sales to the EU are included). We note, however, that a large part of VAPSD's revenues comes from the trading of unprocessed fish.

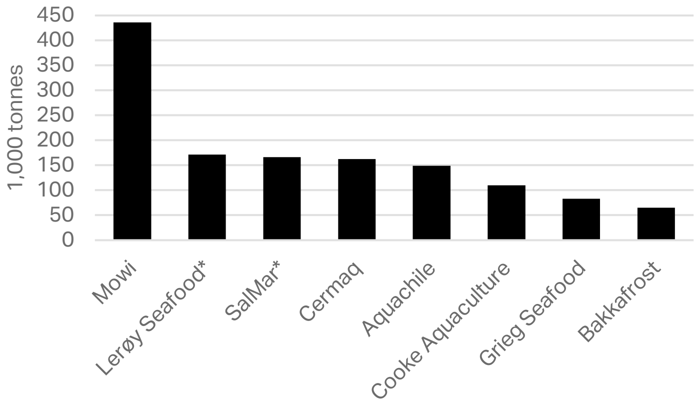
In salmon farming, there are increasing barriers of entry due to limitations on the number of licences and limits on maximum biomass per licence. Moreover, high investments are required to scale up production, while positive cash flows usually take about three years to emerge. These barriers, partly biological, partly regulatory, and partly financial, explain the sector's high profitability. We believe that the increasing costs and investments needed to satisfy environmental requirements and improve salmon welfare (the sea lice problem in particular) will lead to increasing consolidation in the sector. While we expect supply growth to be limited over the next few years, technology could lead to stronger growth from a longer-term perspective. To have a real impact on supply, however, significant investments are needed in production facilities and working capital. We note that the production cycle for Atlantic salmon takes three years from spawning to harvesting.

Figure 11. Norway's largest salmon and trout farmers, 2019



Source: Mowi (Salmon farming industry handbook 2020).*Includes 50% of Scottish Sea Farms

Figure 12. Largest global salmon and trout farmers, 2019



Based on company data. *Includes 50% of Scottish Sea Farms.

Havfisk has licence rights to harvest just over 10% of total Norwegian cod quotas in the zone north of 62 degrees latitude, corresponding to around 30% of the total quota allocated to the trawler fleet. The total catch in 2020 was 68,419 tonnes, up from 62,000 tonnes in 2019 and is projected to increase by about 7% in 2021. Lerøy aims to improve Havfisk's competitiveness and has the scale to make an impact in this respect. It can also provide significant wholesale and processing solutions.

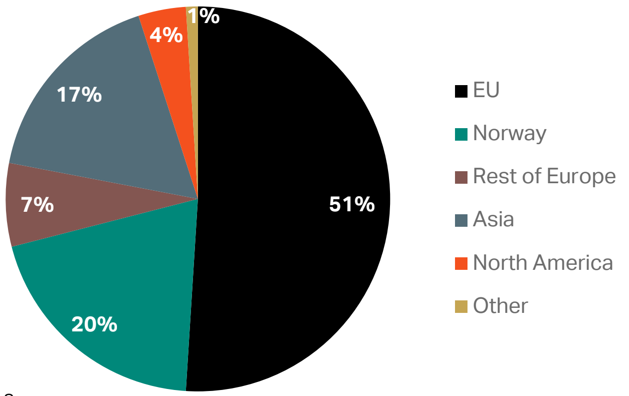
A diversified seafood company

Size and diversification scores 'a-'

Lerøy has a more diverse spectrum of products and less concentrated production than most of its peers. Its profitability is, however, dependent on salmon prices internationally, and particularly in Europe. The company generates half of its revenues in Europe but exports a significant amount of production to Asia and North America. The salmon market is relatively efficient in that volumes tend to move where prices are higher, and major markets in both Asia and North America can be served by air freight. Transport costs to these destinations from Chile and Norway are broadly similar.

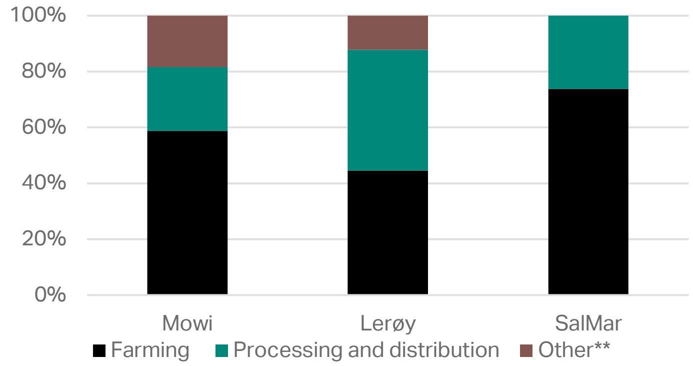
Lerøy is a fully integrated seafood producer, and a significant proportion of its production and catch is processed at its own processing plants. Secondary processing (filleting, portioning, slicing, marinating, and coating) adds less value to the bottom line than farming due to the fragmented and competitive nature of the international processing industry but increases flexibility in production and offers some protection against low prices. Moreover, it reduces the company's environmental footprint by reducing the volumes transported to end-customers. The broad and fragmented customer base of secondary processors, HoReCa customers, and retailers means that individual customers more or less act as price takers.

Figure 13. Lerøy's revenues by geographic market, 2020



Source: company.

Figure 14. Largest Norwegian salmon farmers – distribution of revenues*, 2020



Based on company data. *Eliminations subracted from processing and distribution revenues. **Other: Mowi: Feed, Lerøy: Wildcatch.

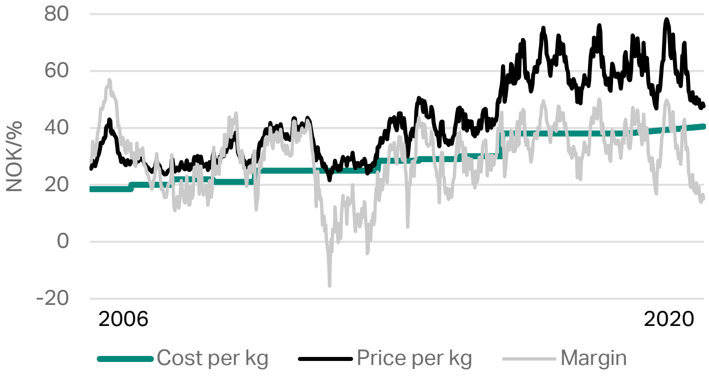
Cost efficiency in line with peers

Operating efficiency scores 'bbb'

Lerøy's margins in its main areas of operation have historically been close to its peer group average. In recent years, however, an increase in sea lice in central Norway has hit Lerøy harder than many other fish farmers operating in the area. The company has more stringent standards for levels of sea lice per salmon than its peers, forcing it to incur higher costs to reduce infestation (see Figure 16). We note some differences in reporting across the sector, for example some low-margin processing-related activities are included in Lerøy's Farming segment.

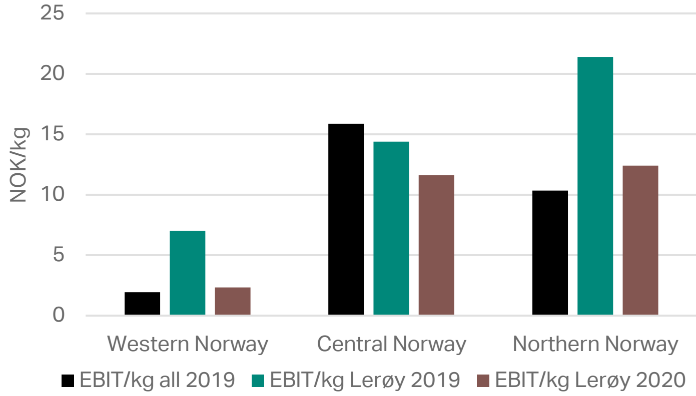
We believe that Lerøy has higher-than-average feed costs due to high quality requirements and a strong environmental focus in its sourcing activities. Industry operating costs per kg of harvested salmon have increased by an average of about 5% annually over the past decade. Feed, which is the most important cost element (close to 50%), consists of vegetable meal (~50%), vegetable oil (~20%), fish meal (~17%), fish oil (~11%), and other substances (~3%). Fish meal and oil are about 50% more expensive than vegetable raw materials. We assume that operating costs will continue to increase in line with historical levels in the years ahead.

Figure 15. Weekly Norwegian salmon export price and cost per kg, 2006–2020



Source: Statistics Norway, Mowi.

Figure 16. Lerøy costs per kg by geographic area, 2019–20



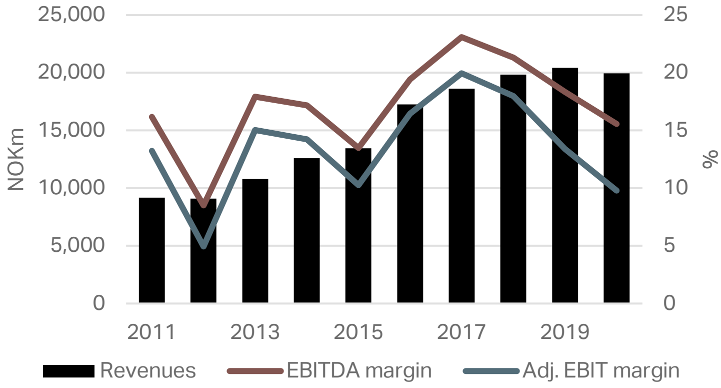
Source: Directorate of Fisheries and company data.

Besides volatile salmon prices, the main risk for a salmon farmer is biological, primarily in the form of disease and sea lice. In Norway, disease outbreaks often lead to premature culling of salmon stocks, entailing lost revenues. Antibiotics are rarely used in Norwegian salmon farming due to extensive vaccination programs for treatable diseases. Sea lice are present all along the coast but have historically been a bigger issue in western Norway, due to higher temperatures and a relative lack of cooperation between fish farming companies. Sea lice have a negative impact on EBIT of close to NOK 10 per kg harvested due to direct and indirect costs and lost revenues. Trout have proven to be more resilient to sea lice than salmon (due to farming in brackish water), which explains Lerøy's extensive trout farming business in the fjords of western Norway. Winter wounds have become a problem since the industry started to release smolt during winter. This impacted Lerøy's margins negatively in northern Norway in 2020 and the effects are continuing in 2021.

Comparison with the wider European seafood processing industry is distorted by the relatively high proportion of whole fresh and frozen fish in the VAPSD segment's revenue base (see Figure 20). Historically, the segment's margins are low but stable, and it generates more predictable cash flow than the more volatile farming segment (see Figure 19).

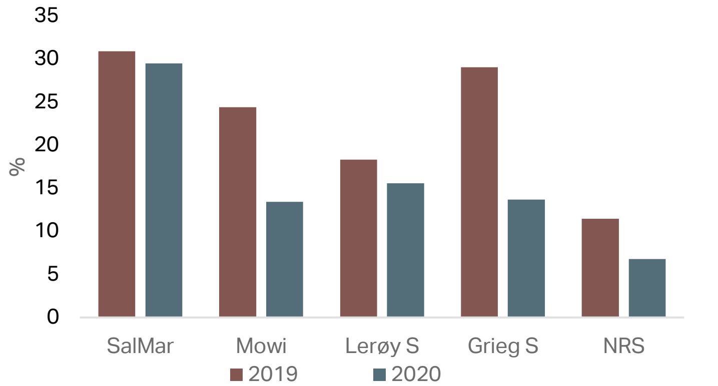
The Wildcatch segment operates with EBITDA margins of around 10%. Since fishermen's renumeration is linked to the value of the catch, labour costs in this segment are highly flexible. The whitefish processing activities constrain margins, but these operations are difficult to streamline since fishing licences are conditional on the fishing company having operations on land.

Figure 17. Lerøy's revenues and margins, 2011–2020



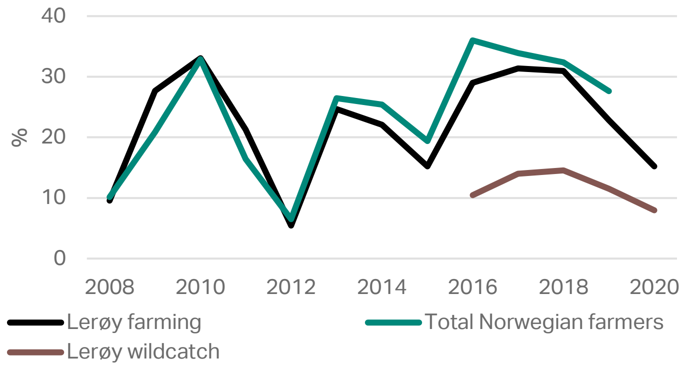
Source: company.

Figure 18. Norwegian salmon farmers' EBITDA margins, 2019–20



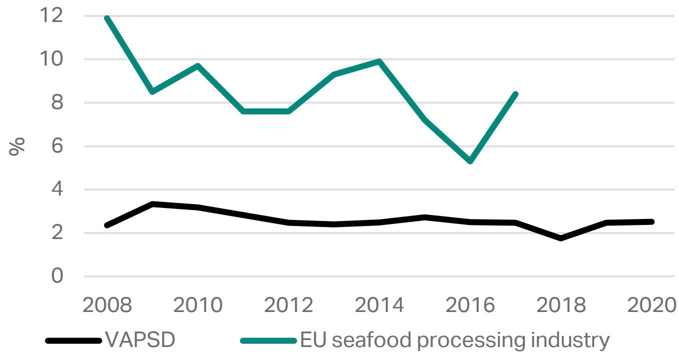
Based on company data.

Figure 19. Lerøy and Norwegian farming and wildcatch EBIT margins, 2004-2020



Based on Norwegian Directorate of Fisheries and company data.

Figure 20. Lerøy VAPSD and EU processing EBIT margins, 2011–2020



Source: company, The EU Fish Processing Sector Economic Report 2020.

FINANCIAL RISK ASSESSMENT

Financial risk assessment is 'bbb+'

Our financial risk assessment reflects Lerøy's strong balance sheet and cash generation. However, we view the company's risk appetite as greater than reflected by its credit metrics. In particular, we consider the company's volatile EBITDA margins and the company's recent history of paying dividends above its policy targets as an additional risk factor. In our forecast, we consider that Lerøy has plenty of headroom in its financial policy and we believe that the company will need to sustain a high level of investment to keep up with technological developments and generate revenue growth.

Ratio analysis scores 'a-'

Strong balance sheet and cash flow

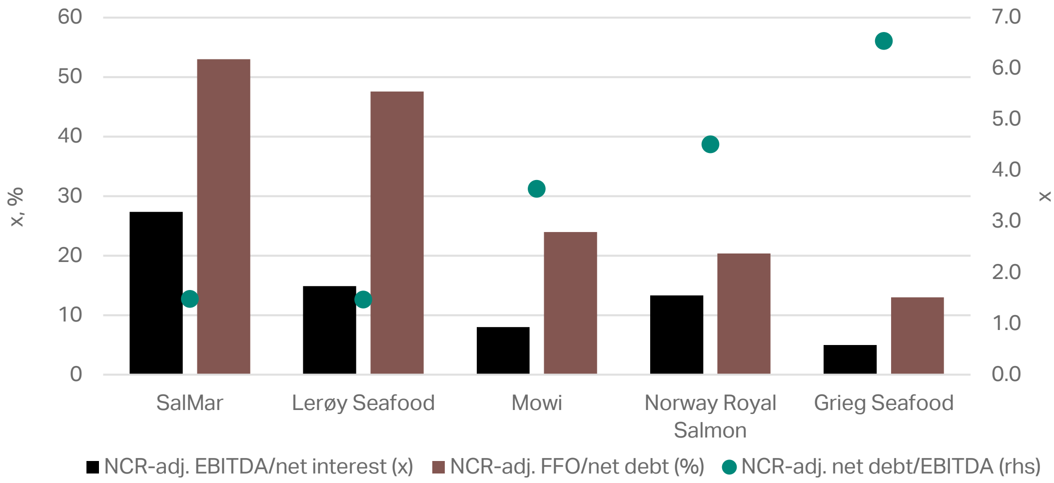
Lerøy has been through a period of heavy investments in smolt and processing capacity but still has strong credit metrics both in absolute terms and compared with most of its peers. The company's strategy is to build capital during economic upturns to make value-creating transactions in downcycles. It has invested less in new farming technology than some of its peers, except for investments in state-of-the-art facilities using RAS technology (closed-containment aquaculture systems using recirculated water) for production of large smolt, which are more resilient to sea lice, and potentially facilitating land-based fish farming.

In our forecasts, we assume an equity ratio in the 57-59% range (minimum target is 30%) and that the company will invest in upgrades and new facilities over the forecast period. Our forecasts imply that Lerøy's debt/EBITDA ratio will remain close to the current level of 1.5x.

In our base case we assume that the company will:

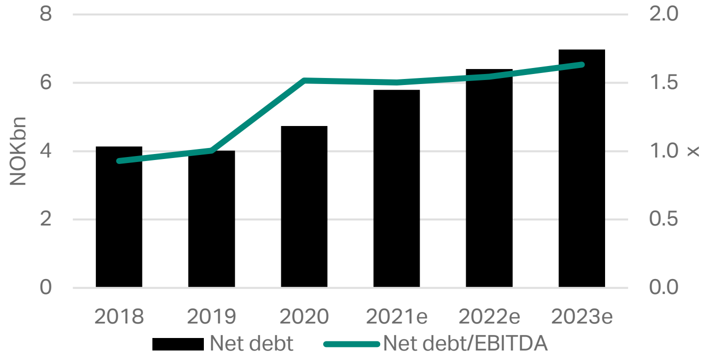
- Increase revenues by an average of 7% annually in the coming three-year period due to a combination of higher volumes and prices;
- achieve an average EBITDA margin of 18% from 2021, up from 16% in 2020;
- make capital investments of about NOK 5bn over the next three years; and
- distribute 50% of net profit in dividends (see under Risk appetite below).

Figure 21. Lerøy peer group adjusted credit metrics, 2020



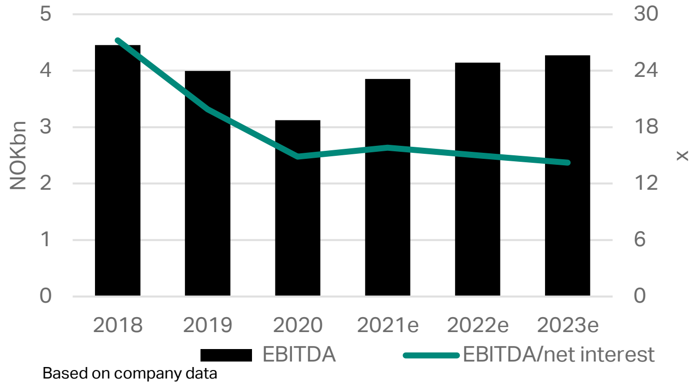
Based on company data.

Figure 22. Lerøy NCR-adjusted net debt and net debt/EBITDA, 2018–2023e



Based on company data

Figure 23. Lerøy NCR-adjusted EBITDA and EBITDA to net interest, 2018–2023e



Based on company data

Figure 24. Lerøy adjusted and unadjusted credit metrics, 2018–2023e

Credit metrics	2018	2019	2020	2021e	2022e	2023e
Reported net debt/ EBITDA (x)	0.4	0.4	0.7	0.8	0.9	1.0
Reported EBITDA/interest (x)	31.6	32.7	24.2	24.3	21.6	19.8
Reported FFO/net debt (%)	207.7	191.0	118.3	79.9	70.9	64.3
NCR-adj. net debt/EBITDA (x)	0.9	1.0	1.5	1.5	1.5	1.6
NCR-adj. EBITDA/ interest (x)	27.2	19.9	14.9	15.8	15.0	14.2
NCR-adj. FFO/net debt (%)	86.7	83.1	54.0	45.7	44.6	42.4

Based on NCR estimates and company data. e–estimate.

Figure 25. NCR's adjustments to Lerøy's reported credit metrics, 2018–2023e

NOKm	2018	2019	2020	2021e	2022e	2023e
EBITDA	4,515	3,926	3,214	4,042	4,285	4,413
Dividends from JVs and associates	245	266	29	53	113	119
Share of profit from JVs and associates	-287	-180	-105	-225	-239	-246
Activated R&D	-19	-16	-14	-14	-14	-14
NCR-adjusted EBITDA	4,455	3,997	3,123	3,856	4,145	4,273
Cash and cash equivalents	3,036	3,031	2,966	3,440	3,320	3,772
Restricted cash	-117	-132	-158	-183	-177	-201
NCR-adjusted cash and equivalents	2,920	2,899	2,809	3,257	3,143	3,571
Gross interest-bearing debt	4,642	4,616	5,207	6,707	7,207	8,207
Long-term leasing liabilities	2,410	2,295	2,339	2,339	2,339	2,339
Retirement benefit obligations	4	3	3	3	3	3
NCR-adjusted cash and equivalents	-2,920	-2,899	-2,809	-3,257	-3,143	-3,571
NCR-adjusted net debt	4,136	4,015	4,740	5,792	6,406	6,978
Net interest	-143	-120	-133	-166	-199	-223
Financial costs from leasing	-21	-81	-77	-77	-77	-77
NCR-adjusted net interest	-164	-201	-210	-244	-276	-300
Adjusted EBITDA	4,455	3,997	3,123	3,856	4,145	4,273
NCR-adjusted net interest	-164	-201	-210	-244	-276	-300
Current taxes	-704	-461	-356	-963	-1,013	-1,014
NCR-adjusted FFO	3,587	3,335	2,558	2,648	2,856	2,958

Based on company data. JVs–joint ventures.

Technological advances in salmon farming could create need for larger investments

Risk appetite scores 'bbb+'

We view Lerøy's risk appetite as greater than reflected by its current financial ratios, although we believe that our forecast financial ratios are reasonably conservative. The company has a history of volatile credit metrics, largely due to price fluctuations but also due to the unpredictable cost base of its farming operations. We view the company's recent history of paying dividends well in excess of its policy targets as an additional risk factor.

We note that Lerøy's financial policy allows increased financial gearing. The company has a minimum equity ratio requirement of 30% embedded in its financial policy and bank covenants (which also include net interest coverage of more than 5x). This is slightly more than half of the current equity ratio, allowing for increased gearing. We believe that Lerøy, in line with the sector in general, will need to make substantial investments to keep up with advances in farming methods and technologies. In addition, the company's dividend policy states that, over time, dividends should amount to 30-40% of net profit. However, we note that the company paid 81% in 2020 (43% in 2019) and that dividends have averaged 65% of net profit for the past 10 years (and occasionally have been above 100%). We believe it likely that the owners will continue to require high dividends in the years ahead to offset loss-making operations outside of Lerøy (see Ownership analysis below).

Lerøy has a history of acquisitions during periods of weak market conditions. The last significant transaction by the Farming segment was in 2013, when it acquired Villa Organic AS. Lerøy's largest acquisition to date was in 2016 when Havfisk and Norway Seafood were bought from Aker for NOK 3.2bn. In addition, the company has made several bolt-on acquisitions. The recent acquisition by the VAPSD segment of processing and distribution company Seafood Danmark A/S, with DKK 1.2bn in revenues in 2020, is one example. We also note that joint venture Scottish Sea Farms has recently entered an agreement to acquire Grieg Seafood's operations in Shetland (24,000 tonnes harvested in 2020) for GBP 164m. The transaction will be funded with external debt and new equity.

The company has a strong focus on credit risk and has incurred low losses on accounts receivable in recent years. In 2020, 77% of Lerøy's operating revenues were denominated in foreign currencies, the largest being the euro (46%) and the US dollar (17%). Lerøy has fixed price contracts currently covering

30% of its volumes. Contractual sales are hedged and sales revenues adjusted for the effect from currency forward contracts. About 8% of net interest-bearing debt is denominated in euro and 2% in other currencies. We do not see currency risk as a significant factor in the short term, although changes in the EUR/NOK exchange rate have a direct impact on revenues.

In 2019, the European Commission launched an inquiry into Lerøy and a number of other Norwegian aquaculture companies over alleged price fixing. Subsequently, similar investigations were launched in the US and Canada, and a class action suit was filed against salmon farming companies in the US. Lerøy has made no provisions in respect of these actions, maintaining that it has not engaged in any form of price fixing.

ADJUSTMENT FACTORS

Adjustment factors are neutral

Adjustment factors are assessed as neutral and have no effect on our stand-alone credit assessment.

Liquidity

Liquidity assessed as neutral

We assess Lerøy's liquidity position as adequate. The company has a strong cash position and unutilised credit facilities that more than outweigh its committed financial obligations over the next 12 months. We note that the company has not utilised supply chain finance as a financing source. We further include dividends in our calculations as we expect the owners to require some payment over the year.

We estimate the following primary liquidity sources for 2021, totalling NOK 8.0bn:

- NOK 2.8bn, excluding NOK 157m in restricted cash;
- NOK 3.4bn in committed available credit facilities; and
- NOK 1.8bn, reflecting 75% of FFO over the period.

This compares with the following estimated uses of liquidity, totalling NOK 3.1bn:

- NOK 900m in amortisation of secured debt and lease instalments;
- NOK 1.1bn in dividend payments; and
- NOK 1.1bn in committed capital spending.

Environmental, social and governance factors

ESG factors assessed as adequate

In our view, Lerøy's environmental, social and governance (ESG) efforts support the company's overall competitive position. The farming and wildcatch industries generate environmentally damaging emissions, especially through food sourcing and energy usage, and interfere in natural ecosystems. Farming also creates fish health problems. Lerøy recognises these problems. The company's ESG efforts are science-based and designed to reach the goals set out in the Paris Agreement. The Governance Group AS, a domestic ESG monitoring and advice service, regards the company as one of the best Norwegian listed companies in terms of reporting on ESG problems, and believes the wider fish farming industry is highly aware of its impact on the environment. Fish as a sustainable protein source could challenge other sources with higher emissions, increasing the overall competitive position of the industry, and improving Lerøy's operating environment.

Lerøy publishes an annual sustainability report following the principles of the Global Reporting Initiative and has launched a sustainability library containing policies and targets aimed at increasing transparency. In our view, transparency is of high importance in the livestock and wildcatch industries, as consumers become increasingly aware of issues such as animal welfare, use of medicines and antibiotics on animals, and the composition of nutrients in food products. The fish farming industry is highly regulated, and consistent reporting facilitates regulatory compliance and reduces the risk of regulatory action.

Fish farming is not yet incorporated into the EU Taxonomy, which we expect to increase transparency into sustainable investments. However, its environmental footprint is significantly smaller than beef production, at 7.9 kg carbon equivalent per kilo of edible product compared with 39 kg. In our view, ongoing efforts to include the industry in the EU Taxonomy are likely to succeed given its potential for classification as a climate change mitigating activity. Lerøy's RAS technology for large smolt production could be used in land-based salmon farming if it reduces emissions and harm to ecosystems. In addition, RAS has the potential to improve fish welfare.

The main ESG issues that could affect our credit rating on Lerøy are factors that could contribute to loss of revenue, increased operational costs, increased capital spending, loss of value of assets, decreased access to funding, or loss of operating rights. In this context, the main credit risks are fish health and emissions and their potential impact on the social perception of fish farming and fish as a sustainable source of protein. Increasing capital spending to comply with changing regulations could further strain liquidity. However, we see Lerøy's liquidity position as solid and expect that the company could easily adapt to changing regulations.

Lerøy operates close to other operators in Western Norway, increasing the risk of sea lice and disease and increasing the difficulty of treatment due to the different approaches and standards among companies. In our view, the company could be negatively affected by operations outside its control.

Figure 26. Lerøy ESG considerations

Issue	Risks	Mitigating efforts	Results
Sea lice and disease	Loss of revenue through early harvesting or mortality. Increased costs due to treatment. Reduced revenue potential due to lower volume growth. Diseases could affect consumer perception of salmon as a healthy protein source.	Medical treatments such as baths and through feed. Vaccination. Aim to use zero antibiotics, but emphasis on fish welfare in line with relevant legislation.	0.16 fully grown lice per fish in 2020, well below regulatory levels. The level varies from 0.12 to 0.17 in different areas. A total of 19kg of antibiotics were used in 2020, zero in 2019 and 7.4kg in 2018. Survival rates of 92.5% at sea are acceptable but not best in class.
Trawler operations	Negative publicity could affect brand reputation, lowering overall demand for Lerøy's products. Trawling could increase political or social tension.	Trawling is highly regulated. Lerøy aims to trawl in the same locations to limit unwanted effects on seabed ecosystems. Increased focus on research and development to reduce risk.	Concentrated usage of trawling, in compliance with local regulations, mitigating risk of negative media focus and scrutiny.
Escapes	Loss of revenues and increased costs. Escapes impact the environment and negatively affect wild salmon. They are thoroughly monitored by non-governmental organisations. Could result in restrictions on open cages.	Continuous work on quality of pens. Close cooperation with local fishermen to catch escaped fish.	208 escapes in 2020, up from 85 in 2019, but not high.
CO_2 emissions	Any increase in related regulation and taxation could reduce operating efficiency and access to funding. Regulatory requirements could increase capital spending significantly.	Increased focus on renewable energy such as battery/hydrogen power for service boats. Climate target (approved by the Science Based Targets initiative) aims to reduce emissions by 46%.	Scope 1 and 2 emissions down 7% and 30% respectively in 2020 from 2019. However, 91% of emissions in 2019 were Scope 3 emissions.
Fish feed ingredients	Use of both unsustainable plant-based ingredients and marine products could attract regulatory scrutiny and negatively affect consumer perceptions.	Aim to use suppliers with sustainability certifications. High focus on finding sustainable alternatives. Aim to use ingredients that are not sourced from areas threatened by deforestation. The company is part of the Pro Terra environmental foundation, and committed to certified soy production only. Avoidance of ingredients based on marine products.	Some 90% of marine ingredients certified, supported by own production through waste from wildcatch. 100% traceability. In total, 41% of raw materials certified.

Source: company.

Ownership analysis

Ownership assessed as adequate

Lerøy's majority owner is Austevoll Seafood, a pelagic fishery company controlled by the Møgster family. Austevoll Seafood is an industrial owner, which provides raw material for the fish feed industry, has expertise in fisheries, and owns a salmon farming operation in western Norway (harvested 7,318 tonnes in 2020). Some 85% of Austevoll Seafood's EBITDA is generated by Lerøy. Pelagic fishery is a low-margin and cyclical industry while the salmon farming operations outside Lerøy are loss making.

The Møgster family has significant other business activities, mainly in the offshore industry. Given the current state of the offshore industry, we are not certain that the majority owner would contribute capital support in an event of financial distress. Austevoll Seafood did not contribute to a NOK 2.2bn share issue to fund the acquisition of Havfisk and Norwegian Seafood Group in 2016 but sold stock for NOK 969m instead and reduced its ownership from 62.6% to the current level of 52.7%.

Figure 27. Lerøy ownership structure, 10 May 2021

Owner	Share of votes and capital
Austevoll Seafood	52.7%
Folketrygdfondet	5.3%
State Street Bank and Trust Co.	1.6%
UBS AG	1.5%
Pareto Aksje Norge	1.2%
Other	43.0%
Total	**100.0%**

Source: company.

ISSUE RATINGS

Lerøy is financed primarily by secured bank debt and long-term leasing liabilities. For this reason, long-term senior unsecured obligations will be rated one notch below the issuer rating, unless the secured debt as a percentage of total debt falls below 50%, in line with our criteria. Currently, the company has no outstanding bond debt.

Figure 28. Lerøy key financial data, 2017–2020

NOKm	2017	2018	2019	2020
INCOME STATEMENT				
Total revenue	18,624	19,838	20,427	19,960
Gross profit	8,707	8,829	9,143	8,615
EBITDA	4,603	4,515	3,926	3,214
EBIT	4,019	3,855	2,914	2,055
Net financial items	-210	-161	-215	-241
Pre-tax profit	2,093	4,449	2,365	987
Net profit	1,749	3,598	1,870	790
BALANCE SHEET				
Property, plant and equipment	4,329	5,699	6,230	6,797
Goodwill	2,132	2,218	2,220	2,225
Intangible assets other than goodwill	5,888	5,948	5,931	6,082
Interests in associates	961	1,016	950	1,055
Other non-current assets	977	997	2,466	2,542
Non-current assets	14,286	15,878	17,797	18,702
Cash and cash equivalents	3,514	3,036	3,031	2,966
Other current assets	7,858	9,459	9,362	8,495
Total current assets	11,372	12,495	12,393	11,461
Total assets	**25,658**	**28,373**	**30,189**	**30,163**
Total equity	14,482	17,134	17,763	17,633
Long-term borrowings	4,142	3,796	3,629	3,994
Long-term leasing liabilities			1,880	1,900
Retirement benefit obligations	3	4	3	3
Deferred tax liabilities	2,314	2,444	2,475	2,320
Other long-term liabilities	900	818	31	34
Non-current liabilities	7,360	7,061	8,017	8,251
Current liabilities	3,816	4,177	4,409	4,279
Total equity and liabilities	25,658	28,373	30,189	30,163
CASH FLOW STATEMENT				
Pre-tax profit	2,093	4,449	2,365	987
Adjustments not in cash flow	1,711	-1,115	661	1,663
Cash flow before changes in working capital	3,804	3,334	3,027	2,650
Changes in working capital	-116	-552	-168	-283
Operating cash flow	3,688	2,783	2,859	2,367
Cash flow from investing activities	-1,429	-1,615	-876	-1,354
Cash flow from financing activities	-979	-1,645	-1,988	-1,077
Cash and cash equivalents at beginning of year	2,234	3,514	3,036	3,031
Cash flow for year	1,280	-478	-5	-65
Cash and cash equivalents at end of year	**3,514**	**3,036**	**3,031**	**2,966**

Source: company.

Figure 29. Lerøy rating scorecard

Subfactors	Impact	Score
Operating environment	20.0%	bb
Market position	10.0%	bbb
Size and diversification	10.0%	a-
Operating efficiency	10.0%	bbb
Business risk assessment	50.0%	bbb-
Ratio analysis		a-
Risk appetite		bbb+
Financial risk assessment	50.0%	bbb+
Indicative credit assessment		**bbb**
Liquidity		Adequate
ESG		Adequate
Peer comparisons		Neutral
Stand-alone credit assessment		**bbb**
Support analysis		Neutral
Issuer rating		**BBB**
Outlook		Stable
Short-term rating		**N-1+**

DISCLAIMER

NORDIC CREDIT RATING AS

nordiccreditrating.com