TAYLOR COLLISON

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Clean Seas Seafood Ltd (CSS)

Hold

Initiating Coverage: Time to Mullet Over – FCF below par until FY19

$0.035

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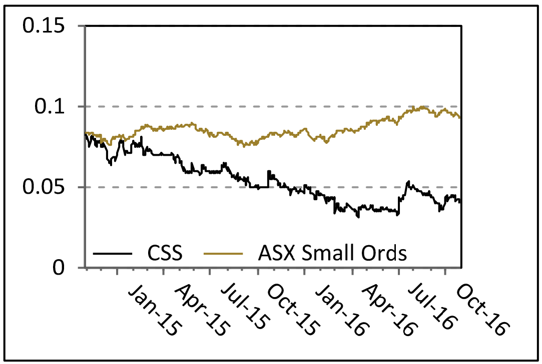
Summary (AUD)

Market capitalisation ($m)	**$47.7**
Share price	**$0.035**
52 week high	$0.054
52 week low	$0.029
Ave Monthly Vol (year rolling)	26.515m

Key Financials (AUD)

Period	FY16 Act.	FY17 Est.	FY18 Est.
Revenue ($m)	**30.6**	**38.1**	**47.6**
EBIT Adj. ($m)	0.7	(3.4)	4.9
NPAT Adj. ($m)	**1.5**	**(3.7)**	**4.7**
EPS Adj.	0.1	(0.3)	0.3
DPS (c)	0.0	0.0	0.2
Div Yield Adj.	**0.0%**	**0.0%**	**4.3%**
Franking	0.0%	0.0%	0.0%
Payout ratio Adj.	**0.0%**	**0.0%**	**43.7%**
PE Adj. (x)	**25.5**	**(13.1)**	**10.2**
EV ($M)	50.3	52.4	51.1
EV/EBIT Adj. (x)	76.2	(15.4)	10.5
NTA (c)	3.9	3.5	3.8
ROE Adj.	(18.9%)	(8.1%)	9.4%

Share Price Graph (AUD)



Our View

At $0.035ps CSS offers investors:

- **An opportunity to invest in a company which holds a clear market leader position exposed to favourable industry dynamics;**
- **Approx. 4,500 tonnes of excess capacity (180% of current production);**
- **Free option over pending legal claim which could pay out +4cps; and**
- **13+ years experience farming a complex fish species which provides significant advantages over new entrants**

The period since CSS' listing has not been without its challenges, but production is now humming, the biomass is coming into balance, farm gate prices are on the rise and CSS now has a "sales focused" CEO who with key recruitments is positioning the Company to succeed. However, CSS growth strategy is still untested with competition in some targeted growth markets and little market data available. Furthermore, we estimate FCF conversion will be below par until at least FY19. At present we believe the opportunity and risks are balanced, and therefore we initiate with a HOLD recommendation, and await signs of growth without price or margin deflations as well as signs of improved FCF generation before upgrading.

Key Points

Biomass coming into balance in FY18 providing cost savings – Higher feed conversion rates ("FCR") should subside in FY18 as the biomass becomes closer to balance. All things being equal we estimate that the FCR will reduce by 10% from FY17 levels which should save CSS approximately $1.5m p.a. in feed costs from FY17 to FY18.

Globally fish as a source of food is forecast to grow 21% by 2025 – By 2025 fish as a global source of food is forecasted to grow by 21% driven by rising living standards; population growth; rapid urbanisation; growing recognition of fish as a healthy and nutritious food; and technological developments in food, processing, packaging and distribution. With wild caught fish virtually capped the vast majority of supply will be provided by aquaculture. This macro tailwind is a positive for CSS.

Pending legal claim could be a "game changer" – An Independent Forensic Accountant has assessed the quantum of the claim (excluding interest and costs) for the Taurine deficient feed which resulted in increased mortalities and suppressed growth from 2008-2012 to be $34.5m-$39.1m. We believe the defendant is adequately equipped to settle the claim if required. The first stage being mediation is anticipated for mid CY17. If successful the compensation range could be anywhere from $1m-$50m.

Current footprint has excess capacity – CSS' existing hatchery infrastructure and farm leases support growth in production up to +7,000 tonnes. Combined with the existing production infrastructure we believe CSS are well positioned to quickly support rapid sales volume growth without significant capital investment required.

Positive FCF Yield by FY18 but still below par – We estimate CSS will return to a positive FCF yield of 2.8% during FY18 driven by (1) cost savings from processing and packing the fish in-house, (2) feed savings from the biomass being in balance; and (3) improved average sale prices from the finalised sell down of the FY16 written down stock in FY17. In saying this we believe the conversion of NPAT to FCF during FY18 will remain low (TC est. 27.6%), and therefore initiate with a HOLD recommendation and await signs of improved FCF generation before upgrading our recommendation.

Clean Seas Seafood - Summary of Forecasts Price $ 0.035

PROFIT & LOSS SUMMARY (A$m)				
Period	**FY15A**	**FY16A**	**FY17E**	**FY18E**
Operating Revenue	18.5	30.1	38.1	47.6
Other Revenue	1.5	0.5	0.0	0.0
Total Revenue	**20.0**	**30.6**	**38.1**	**47.6**
EBITDA	2.6	2.5	(1.4)	7.0
Dep'n	(1.7)	(1.8)	(2.0)	(2.1)
Amort'n	0.0	0.0	0.0	0.0
EBIT	**0.9**	**0.7**	**(3.4)**	**4.9**
Net Interest	0.1	(0.1)	(0.3)	(0.2)
Pre-Tax Profit	1.0	0.6	(3.7)	4.7
Tax Expense	3.1	0.9	0.0	0.0
Minorities	0.0	0.0	0.0	0.0
NPAT	**4.1**	**1.5**	**(3.7)**	**4.7**
Abnormals	0.0	(10.5)	0.0	0.0
Reported Profit	**4.1**	**(9.0)**	**(3.7)**	**4.7**
Margins on Sales Revenue				
EBITDA	14.2%	8.2%	-3.7%	14.6%
EBIT	5.0%	2.2%	-8.9%	10.2%
NPAT	22.2%	5.0%	-9.6%	9.8%
Change on pcp				
Total Revenue	69.1%	52.7%	24.5%	25.2%
EBITDA	-32.2%	-5.6%	-156.4%	597.0%
EBIT	-60.9%	-28.6%	-615.0%	243.0%
NPAT	-21.0%	-63.0%	-340.5%	228.2%

PER SHARE DATA				
Period	**FY15A**	**FY16A**	**FY17E**	**FY18E**
EPS (c)	**0.4**	**0.1**	**(0.3)**	**0.3**
Growth (pcp)	*-30.6%*	*-63.0%*	*-294.9%*	*228.2%*
Dividend (c)	0.0	0.0	0.0	0.2
Franking	0%	0%	0%	0%
Gross CF per Share (c)	(0.6)	(0.2)	(0.4)	0.2
NTA per share (c)	4.4	3.9	3.5	3.8

KEY RATIOS				
Period	**FY15A**	**FY16A**	**FY17E**	**FY18E**
Net Debt / EBITDA (x)	(0.5)	1.0	(3.4)	0.5
Net Debt : Equity (%)	-2.4%	5.9%	10.0%	6.5%
EBIT Interest cover (x)	132.0	6.9	(13.5)	27.0
Free CF / NPAT Adj. (3 yr avg)	n/a	n/a	n/a	n/a
Current ratio (x)	15.1	5.0	4.0	4.3
ROE (%)	8.2%	-18.9%	-8.1%	9.4%
ROIC (%)	8.2%	-18.3%	-7.4%	8.5%
Dividend Payout Ratio (%)	0.0%	0.0%	0.0%	43.7%

BALANCE SHEET SUMMARY				
Period	**FY15A**	**FY16A**	**FY17E**	**FY18E**
Cash	1.5	0.6	0.4	1.8
Receivables	6.2	3.7	4.8	6.0
Inventory	2.5	4.1	5.1	6.4
Biological Assets	27.6	25.0	27.5	29.7
Other	0.2	0.2	0.2	0.2
Total Current Assets	38.0	33.6	38.0	44.1
Property, Plant & Equipment	13.3	13.0	15.5	14.9
Biological Assets	0.2	0.2	0.2	0.2
Intangible Assets	3.0	3.0	3.2	3.3
Total Non-Current Assets	16.5	16.3	18.9	18.5
TOTAL ASSETS	**54.5**	**49.9**	**56.9**	**62.6**
Accounts Payable	1.8	3.1	3.8	4.8
Borrowings	0.2	3.1	5.1	5.1
Provisions	0.6	0.5	0.5	0.5
Total Current Liab	2.5	6.7	9.4	10.4
Borrowings	0.1	0.1	0.1	0.1
Provisions	0.0	0.2	0.2	0.2
Total Non-Current Liab	0.1	0.3	0.3	0.3
TOTAL LIABILITIES	**2.6**	**7.0**	**9.7**	**10.6**
TOTAL EQUITY	**51.9**	**42.9**	**47.3**	**51.9**

CASH FLOW SUMMARY				
Period	**FY15A**	**FY16A**	**FY17E**	**FY18E**
EBIT (excl Abs/Extr)	**0.9**	**0.7**	**(3.4)**	**4.9**
Add: Depreciation	1.7	1.8	2.0	2.1
Amortisation	0.0	0.0	0.0	0.0
Change in Working Capital	(12.9)	4.8	(3.9)	(3.8)
Other non cash/unusual items	0.0	(10.5)	0.0	0.0
Less: Tax Paid	3.1	0.9	0.0	0.0
Net Interest	0.1	(0.1)	(0.3)	(0.2)
Gross Cashflows	(7.1)	(2.4)	(5.5)	3.0
Net Capex	(1.6)	(1.4)	(4.5)	(1.5)
(Acquisitions) / Divestments	0.0	0.0	0.0	0.0
Other investments	0.1	0.0	(0.2)	(0.2)
Free Cashflows	(8.5)	(3.7)	(10.2)	1.3
Dividends Paid	0.0	0.0	0.0	0.0
Debt issued / (Repaid)	0.1	2.9	2.0	(0.0)
Equity issued / (Buyback)	0.0	0.0	8.0	0.0
Net Cash Flow	**(8.4)**	**(0.9)**	**(0.2)**	**1.3**

VALUATION MULTIPLES				
Period	**FY15A**	**FY16A**	**FY17E**	**FY18E**
PER (x)	**9.4**	**25.5**	**(13.1)**	**10.2**
Dividend Yield (%)	**0.0%**	**0.0%**	**0.0%**	**4.3%**
Free CF Yield	-22.1%	-9.7%	-21.3%	2.8%
EV/EBITDA (x)	17.7	20.3	(37.5)	7.4
EV/EBIT (x)	50.3	76.2	-15.4	10.5

Notes

We have accounted for the feed trials on a net outflow basis capitalising the $150k p.a. cost into intangible assets.

Business Overview

History

Clean Seas Seafood Limited ("CSS") is an Australia-based company engaged in the propagation of Hiramasa Yellowtail Kingfish, producing fingerlings for sale and grow out; grow out of Hiramasa Yellowtail Kingfish for harvest and sale, and research and development activities to produce juveniles of Southern Bluefish Tuna ("SBT"). CSS is Australia's only commercial producer of Yellowtail Kingfish and has established a pool of genetically selected Yellowtail Kingfish with the ability to produce fingerlings at any time of the year. In saying this Huon Aquaculture have recently commenced trials to farm 25,000 fingerlings in Port Stephens, NSW – which is immaterial at the moment in comparison to CSS which successfully breeds 1.5m fingerlings of which approx. 50% are farmed at sea.

CSS was incorporated as a subsidiary of Stehr Group in September 2000 with the purpose of providing hatchery services for large finfish species, namely Kingfish, Mulloway and SBT. Over the next five years trials were undertaken to commercialise the hatchery and subsequent grow out of Kingfish and Mulloway and in 2005 CSS listed on ASX – with the purpose of the issue being the funding for the three year SBT aquaculture breeding plan and pre-commercialisation of the SBT business. Initially grow out of the Mulloway and Kingfish was being contracted by Clean Seas Aquaculture Growout Pty Ltd (100% owned by the Stehr Group).

In 2007 CSS took direct control of Yellowtail Kingfish farming operations owned by the Stehr Group giving it control of both onshore and offshore infrastructure. Over the next few years it expanded hatchery and grow out capacity via acquisition.

From 2008-2012 CSS experienced significant stock losses in the Yellowtail Kingfish biomass from Taurine deficient feed. Hamstrung by cashflow, in 2013 shifted the strategy to focus on expanding Yellowtail Kingfish production under the Hiramasa Kingfish brand, while the R&D into propagation of SBT was scaled back but broodstock maintained.

Operations

The life cycle of CSS Hiramasa Kingfish between hatching to harvest is between 16-24 months made up of:

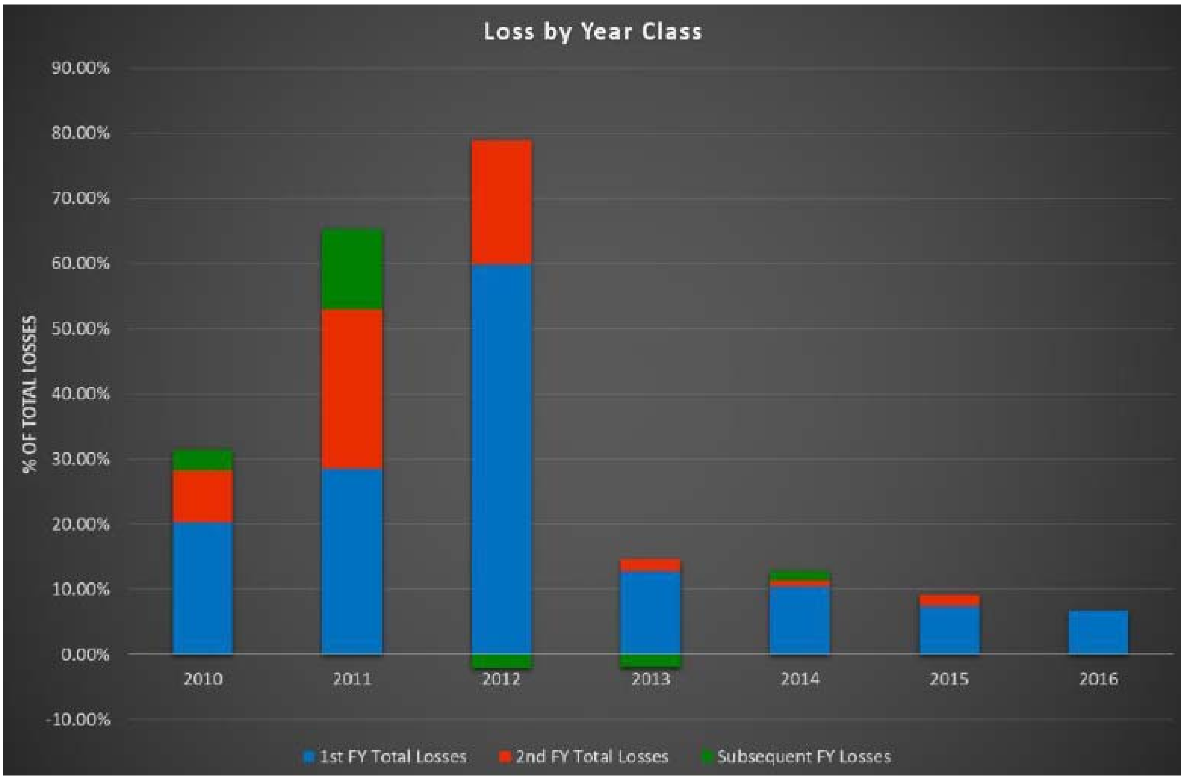
- Life cycle begins with eggs from CSS selectively bred brood stock
- Eggs then transferred to an incubator where they hatch just 48 hours later
- Larvae bathed before transfer to custom designed larval rearing tanks
- The next 21 days Larvae diet of live feeds until 0.1 grams before moving to the Nursery
- Diet in Nursery is specially formulated feed that replicates what would eat in the wild
- They remain in the Nursery until 15-35 grams before being transferred to sea cage via helicopter or oxygenated road-transport
- Approximately 75 days after hatching the Hiramasa Kingfish reside in the cool ocean waters of the Spencer Gulf
- These waters are replenished year round by the cold Antarctic currents that flow from the Southern Ocean
- Kingfish remain at sea until humanely harvested after 16 -24 months

CSS existing hatchery infrastructure and farm leases support growth in production up to 7,000 tonnes (approx. 4,500 tonnes unused capacity). The map below demonstrates geographically in the Spencer Gulf where farm operations are currently setup or under application.

Source: CSS Investor Presentation – 27 October 2016

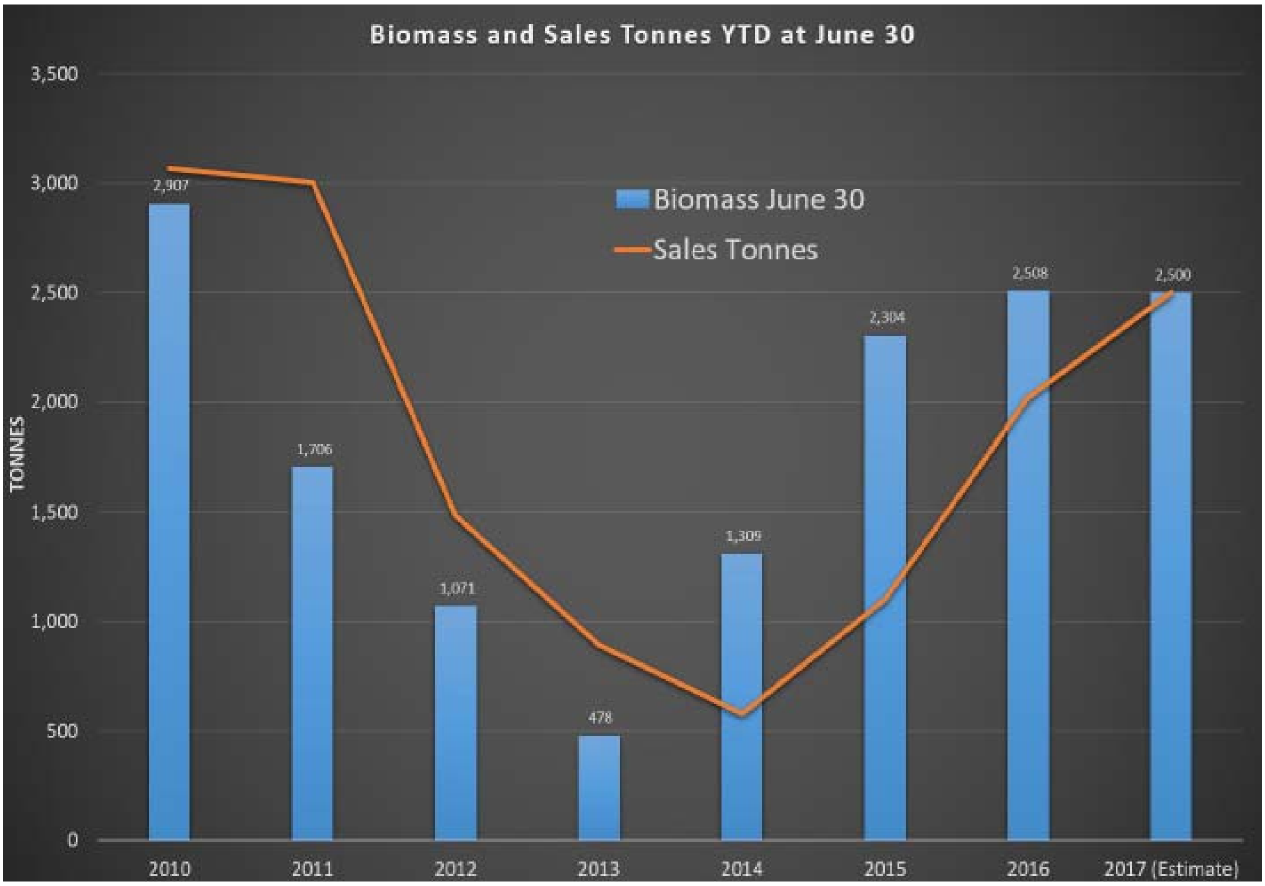
Currently post harvest processing is outsourced to a range of contractors in South Australia, New South Wales and Vietnam. Current arrangements are quite costly which are soon to be replaced with in-house processing (<2 year project payback). In-house facilities are also expected to improve a number of aspects of product quality including reducing delivery times for fresh product from marine harvest to market. This will also allow CSS to become more elastic with market demand and will improve capacity for product development as well as improving control over the supply chain.

One of the largest drivers of operational efficiency in aquaculture is mortality rates, and this is reflected in the P&L through “net gain arising from changes in fair value of Yellowtail Kingfish” under SGARA accounting standards. The graph below shows the peak period in mortality was FY12 at just under 80% - driven by Taurine nutrient deficiency in the feed (2008-2012). Now this issue has been rectified CSS mortality rates for Kingfish have improved to 10-15%.



Source: CSS Investor Presentation – 27 October 2016

The Taurine crisis led to two structural imbalances in the Company, firstly CSS were forced to exit key markets as volumes substantially reduced from the higher mortality rates, and secondly in FY14 it increased its fingerling production to meet expected sales increases from re-entry into these markets, however in the short-term CSS were unsuccessful. This resulted in higher feed conversion rates to keep larger fish alive as well as a $10.5m write-down to inventory during FY16. The graph below highlights these two structural imbalances.



Source: CSS Investor Presentation – 27 October 2016

<u>Supply</u>

With very little data in the market on Yellowtail Kingfish production we have summarised in the table below an overview of the worldwide farmed production volumes of all species of Kingfish.

WORLDWIDE FARMED PRODUCTION VOLUMES				
Type	**Japanese/Korean***	**Blue Ocean Mariculture (HI)**	**CSS (AUS)**	**Baja Seas (MEX)**
Seriola quinqueradiata - Japanese Yellowtail, Gold striped amberjack, Mojaka, Hamachi, Buri	150,000 tonnes Japan/Korea. Japanese Himachi accounts for >80% of global production	NIL	NIL	NIL
Seriola lalandi – Yellowtail Kingfish, Kingfish, Gold striped amberjack, Hiramasa		NIL	2500 tonnes FY17	800 tonnes FY17
Seriola dumerili - Amberjack, Greater Amberjack, kampachi		NIL	NIL	NIL
Seriola rivoliana - Pacific Yellowtail, long-fin amberjack, Almaco Jack, Kahala, Kampachi	NIL	750-1000 tonnes	NIL	NIL

* Wild Japanese Yellowtail accounts for 70,000-80,000 tonnes p.a. *Source: FOA*

Consumption

The table below demonstrates Kingfish consumption per market and production origin. Outside of Japan and Korea, the next largest market for Yellowtail Kingfish is the USA.

WORLDWIDE FARMED CONSUMPTION VOLUMES (TONNES)				
Producer	Asia	USA	Australia	Western Europe
Japanese/Korean	144,450	5,300	0	250
Blue Ocean Mariculture (HI)	0	800	0	0
CSS (AUS)	250	250	1,300	700
Baja Seas (MEX)	0	800	0	0
TOTAL	**144,700**	**7,150**	**1,300**	**950**

Source: FOA & TC Est.

Huon Aquaculture is in partnership with the NSW Government to establish a Yellowtail Kingfish farm in Port Stephens, in an effort to diversify its product range. Currently in trial, if successful this will add competition in the Australian Hiramasa market. This is still a number of years away from having commercial production but is an endorsement that other aquaculture producers see demand for Hiramasa growing.

Marketing Strategy

CSS strategy is clear but untested:

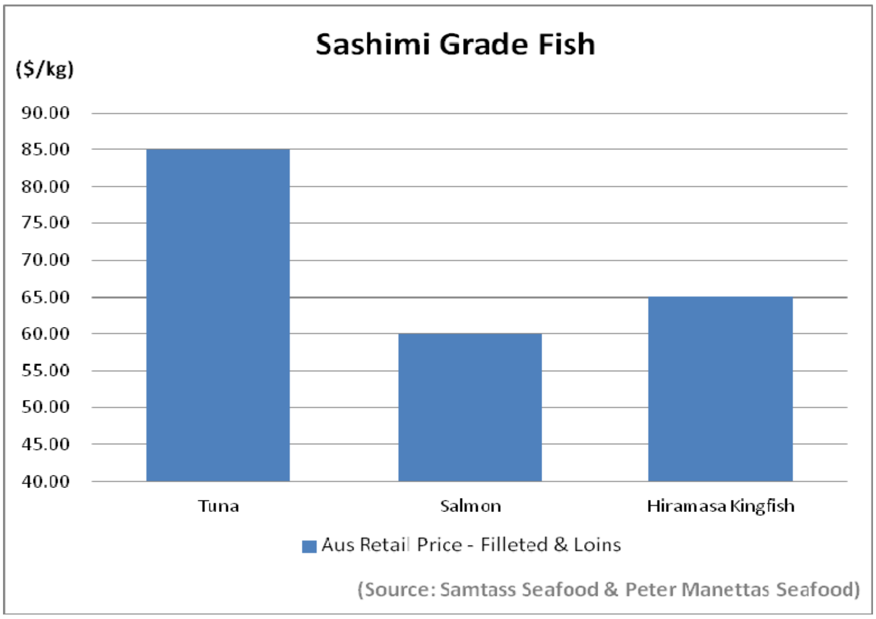
- Reposition Hiramasa Kingfish as a Premium Seafood supported by Port Lincoln as a unique provenance, and leverage this to increase farm gate prices.
- Arrange laboratory, kitchen and field assessments with Chefs, food writers, professional panellists including handling, preparation and cooking.
- Seek ASC Accreditation to strengthen sustainability, environmental and social credentials – critical in US and European markets
- An activation program targeting leading restaurants and chefs in key global markets (top 500 per city)
- Activation program based on market segmentation profile from new database of key markets

While we do not question the quality of management we believe most of the measures will take time to succeed.

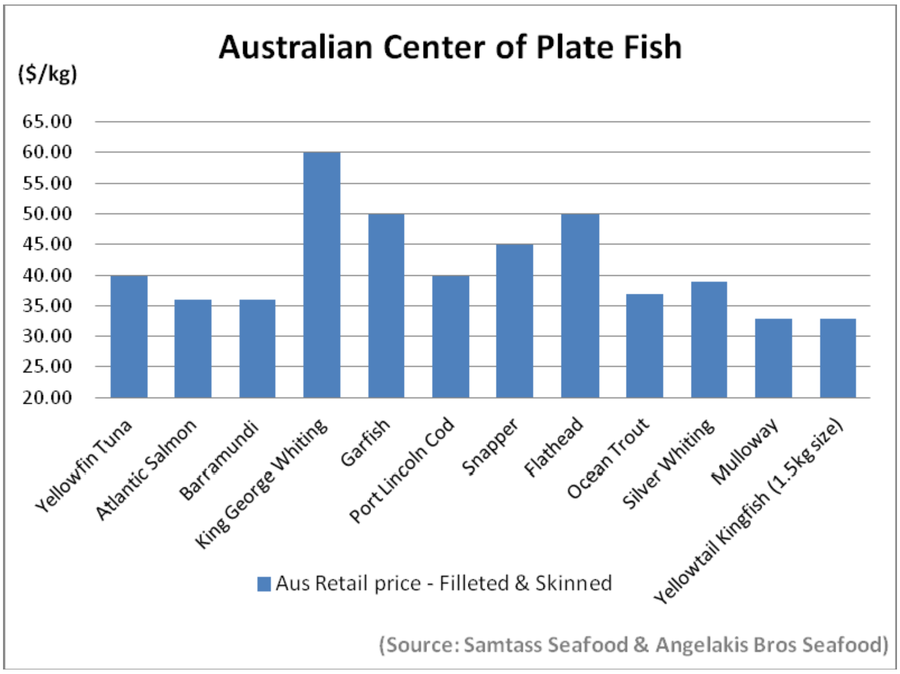
Delving into the activation program in the US in a little more detail currently only Baja Seas (est. 2014) and CSS provide Hiramasa into the US. While Baja Seas would exhibit cost advantages through feed and labour being situated in the warmer waters of the Californian Gulf it is arguable the colder waters of the Spencer Gulf provides a better texture for sashimi form. Nevertheless having two advocates for Hiramasa Kingfish in the US is a positive for building awareness against the already established Hamachi Kingfish.

While data is difficult to acquire we have tried to benchmark Hamachi vs. Hiramasa prices in the US to ascertain the price differential (if any). From our analysis fresh filleted Baja Hiramasa is comparable in price to fresh filleted Japanese Hamachi at approximately US$25-$30/lb. CSS strategy is to brand their Kingfish “Australian Hiramasa” – we believe it will be more successful converting new customers as opposed to winning market share from already established operators, as price suggests Hiramasa is not currently viewed as a premium product to Hamachi.

CSS has stated its Australian market has always been its most profitable market. We would prefer CSS focus on growing its home market where it is the only commercial farmer of Yellowtail Kingfish and remains protected by trade restrictions. Traditionally Yellowtail Kingfish has been consumed in sashimi style but is slowly becoming more popular as a center of plate dish in the filleted (whole 1-2kg fish) market. Until now the vast majority of CSS sales are whole fresh fish (TC est. 90% are 4-5kg "Hiramasa" sashimi quality) that end up in top end restaurants. The graph below highlights the retail price differential between sashimi quality Salmon, Tuna and Hiramasa Kingfish in Australia. With various price rises over the years Salmon is quickly becoming comparable in price to Hiramasa Kingfish, whilst Tuna is still seen as the premier sashimi cut retailing at a 30% premium to peers.



As a center of plate dish Yellowtail Kingfish is very price competitive to other fish breeds, languishing behind its sashimi rivals of Tuna and Salmon (see the graph below). We view the center of plate market in Australia as an opportunity for CSS to build volumes in the everyday affordable category (1-2kg whole fish), however are not forecasting this to grow in the short-term as all marketing efforts are currently focussed towards restoring the Hiramasa business (4-5kg whole fish).



Longer Term Business Attractions

We believe the following factors will be key drivers of the business and share price going forward:

1. Production humming, now resources are being allocated to sales and marketing

After correcting the Taurine deficient feed that plagued operations from 2010-2012, mortality rates have continued to decline, now at approx. 10-15%. Combined with improved quality of fish (less deformities due to ongoing IP development) this has allowed CSS to more ruthlessly cull slow growing stock before they reach grow out which has contributed to the large ramp up in biomass. With production now performing strongly we are encouraged by the upcoming appointments of GM Sales, Marketing and Product Development Manager. Before these appointments CSS were under-resourced with only three staff responsible for sales.

2. Current footprint has excess capacity

CSS existing hatchery infrastructure and farm leases support growth in production up to 7,000 tonnes. At present the hatchery runs four batches p.a. up to 500,000 fingerlings of which 50% are terminated before the best of breed are transported to grow out. An application is under-review to add a further 2,000 tonnes capacity at Wallaroo. Combined with the existing production infrastructure we believe CSS are well positioned to quickly support rapid sales volume growth however would require some capital investment.

3. Structural imbalance is now in control

As CSS clearly depicted in its 27 October 2016 Investor Presentation, production and sales are coming into balance. This of course has not come without a cost to the Company as $10.5m in inventory write-downs were provisioned in FY16, most of which was applied to discounting stock to be sold in frozen form in new markets (in order to protect farm gate prices in existing whole fresh markets). As a result the biomass from this measure reduced by 750 tonnes, and combined with positive momentum in sales volumes CSS should be in balance by FY18. In our view this provides two positives to the Group: (1) It limits feed costs from not maintaining oversized fish through another winter; and (2) limits the risk to future biomass write-downs.

4. Aquaculture Stewardship Council (“ASC”) accreditation should open new markets in the US & Europe

CSS has found that many customers in Europe and the US require ASC accreditation before trading as they only want to do business with sustainable and responsibly produced suppliers. We expect accreditation to be finalised by the end of FY17.

5. Globally Fish as a source of Food is forecast to grow 21% by 2025

Currently fish make up 16% of total animal protein consumed. By 2025 fish as a global source of food is forecast to grow by 21% driven by rising living standards; population growth; rapid urbanization; growing recognition of fish as healthy and nutritious food; and technological developments in food, processing, packaging and distribution. With wild caught fish virtually capped the vast majority of supply will be provided by aquaculture. This macro tailwind is a positive for CSS providing it can appeal to everyday users.

6. Feed conversion rates (“FCR”) should improve through FY18

Higher feed conversion rates should subside in FY18 as the biomass becomes closer to balance. All things being equal we estimate that the FCR will reduce by 10% from FY17 levels which should save CSS approximately $1.5m p.a. in feed costs.

7. Pending legal action could provide for a significant payout to CSS

CSS has commenced proceedings out of the Supreme Court of South Australia against one is feed suppliers for the Taurine deficient feed which resulted in increased mortalities and suppressed growth of the CSS’s Yellowtail Kingfish from 2008-2012. Independent Forensic Accountants assess the quantum of the claim (excluding interest and costs) to be $34.5m-$39.1m. We believe the defendant is adequately equipped to settle the claim if required. The first stage of mediation is anticipated for mid CY17.

Key Risks

Kingfish farm gate prices

The farm gate price for Kingfish has remained stable the past few years but trended up strongly growing approximately 65% from June 2007. New entrants in the Australian or International market could put pressures on farm gate prices ultimately effecting the profitability of CSS.

Foreign currency risk

Currently the majority of CSS sales are in AUD, with sales into other markets such as Europe, US and China in local currencies. Foreign currency risk is covered with forward contracts. We estimate a 1% strengthening of the AUD against EUR would impact earnings by $75k-$100k and by $25k-$50k against the USD.

One hatchery operation at Arno Bay

CSS has only one hatchery operation located at Arno Bay and therefore if it experiences contamination or operational issues then that years class breeding program could be compromised.

Livestock risk

Yellowtail Kingfish in open-sea nets are susceptible to many dangers, in particular predators and disease. While CSS take every measure to reduce these risks it remains a prospect from year to year.

Competition risk

As the Hiramasa Kingfish market continues to grow competition is entering, such as Huon in Australia and Baja Seas in Mexico which could impact on CSS margin in the medium term. However, CSS has 13+ years in farming this complex fish species which should position it strongly against competition. We also view this as a positive in improving the image of Hiramasa Kingfish with everyday consumers.

Environmental risk

There are a number of environmental conditions attached to the water use licences of CSS. Failure to meet such conditions could lead to forfeiture of these licences. Future legislative and regulatory changes may have a possible adverse impact on CSS profitability.

Key production personnel risk

Given the specialised nature of the CSS hatchery and grow out, a risk exists that if key personnel leave they may not be able to be adequately replaced. We believe the newly created role of GM Aquaculture should alleviate this risk to some degree.

Licensing risk

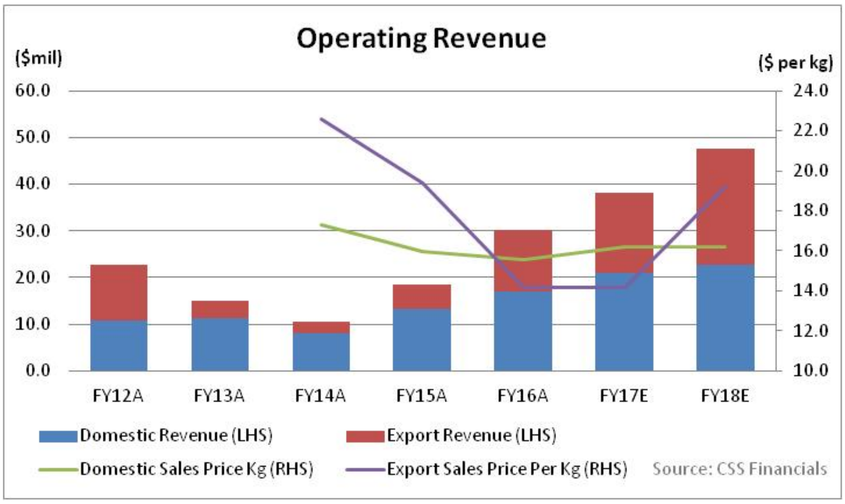
CSS currently holds licences which permit it to propagate and grow out Yellowtail Kingfish. In the event that CSS breaches its agreement with PIRSA it may result in these licenses being removed.

Analysis of FY16 Financials

CSS Financial Forecasts	FY15A	FY16A
Opening Biomass (tonnes)	1,309	2,304
Closing Biomass (tonnes)	2,304	2,508
Closing Stock Value (per kg)	$ 11.98	$ 9.98
Sales volumes (tonnes)	1,098	2,018
Sales Price (per kg)	$ 16.83	$ 14.91
Total Revenue ($m)	20.0	30.6
EBITDA ($m)	**2.63**	**2.48**
D&A ($m)	(1.71)	(1.82)
EBIT ($m)	**0.92**	**0.66**
Net Interest ($m)	0.11	(0.09)
Abnormals	-	(10.50)
Tax Expense	3.08	0.95
NPAT	**4.11**	**(8.98)**
Adj. ROE %	8.2%	(18.9%)
Free CF Yield	(22.1%)	(9.7%)
NTA per share (c)	4.4	3.9
EPS (c)	0.37	0.14

For aquaculture companies the need to focus on FCF as opposed to EBIT is more exaggerated. The application of SGARA Accounting Standards during a period of rapid biomass expansion is at times conducive to counting profits when in fact an end market may not exist for that product at the time. This is exactly what happened with CSS during FY16 – $10.5m in write-downs were made to inventory which had been included as SGARA gains in prior periods.

Sales volumes increased approximately 900 tonnes during FY16 on pcp (84%). This was largely driven by growth in export markets, up 240% on pcp from 271 tonnes to 924 tonnes. We believe the majority of this growth was from opening new markets in parts of Europe, China, Hong Kong and Korean using the discounted inventory as a driver for entry. Pleasingly the domestic market grew by 32% on pcp while maintaining farm gate prices (see graph below).



This resulted in FCF yield of -9.7% despite D&A outpacing capex – increasing net debt by $3.7m, and another year of nil shareholder returns. As at FY16 net debt to equity was a modest 5.9% and tax losses amounted to approximately $85m. This is reflective of the wealth destruction CSS has experienced since listing in 2005.

Financial Forecasts

CSS Financial Forecasts	FY17E	FY18E
Production (tonnes)	2,500	2,700
Closing Biomass (tonnes)	2,500	2,700
Closing Stock Value (per kg)	$ 11.00	$ 11.00
Sales volumes (tonnes)	2,500	2,700
Sales Price (per kg)	$ 15.22	$ 17.64
Fish Selling and Processing Costs (per kg)	$ (3.75)	$ (3.60)
Production Costs (per kg)	$ (10.44)	$ (9.99)
Net gain arising from changes in fair value of Yellowtail Kingfish (per kg)	$ 0.99	$ 0.81
Provision for excess stock		
Cost of goods sold – Frozen inventory	$ (0.50)	$ (0.19)
Variable contribution (per kg)	$ 1.52	$ 4.69
Variable contribution ($m)	3.80	12.66
Fixed Labour ($m)	(2.70)	(3.20)
Other Expenses ($m)	(2.50)	(2.50)
EBITDA ($m)	**(1.40)**	**6.95**
D&A ($m)	(2.00)	(2.09)
EBIT ($m)	**(3.40)**	**4.86**
Net Interest ($m)	(0.25)	(0.18)
PBT ($m)	**(3.65)**	**4.68**
Adj. ROE %	(8.1%)	9.4%
Free CF Yield	(21.3%)	2.8%
NTA per share (c)	3.5	3.8
EPS (c)	(0.27)	0.34
PER (x)	(13.1)	10.2

We forecast biomass will be tracking slightly above optimal levels through FY17 – leading to increased feed costs. However we are not perturbed and believe CSS has positioned itself to far outperform Adj. NPAT in comparison to pcp due to: (1) holding discounted inventory allowing it to penetrate new markets; (2) already successfully obtaining a price rise of $0.80/kg to $17.50 on domestic sales prices; and (3) re-entering markets it left behind from the Taurine deficient feed increased mortality rates.

We are confident CSS can grow sales volumes by approx. 500 tonnes from FY16 to FY17 given it held approx. 500 tonnes of discounted frozen inventory at FY16. We believe growth of 200 tonnes in sales between FY17 and FY18 is achievable through additional marketing and activation programs in Europe and the US and note this will be a lot more difficult to achieve after cycling 500 tonnes of discounted sales during FY17. Investors should understand the difficulty in forecasting sales growth in a market where data is scarce. Therefore, we see timing and execution risk as the most obvious areas for a potential miss in our forecast.

We have assumed increased feed costs per kg through FY17 (included in production costs), reducing during FY18 as biomass becomes more in balance. Additional fixed labour includes key recruitments such as: GM Aquaculture, GM Sales, Marketing and Product Development Manager and Processing Manager.

FCF will remain poor during FY17 (TC est. FCF yield -21.3%) but should somewhat improve from FY18 as processing synergies, increases in average sales prices and feed savings all come through at the same time. Our FY18e has net debt at $3.4m which should place CSS in a position to declare an unfranked dividend to shareholders (TC est. 0.15cps).

Valuations / Price Target

The tables below compare CSS to listed aquaculture and listed Australian agricultural peers.

LISTED AQUACULTURE PEERS							
	Mkt Cap	PE		EV/EBITDA		EV/EBIT	
	(AU$m)	Yr 1	Yr 2	Yr 1	Yr 2	Yr 1	Yr 2
Leroy Seafood Group	4,416	13.1	9.1	9.2	6.1	10.8	7.0
Grieg Seafood	1,450	11.7	9.0	7.6	6.2	7.0	6.7
Salmar	4,587	14.1	11.1	10.5	8.3	11.8	9.3
Sanford	595	15.7	14.7	10.2	8.9	12.7	11.2
Norway Royal Salmon	1,357	14.3	12.1	12.4	9.1	13.5	9.4
Marine Harvest	11,075	16.9	11.3	10.7	8.0	12.2	9.3
Tassal Group	604	14.0	12.4	7.9	7.0	10.4	9.2
Huon Aquaculture Group	328	19.1	11.4	8.3	5.7	14.6	8.4
Clean Seas Seafood	48	-13.1	10.2	-37.5	7.4	-15.4	10.5
Peer Average (excl. CSS)		**14.9**	**11.4**	**9.6**	**7.4**	**11.6**	**8.8**

AUSTRALIAN AGRICULTURAL STOCKS							
	Mkt Cap	PE		EV/EBITDA		EV/EBIT	
	(AU$m)	Yr 1	Yr 2	Yr 1	Yr 2	Yr 1	Yr 2
Bellamy's Australia	646	20.4	17.3	13.0	10.8	13.1	10.9
Treasury Wine Estates	7,706	27.2	22.7	14.4	12.3	18.2	15.2
Webster	482	23.7	18.3	14.8	12.5	18.2	14.8
Rural Funds Grp	361	13.3	11.7	16.7	14.2	15.7	12.7
Bega Cheese	615	22.3	17.3	10.3	8.5	15.8	12.9
TFS	644	25.7	23.2	10.6	10.5	12.2	12.3
GrainCorp A	2,133	17.7	15.8	8.6	7.9	14.8	13.1
Huon Aquaculture Group	328	19.1	11.4	8.3	5.7	14.6	8.4
Tassal Group	604	14.0	12.4	7.9	7.0	10.4	9.2
Incitec Pivot	6,057	19.5	15.3	9.6	8.2	14.8	11.9
Nufarm	2,438	17.9	14.8	7.3	6.6	9.6	8.5
Ridley	385	15.4	13.8	7.4	6.4	10.2	8.7
Fonterra Shareholdr	692	11.0	10.2	3.5	3.3	5.1	4.8
Select Harvests	484	16.2	14.8	9.3	8.5	12.1	10.8
Ruralco	244	14.9	13.1	6.7	6.1	8.5	7.5
Clean Seas Seafood	48	-13.1	10.2	-37.5	7.4	-15.4	10.5
Peer Average (excl. CSS)		**18.5**	**15.5**	**9.9**	**8.6**	**12.9**	**10.8**

In our view FY17e is not indicative of future profitability driven by discounted inventory still on hand at FY16 and biomass out of balance until FY18. Therefore we believe FY18 ("normalised") earnings is a better measure of the valuation of CSS at this time.

CSS should be valued at a discount to listed aquaculture peers because:

1. Kingfish does not have the same brand penetration that other products do (for example Salmon);
2. With a market cap of <$50m CSS does not have the liquidity the others possess; and
3. CSS is yet to prove it is capable of taking market share without significant marketing, trade spend or discounting.

CSS is cycling a low base and the opportunity for growth is far greater than some peers, but with no market data available, investors need to put faith in senior management and their ability to execute the sales growth strategy. While acknowledging the market opportunity could be large we cannot look past what appears to be ongoing operating cash burn through FY17 and poor cashflow conversion in FY18. Despite what could be a lucrative court settlement on the Taurine deficient feed **we initiate coverage with a HOLD recommendation and await for signs of operating cashflow improvements before upgrading.**

Board of Directors / Key Management

Paul Steere – Independent Non-Executive Chairman (Joined May 2010, appointed Chairman May 2012)

Founding CEO of New Zealand King Salmon (NZK) (1994-2009) and Non-Executive Director since 2009. NZK listed on ASX and NZX in October 2016 , is the leading aquaculture company in NZ and the largest Chinook salmon farmer globally. Chairs and Directorships in Wine, Aviation, Education and Architectural sectors. Chairs the Remuneration and Nominations Committee

Nick Burrows – Independent Non-Executive Director (April 2012)

21 years (1988 – 2009) as CFO and Company Secretary of Tassal Group Limited, Australia's largest aquaculture company. Holds a diverse range of Non-Executive Director and advisory roles. Chairs the Clean Seas Finance, Audit and Risk Management (FARM) Committee with substantial experience in similar roles.

Hagen Stehr AO – Non-Executive Director (September 2000)

A founding Director with extensive knowledge of and experience in the fishing and aquaculture industries, having been involved in the tuna industry in Australia since 1960. A Director of Australian Tuna Fisheries Pty Ltd which is Clean Seas' largest shareholder (7.4%). Holds leadership roles in a number of industry Associations.

Marcus Stehr – Non-Executive Director (September 2000)

Marcus is a founding Director and has over 25 years of hands on experience in marine finfish aquaculture operations encompassing Tuna, Kingfish and Mulloway. Marcus is Managing Director of Australian Tuna Fisheries Pty Ltd and holds leadership roles in a number of industry Associations.

David J Head – Managing Director & CEO (January 2016)

Over 25 years experience as a CEO, Non-Executive Director and Corporate Advisor in a wide range of industry sectors in Australia, New Zealand, Asia and Europe in public and privately owned companies. This includes Chief Executive roles at Pepsi, Lion Nathan, Calum Textile Group and Leigh Mardon Group.

Wayne Materne – CFO & Company Secretary (August 2014)

Over 20 years experience in CFO and senior finance roles mainly in the agribusiness and manufacturing sectors with ASX listed and unlisted companies. This includes livestock, forestry and wine / viticulture with companies including Elders, SA Forestry Corporation, Southcorp and Nepenthe.

Major Shareholders

As at 30 November, CSS's 20 largest shareholders were:

Shareholders	Shares Held	% of issued shares
Bonafide Wealth Management AG	13,551,855	1.0%
Chen Xianghui	12,199,668	0.9%
Jason Squire	11,500,000	0.8%
Ermanno Feliciani	10,833,333	0.8%
Jamie Lewis	8,800,000	0.6%
4 Eyes Ltd.	8,750,000	0.6%
Hagen Stehr	7,199,069	0.5%
Walpole Enterprises Pty Ltd	6,106,704	0.4%
RDLK PTY LTD	6,000,000	0.4%
Bruce Maton	5,936,863	0.4%
Hans And Delwyn Pty. Ltd.	5,349,465	0.4%
J.R. Simplot Company	5,231,250	0.4%
Leon Gaffney	5,050,665	0.4%
Anthony Snaith	5,000,000	0.4%
Hui-Chen Tsai	4,700,000	0.3%
Yong International Investments Pty Ltd	4,449,465	0.3%
M. Rowe	3,890,810	0.3%
Lesley Rowe	3,890,810	0.3%
David Head	3,881,000	0.3%
Michael O'Neill	3,550,000	0.3%
TOTAL	**135,870,957**	**10.0%**

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