Nordic Credit Rating

SECTOR COMMENT

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Norway salmon farms face sharp tax hike

ANALYSTS
Geir Kristiansen
+4790784593
geir.kristiansen@nordiccreditrating.com

Gustav Nilsson
+46735420446
gustav.nilsson@nordiccreditrating.com

The Norwegian government has proposed a 35% "resource rent tax" on the sea-phase production of salmon and trout, to take effect retroactively from 1 Jan. 2023. This is 5pp lower than the originally proposed rate set out in an initial consultation draft in September 2022. Under the revised proposal a previously suggested "norm price" based on Nasdaq spot prices would be scrapped; instead a "norm price board" would be set up in 2024. Although the mechanism for setting the norm price is not yet clear, we believe parliament would resolve the uncertainty before the proposed tax becomes law. In any event, we believe the proposal, if adopted, would likely open the market once again for long-term price contracts.

However, it is not entirely certain that the proposal will be adopted at all, due to opposition from both the left (which wants higher tax levels) and the right (which wants to scrap the proposal altogether). In fact, the main centre-right conservative party (Høyre) says it would scrap the tax altogether if it were to win the next general election scheduled for 2025, which seems likely on the basis of recent opinion polls.

In our view, the proposed tax would be slightly credit negative for the country's salmon farmers; the impact on their cash-flow metrics is likely to be moderate and could be mitigated by lower dividend payments to shareholders. As it stands, the proposal is unlikely to trigger any NCR rating actions. However, the long-term effects on the industry could be substantial and falling market shares and/or profitability or increased financial leverage could negatively modify our view over time.

THE PRIMARY FEATURES OF THE GOVERNMENT'S PROPOSAL

The government's overall proposal for the industry consists of the new resource rent tax in tandem with an existing production tax.

The resource rent tax:

- The tax will be structured as a cash-flow tax with immediate deductions for investments that are used only during the sea phase of production.
- The effective rate will be set at 35%.
- Deductions will be granted for investments made prior to 1 Jan. 2023 through depreciation of remaining tax values.
- No deductions will be granted for the value of fish farming licences, however a template deduction in revenue will be permitted for licences purchased at auction in 2018-2020 and allocated at fixed prices in 2020.
- An independent price board will be established to determine the level of taxable revenue. The board will be tasked with setting the market value when the fish are removed from the pen; this will apply to salmon and trout prices from 2024. Regulations governing the price board will be made available for consultation. For 2023, the producers themselves will set the market values when fish are removed from the pen, and these values will be used as the basis of the relevant tax return under self-reporting principles.
- Negative resource rent can be carried forward with interest, and if activities cease the tax value of the negative resource rent will be disbursed.
- A standard deduction of NOK 70 million will ensure that only companies with "significant" profits will pay the resource rent tax.

The production tax:

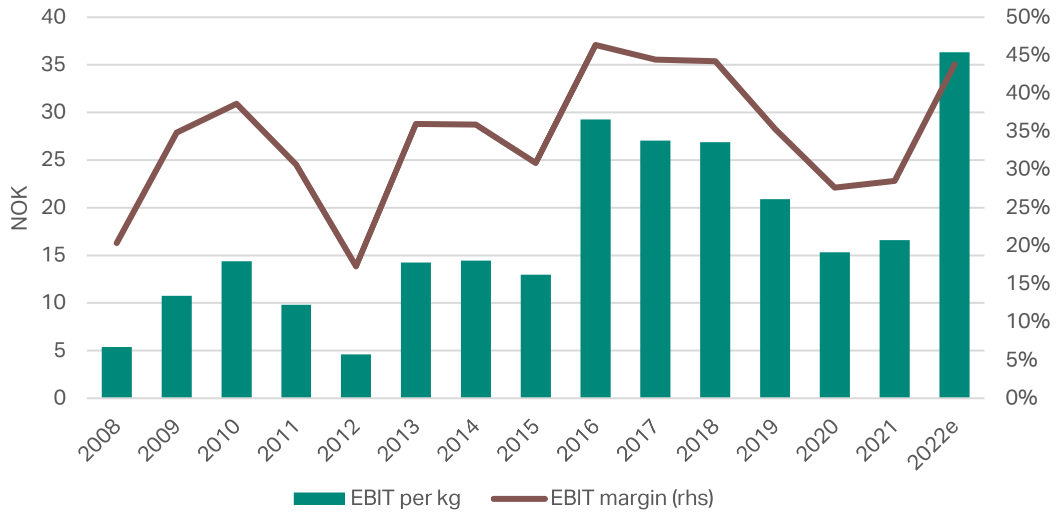
- Under the latest proposal, the production tax will be set at NOK 0.9 per kg. The tax is intended to generate broadly stable revenues for municipal and county authorities in local government areas where fish farming operations are located. The production tax can be deducted from the resource rent tax determined.

A previous proposal to introduce a "natural resource tax" will not be introduced. The proposed production tax of 0.9 per kg is lower than the aggregate total of the production tax and natural resource tax (NOK 1.12 per kg) originally suggested in the consultation proposal. Under the latest proposal, producers that have too low profit to pay resource rent tax will pay slightly less tax than anticipated in the consultation proposal.

HIGHER TAX ON UTILISATION OF SHARED RESOURCES

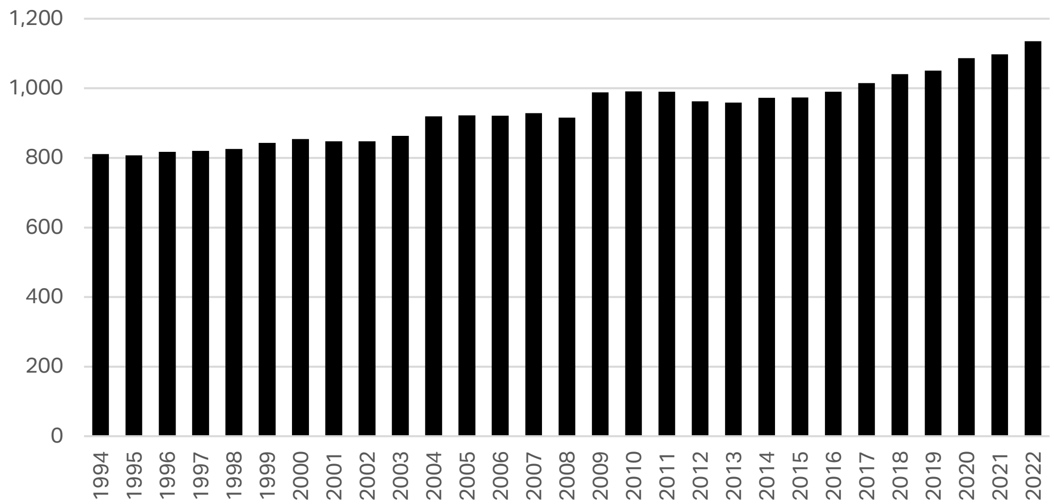
Essentially, the current government wants to increase taxation of the highly profitable salmon farming sector. The proposed resource rent tax on fish farmers would effectively raise the tax they pay to 57% from the ordinary corporate tax level of 22%. The argument is that salmon farmers benefit from natural resources such as clean water and advantageous climate conditions and that, in the past, production licences have been awarded cheaply or free of charge. In addition, the number of licences which can be awarded has been limited for environmental reasons. Under the current proposal, the proceeds from the new tax will be distributed equally between the state and local governments in counties and municipalities where fish farming operations are located.

Figure 1. Norwegian salmon farmers' EBIT and EBIT margins, 2008-2022e



Based on NASDAQ prices and data from the Norwegian Directorate of Fisheries and NCR.

Figure 2. Number of fish farming licences in Norway, 1994-2022



Source: Directorate of Fisheries.

The industry argues that salmon farming is an investment-heavy food industry which does not primarily harvest natural resources. In addition, producers maintain that they have already paid for the use of any natural resources through previously purchased farming licences. Academic research indicates that only about 5% of existing farming licences were awarded to their current holders free of charge, a practice which took place in the 1970s and 1980s, when such documents had virtually no market value. Since trading in licences was permitted in the 1990s, their value has varied in line with the profitability of the fish-farming sector. The government started selling licences in 2000, but prices were kept low to enable small players to participate. Since 2018, new licences have been allocated at market value through bi-annual auctions.

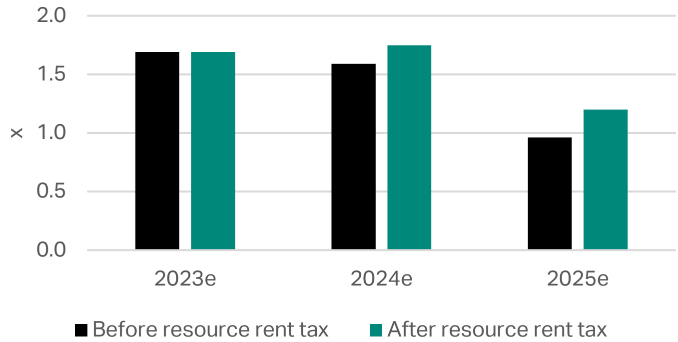
THE EFFECT ON EARNINGS AND CREDIT METRICS

Some of the proposed tax would come from an increase in an existing production tax, independent of profitability, introduced in 2021. We consider this an operating cost that directly reduces EBITDA. Most of the impact would come from the proposed new cash-flow tax to compensate society for the exploitation of natural resources, similar to taxes already imposed on domestic oil and energy companies. The sum of the increased production tax and the cash-flow tax should, according to the proposal, equal 35% of cash flow from the production of salmon in the sea phase of the value chain (including investment in processing facilities but excluding financial costs).

We believe that the proposed increase in the production tax would have only a modest impact on salmon farmers' EBITDA. However, we anticipate that the levy on cash flow from the resource rent tax would likely reduce producers' funds from operations (FFO) and free operating cash-flow metrics. We believe that shareholders will shoulder the brunt of the impact as producers reduce dividend payments and rethink their long-term investment plans.

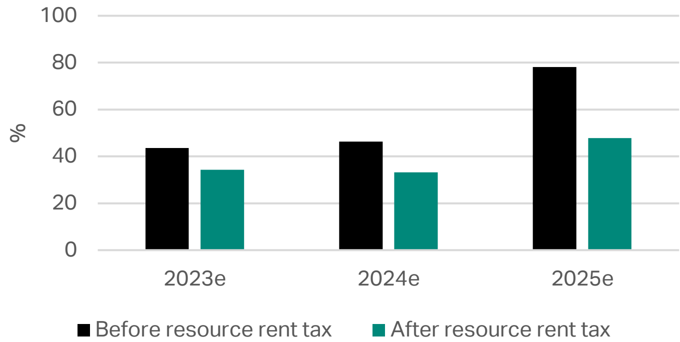
Other risk factors also exist. Producers could increase leverage to maintain their return on equity, despite the resulting reduction in cash-flow flexibility to repay debt. In addition, reduced investment in the industry could lead to loss of market share to producers operating in regions with lower tax requirements. Over time, such factors could reduce creditworthiness across the sector.

Figure 3. SalMar NCR-adjusted net debt/EBITDA, 2003e-2025e



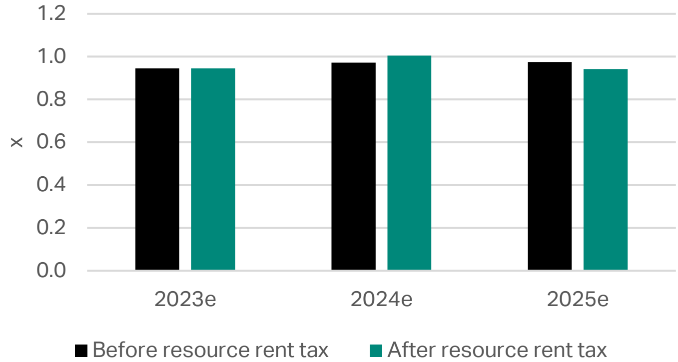
Based on company data.

Figure 4. SalMar NCR-adjusted FFO/net debt, 2003e-2025e



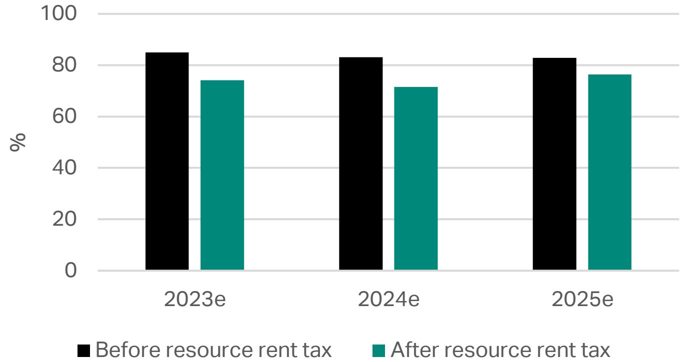
Based on company data.

Figure 5. Lerøy Seafood NCR-adjusted net debt/EBITDA, 2003e-2025e



Based on company data.

Figure 6. Lerøy Seafood NCR-adjusted FFO/net debt, 2003e-2025e



Based on company data.

LIKELY IMPACT ON BUSINESS MODELS AND MARKET BALANCES

The higher level of effective overall taxation as a result of the resource rent tax is likely to reduce salmon farmers' ability and willingness to invest in new capacity. We also believe that investments in aquaculture will become less attractive (despite tax deductibility), and that fewer projects will meet the required rate of return. When the resource rent tax was initially proposed, the subsequent salmon farming licence auction drew little interest, and more than NOK 40bn in related investment was put on hold or cancelled. Over time, this will most likely lead to lower production and/or higher salmon prices.

Norwegian salmon farmers are already investing in other regions, and we believe that increased domestic tax levels will mean that more investment is channelled abroad, with a corresponding negative effect on local communities. One possibility is that alternative production methods where Norway does not have a natural advantage – such as land-based farming and offshore farming – will gain momentum. We believe that such production methods would be more costly than current practices, at least initially, and therefore lead to higher salmon prices.

European retail chains generally seek long-term contracts with suppliers, but this could still prove difficult for Norwegian salmon farmers under the current proposal depending on how the norm price is calculated. One outcome could be lower demand from retailers, which in turn could partly offset upward pressure on prices.

Figure 7. NCR ratings on Norwegian salmon farmers

Issuer	Primary industry	Long-term issuer rating	Outlook
Lerøy Seafood Group ASA	Salmon farming	BBB+	Stable
SalMar ASA	Salmon farming	BBB+	Stable

See NCR's company reports for details.

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