

SMARTER PERSPECTIVE: SEAFOOD INDUSTRY

Retail Seafood Demand is Helping to Offset COVID-19 Foodservice Losses, but Aging Inventories are Increasing Risk

By Dean Hogencamp

In this article we look at the continued struggles of the seafood industry in foodservice and how some companies which have the capability, have pivoted quickly to meet unprecedented levels of retail demand. We also look at the complex landscape asset-based lenders must navigate to best support their seafood portfolio companies and limit their own downside risk during this crisis period.

The COVID-19 pandemic triggered an overall reduction in demand for seafood products in both the U.S. and in markets around the globe. With restaurants, schools, corporate cafeterias, stadiums, and other commercial facilities operating at diminished capacity levels, or closed altogether during various stages of the pandemic, foodservice is bearing the brunt of the impact to the industry. Even hospital cafeterias and other on-premise offerings in medical centers which typically enjoy a robust business service, not only with patient and medical staff populations but visitors as well, have been hit hard as institutional restrictions prevent friends and loved ones from spending time with those receiving

care. On average, close to two-thirds of consumer spending on seafood in the U.S. goes to establishments supplied by the foodservice industry each year; therefore, it is not surprising that the seafood sector has proven itself to be particularly vulnerable to the demand changes that have occurred in the food industry since March 2020.

The fallout from the COVID-19 pandemic restricted the movement of consumers since the beginning of the second quarter of 2020, and, notably, their ability to dine out. While much has been written about the long-term implications of the new habits being formed by consumers in regard to shopping online versus in-store, and working from home versus commuting to an office, less has been discussed regarding whether consumer dining behavior may be forever altered based on COVID-19 imposed restrictions or perhaps a newfound joy for cooking, eating more at home, or the money saved as a result. However, significant concern and speculation among consumers and the foodservice industry (and its many moving supply chain parts) has been centered around how many and which restaurants will survive the duration of the pandemic and the impact. In August of this year, Cushman & Wakefield indicated that, based on its research, fine dining and

fast casual restaurants are at the greatest risk of failure during the pandemic, with an estimated 50% failure rate, followed by mid-range, casual dining at 25%. Fast food establishments seem best suited to survive the crisis, though with a still alarmingly high projected failure rate of 20%.

Market Conditions

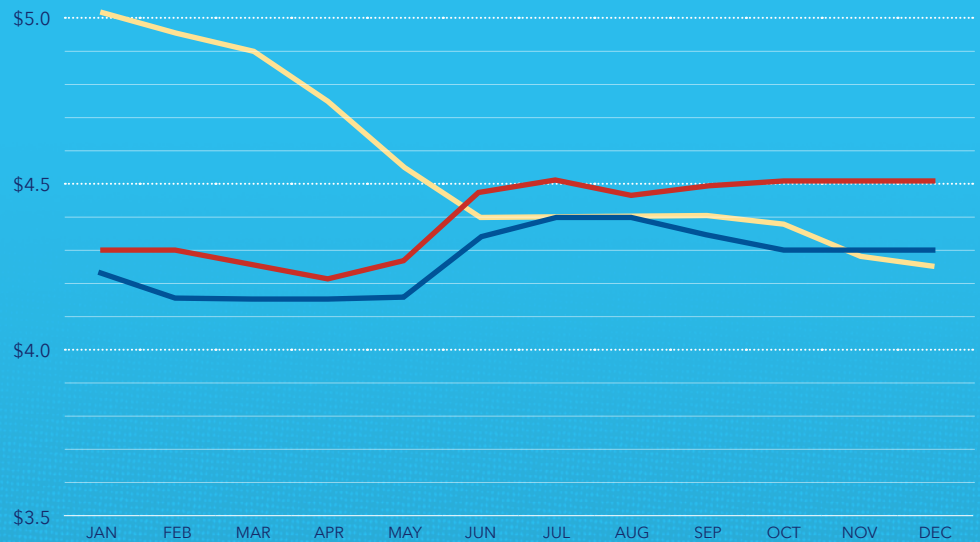
Pandemic-instituted restrictions ranging from a reduced number of workers allowed on production floors to heightened port and customs requirements for goods traveling between countries, have inhibited the seafood supply chain. According to Gordon Food Service, countries such as India and Indonesia have struggled with worker availability and raw material shortages, as international flights have been very limited. This aspect of the pandemic could impact inventory, leading to increased pricing. Shortages in the market thus far have included easy-peel, cooked shrimp, and smaller varieties of raw peeled/deveined and peeled/deveined tail-on due to an uptick in retail sales and delayed shipments from overseas. Overall, a drop of approximately 30% in production output from India is expected for 2020. Even with these developments, decreased demand in the foodservice sector has created pricing pressure across the board on shrimp.

Shrimp

Farm Raised, Asian
Raw, P&D, Tail-Off White
(U.S. \$ Pound)



— 2018
— 2019
— 2020



Source: Urner Barry

Domestic scallops, such as those sourced from Georgia's bank and New England's coasts, are headed in the other direction, as there is less supply due to quotas designed to preserve harvests in future years. Therefore, while demand there is down, it is accompanied by less overall supply. Interestingly, when foodservice started to feel the pinch from the pandemic, scallop processors were forced to freeze higher than anticipated volumes; however, given supply concerns, this has turned out to be a smart move on their part.

At present, we are seeing solid retail demand for salmon, including filets, but there is reason for concern on pricing. The lower margins that salmon is currently achieving in the market are placing pressure on operational costs/working capital needs for companies that specialize, at least in part, in selling this offering. As demand wanes, these products are filling up storage freezers; although these companies will most likely sell their frozen product down the road, they are not actively generating money from those inventories. This presents a problematic

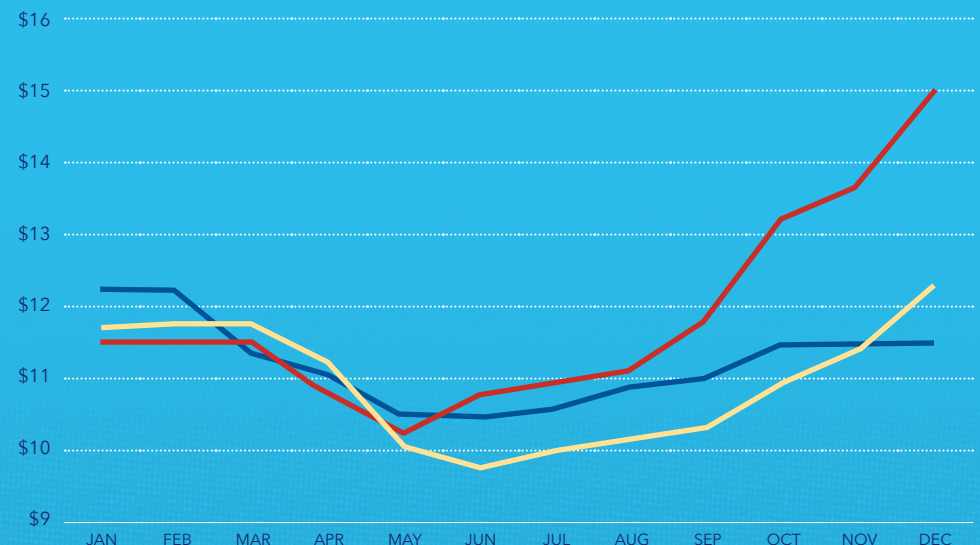
situation for processors, including those in Alaska, for example, who typically strive to secure as much of the harvest as the quota allows from fishermen and cannot simply pull back during a period of low demand or pricing, as this will jeopardize those relationships and their buying potential when markets return to more favorable conditions. Additionally, as in any market, when suppliers see that a customer is unable to buy, competitors with deeper pockets tend to move in quickly to capture both that quota and any potentially underserved customers.

Sea Scallops

Domestic, All Natural
IQF, 10/20 count
(U.S. \$ Pound)



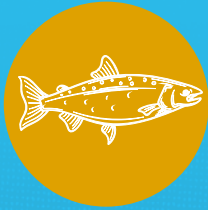
— 2018
— 2019
— 2020



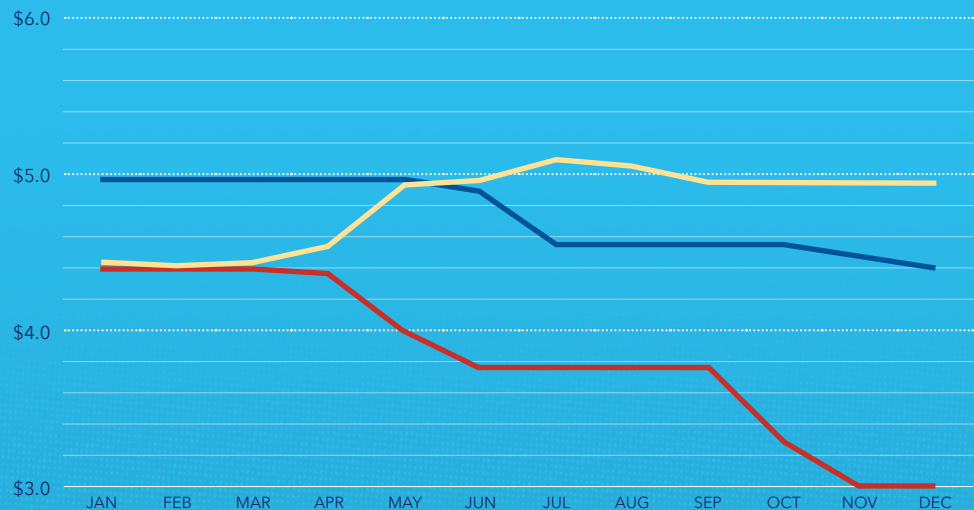
Source: Urner Barry

Salmon

Chile Frozen Fillets
D-Trim, FOB Miami
(U.S. \$ Pound)



— 2018
— 2019
— 2020



Source: Urner Barry

By sheer necessity, consumers have altered the manner in which they obtain and enjoy seafood since the start of the pandemic. According to a recent study by the Global Aquaculture Alliance, one U.S. supermarket chain reported a 40% increase in salmon and shrimp demand and a doubling in snow crab sales during the pandemic. Unfortunately for the industry, even though retail seafood sales have continued at notably elevated levels throughout the course of the crisis, they have not been able to fully offset the decrease experienced in foodservice. This is not for lack of effort on the part of distributors. Retail-focused suppliers have worked to find new supply sources and pump more value-added products, such as breaded and flavored shrimp, into retail avenues, while those who typically supply foodservice or a combination of retail and foodservice have gone to great lengths to modify or augment their offerings to suit the retail environment as well. In some cases, these differentiated products are showing promise in generating higher margins for suppliers during this period. Beyond the need to compensate for lost foodservice revenue, it is important to note that additional impetus to address these efforts is directly connected to the characteristics of seafood itself, and how it is stored and sold.

Industry Complexities

For lenders currently working with companies across the seafood supply chain, it is more essential than ever to understand the many nuances of the industry, starting with considerations such as the types and species of seafood that are typically sold into foodservice versus retail and how those fit into each portfolio company's businesses. This can quickly inform an asset-based lender as to the level of impact a company is likely to experience as the crisis extends into 2021. For example, a top retailer is very interested right now in buying any and all seafood available from sources including distressed or other companies, in order to meet the extraordinary demand of those customers and maximize its own returns during this period. Even with these customers clamoring for product, there are distinct challenges that make capitalizing on such an opportunity difficult. Case in point- many of the largest, most powerful retailers, such as Walmart Inc. and Costco Wholesale Corporation, require certain certifications from overseas aquafarms. Consequently, just because a wholesaler can find a "like" seafood product, that does not mean it will be accepted by every customer. Conversely, a large supplier to Red

Lobster Hospitality LLC, specializing in species that retail does not readily buy, may have nowhere to sell its core product. As a result, it may be at risk of losing valuable relationships with fishing sources and processors unless it has the proper liquidity to support the continued buying and storing of that product in freezer facilities throughout the duration of the crisis. A further complexity right now is that freezer space across the country is filling up rapidly during the pandemic, with some regions now in short supply. Facing the prospect of an added cost on top of the ongoing revenue shortfall they are already experiencing is a daunting prospect for wholesalers. Additionally, if COVID-19 restrictions persist for another 10 or 12 months and supply continues to flow in while foodservice venues remain inhibited, we are likely to see a further issue, as product aging creeps closer to accepted limitations/expiration.

As another example, certain types of shrimp sourced from Asia are individually quick frozen (IQF) or vacuum sealed (each piece is frozen separately) and packed in 30-pound master packs for foodservice customers, but can also be provided to retail in smaller 12-, 16- or 24-ounce packs for consumers to take home, cook, and eat for their own personal use.



Wholesalers of these and other products who sell to both foodservice and retail are in a far better position during the pandemic than their counterparts who do not. This flexibility does not exist, however, with products such as the headless shell-on shrimp found at a "white tablecloth restaurant." These are imported from Mexico and India in five-pound solid (shrimp frozen as a group) blocks suitable only for foodservice customers. Companies who deal heavily in this type of product are currently experiencing a 30% to 40% sales decrease in that category alone. As always, market dictates price. On a positive note, because these items are frozen as a single block, they are less susceptible to temperature change and have a shelf life of up to 36 months, whereas IQF product shelf life is typically in the 18- to 24-month range.

Portfolio companies must remain aware of certain realities here, including the fact that while product can be kept safe and remain highly saleable in freezer storage for longer periods, most lenders do not lend against seafood inventory aged greater than 24 months; part of the asset-based lending role is to encourage its borrowers to move inventory rather than build it up. The key takeaway is that, in seafood, a company's borrowing base is impacted directly by the age of its inventory. So, a company with a \$10 million line and \$3 million in inventory that has just aged out at over 24 months, now has a line of only \$7 million. We advocate that lenders and their portfolio companies work closely together to manage seafood credit lines properly, staying well clear of the cap and any potential breach of covenants.

Conclusions

As we head into 2021, we urge lenders to closely monitor the market. Based on the Center for Disease Control's outlook, COVID-19 and its cascading effects will likely persist well into the new year. Due to this, and assuming supply continues to

outpace demand as it has been, we expect to see continued and perhaps mounting pressure on pricing across seafood well into 2021. This will be observable in the shrinking margins and sales reported by companies in lender portfolios, which, in turn, will impact recovery values. In this environment we strongly suggest the use of mark-to-market reporting, which some companies already adhere to for generally accepted accounting principles (GAAP) purposes, but only at year end. We recommend that lenders push for this practice to be adopted by companies already in their portfolios on a quarterly or even monthly basis, and to structure that requirement into new loan agreements as well. Among other things, reporting in this fashion allows for real time adjustment of inventory levels. Having this type of lever in place as a function of the borrowing base adds efficiency and minimizes unwarranted lender risk.

Assuming supply holds constant, we expect the seafood market to recover in parallel with the global recovery from COVID-19 itself. As dining restrictions are lifted, consumers will begin to eat out again; this demand should drive an appreciation in market pricing for seafood overall. Whether U.S. restaurant and seafood sales figures ultimately return to previous levels, and how quickly that happens, will depend on factors including the percentage of restaurants that survive the pandemic, how swiftly capacity limits are lifted on those establishments, and how much consumer behaviors may have changed over the course of the pandemic. Furthermore, factors such as record or poor harvests for shrimp, scallops, salmon, and other seafood could affect both supply levels and pricing, either adversely or favorably. In the end, it is always about supply and demand equilibrium.

With numerous client engagements currently in progress and dozens of conversations with our contacts across the seafood industry and asset-based lending community taking place every week, we are continuously gaining new

perspectives and insights that empower us to best assist our clients. During this unprecedented period, we urge lenders to work closely with their seafood portfolio companies, paying heightened attention to margins, product aging, and the other factors discussed in this article. If we can be of assistance to you in any way today, or in the weeks and months ahead, please reach out to our team. We are here to help you maximize return on your seafood portfolio!

Hilco Valuation Services

Hilco has significant, validated expertise in the seafood market, including processing, importation, and distribution. Leveraging our deep industry knowledge, we have delivered valuations on 15 of the top 20 seafood suppliers in the U.S. over the past five years. As one of the world's largest and most diversified business asset appraisers and valuation advisors, we serve as a trusted resource to companies, lenders, and professional service advisors, providing value opinions across virtually every asset category. Hilco Valuation Services has the ability to affirm asset values via proprietary market data and direct worldwide asset disposition and acquisition experiences. Access to this real-time information, in contrast with the aged data relied upon by others, ensures clients of more reliable valuations, which is crucial when financial and strategic decisions are being made.

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