Terrasan

INTERIM CHAIRMAN'S REPORT 2018

CHAIRMAN'S REPORT

INTRODUCTION

The period under review was characterized by stable trading conditions and a strong average Rand Dollar exchange rate. The Group is a natural rand hedge with abalone and fish meal sales, which are the biggest contributors to profits, being USD based and an exposure on the importing of canned fish to the Euro. The integration of Saldanha Protein into TerraSan was seamless and their value contribution is seen in our results and alluded to in more detail later in this report. Please note that the corresponding period does not include any income from Saldanha Protein as the effective date of the transaction was 2 October 2017.

GROUP OVERVIEW

Adjusted non-IFRS financial measures

The group uses adjusted operating profit, adjusted earnings before interest, tax, depreciation and amortisation (adjusted EBITDA), adjusted profit for the year and adjusted earnings per share as non-IFRS measures in evaluating performance and as a method to provide shareholders with clear and consistent reporting. These non-IFRS measures are defined as reportable operating profit, EBITDA, profit for the year and earnings per share in terms of accounting standards, excluding the unrealised profit in the fair value adjustment to biological assets, certain one-off and extraordinary items.

Intergroup transactions

Intergroup transactions have not been eliminated for the purposes of reporting on the results of the individual businesses of the Group.

Group Financial Results

The Group financial results were influenced by the acquisition of Saldanha Protein. The transaction was concluded on 2 October 2017. To fund the purchase consideration TerraSan Group issued 3.2m new ordinary shares to Agri-Vie Fund II at R37.50 per share for a total consideration of R120m. The Group also incurred new debt in the form of a term loan of R250m, through the refinancing of inter group debt, and preference share funding of R100m both from ABSA Bank Ltd.

Group revenue increased by 156% to R453.6m (2017: R177.4m) for the period under review. Adjusted EBITDA is 91% higher at R74.1m (2017: R38.8m), adjusted profit for the period under review increased by 32% to R33.1m (2017: R25.0m) while adjusted earnings attributable to the shareholders of the Group increased by 3% to R23.5m (2017: R22.7m). Adjusted earnings per share were 14% lower at 117 cents (2017: 136 cents). The decrease in adjusted earnings per share is due to the increase in the weighted number of shares from 16 856 124 to 20 086 124. All these numbers were distorted by the inclusion of the results of the Saldanha Protein Group.

The reported Group results include the unrealised IFRS adjustment in the fair value adjustment to biological assets, one-off and extraordinary items. These items are:

- the unrealised IFRS fair value adjustment to biological assets amounts to a positive adjustment of R32.4m before tax (2017: R2.8m a positive adjustment) and R23.4m after tax (2017: R2.0m a positive amount);
- a net loss resulting from the red-tide event amounting to RNil before tax (2017: R27.3m) and RNil after tax (2017: R19.7m);
- certain incentives received in respect of the expansion of Roman Bay Farm amounting to R1.2m before tax (2017: R6.0m) and R0.8m after tax (2017: R4.3m);
- costs relating to the acquisition of Saldanha Protein of R2.57m (2017: R1.7m) which is not tax deductible; and
- an IFRS adjustment in relation to the Saldanha Protein transaction of R8.0m before tax (2017: RNil) and R5.8m after tax (2017: RNil).

Including the items above, profit for the year increased by 1690% to R105.4m (2017: R5.9m) and earnings per share increased by 1850% to 429 cents (2017: 22 cents).

The group's adjusted EBITDA margin decreased from 20% to 16% for the period under review. The main reasons for the decline are the inclusion of Saldanha Protein that is a high volume/lower margin business and the lower rope yields and resulting margins experienced by Blue Ocean Mussels.

Cash generated from operations was negative R64.8m (2017: 3.7m positive). The group's cash conversion ratio is traditionally low during the first half of the year because of the annual fishing cycle that requires substantial investments in working capital. Working capital (stock, debtors and creditors) increased by R138m from 31 December 2017 to 30 June 2018.

R21.6m was invested in property, plant and equipment across the group, compared to R32.0m the previous reporting period, of which R9.4m relates to the abalone division, including R4.1m on phase 2 of the Roman Bay expansion, while R4.6m was invested in the upgraded factory of Blue Ocean Mussels. The factories at Marifeed and West Point Processors were upgraded at a cost of R3m and R4.7m respectively. Dividends of R9.0 were paid to shareholders of the Company during the year (2017: RNil). The above resulted in cash and cash equivalents decreasing by R159m (2017: decrease R72.2m) from R61.0m at 31 December 2017 to an overdraft of R98.2m at 30 June 2018.

Interest bearing loans and preference share funding decreased from R371.2m at 31 December 2017 to R360.3m at 30 June 2017. The group's debt: equity ratio increased from 60% to 66%, while the net debt:equity ratio increased from a negative ratio of 50% to a negative ratio of 66%. The increase is mainly because of an investment in working capital alluded to earlier in this report.

The equity attributable to shareholders of the group amounts to R693.4m (2017: R616.9m), which includes an amount of about R105.7m (2017: R82.2m) being the cumulative unrealised after tax profit in the valuation of the group's biological abalone assets of R182.0m (2017: R150.0m).

The number of issued shares increased by Nil (2017: 3 323 050). The weighted number of issued shares used to calculate adjusted earnings per share and earnings per share was 20 086 124 (2017: 16 776 257).

TERRASAN PELAGIC FISHERY (TPF)

As a condition to the approval of the Saldanha Protein transaction the Competition Commission required TerraSan Pelagic Fishery to exit from the Oranjevis Joint Venture. In terms of the Joint Venture agreement the notice to withdraw from the Joint Venture was given at the end of November 2017. In early 2018 TerraSan Pelagic Fishery (Pty) Ltd sold its share in Sea Pride Processors (Pty) Ltd and its interest in the Oranjevis Joint Venture to a third party. The transaction is vendor financed and the proceeds of the purchase consideration are expected to be received over the next 5 to 7 years. The transaction was concluded on 4 May 2018.

As a result of the pending transaction mentioned above, the first fish caught on the TPF quota's and delivered to West Point Processors, took place on 5 May, once the transaction was concluded. This together with the withdrawal of the quota of one of TPF's associates whom has contracted his fish to Oranjevis, has resulted in a decline of catches for TPF during the first 6 months of this year.

Operationally, TerraSan Pelagic Fishery, together with its associated rights holders, delivered 48% less fish at 6 067 tons (2017: 11 718 tons) to West Point Processors. The net effect of the lower catches has resulted in reduced profits for TerraSan Pelagic from fishing operations.

The June 2018 results of TPF include the profit on sale of the Investments held in Sea Pride Processors (Pty) Ltd and the Oranjevis Joint Venture of R65 876 084 before tax (R56 941 111 after tax).

Accordingly, revenue declined by 60% to R13.8m (2017: R34.2m) for the period under review, while EBITDA was 802% higher at R72.5m (2017: R7.7m). TerraSan Pelagic Fishery's profit after tax for the reporting period was R60.7m (2017: R5.7m), 965% higher than in 2017.

SALDANHA PROTEIN

TerraSan Group successfully concluded the acquisition of the Saldanha Protein Group with effect from 02 October 2017.

This Group owns 6 pelagic fishing vessels and has the following pelagic fishing rights which expire at the end of 2020:

- 3.45% of the Total Allowable catch (TAC) for pilchards; and
- 8.80% of the Total Allowable catch (TAC) for anchovy.

The TAC for 2018 was 59 214 tons (2017: 45 560 tons) for pilchards and 295 911 tons (2017: 450 000 tons) for anchovy.

The 6 vessels comprise 3 steel hull and 3 wooden hull vessels with a replacement value of approximately R150m. The steel hull vessels have a capacity of approximately 230 tons for industrial fish and 120 tons for pilchards (because of added ice). The wooden hull vessels have a capacity of approximately 150 tons of industrial fish.

Saldanha Protein has a fishmeal and fish oil processing facility and a pilchard cannery situated in St Helena Bay. The former has the capacity to process up to 1 200 tons of industrial raw fish per day while the latter can process up to 200 tons of raw pilchards per day.

Saldanha Protein imports frozen pilchard cutlets from Morocco, to supplement the company's catches. Imported cutlets are priced in Euros.

All canned pilchards produced by the factory are subsequently sold into the retail and wholesale markets in South Africa while fishmeal and fish oil are predominantly sold into international markets.

To provide a better understanding of the financial results of Saldanha Protein, the results of the corresponding period will be discussed, with the approval of the previous owners. Please note that the Group cannot take responsibility or credit for the results before 2 October 2017.

The current results for Saldanha Protein includes profits made from 5 859 tons of Industrial fish delivered by TerraSan Pelagic to West Point Processors during the current year.

Revenue at 30 June 2018 increased by 44% to R366.5m (2017: R254.6m) for the year under review. EBITDA was 136% higher at R52.2m (2017: R22.1m) and profit after tax for the year increased by 166% to R32.3m (2017: R12.1m).

WEST POINT FISHING

Pilchards

During 2018 the Department of Agriculture, Forestry and Fishing announced an unexpected 30% increase in the TAC for pilchards. Current Industry catches are at 34% of the TAC, indicating that the resource is under pressure and that the full TAC will likely not be caught.

Industrial Fish

The anchovy TAC for 2018 was set at 295 911 tons (2017: 450 000 tons). Industrial Fish landings increased as the division's own vessels landed 19 295 tons of industrial fish (2017: 16 425 tons). Further good catches have been experienced since 30 June and all indications are that the full available quota will be landed.

The combined revenue for pilchards and industrial fish increased by 16% to R50.3m (2017: R43.4m) for the year under review. EBITDA was 64% higher at R6.4m (2017: R3.9m) and profit after tax for the year increased by 80% to R3.8m (2017: R2.1m).

WEST POINT PROCESSORS

Pilchards

In order to mitigate the steady reduction in the pilchard TAC over the past years and to obtain sufficient stocks to supply the market, the division successfully sources quality frozen Pilchard cutlets from Morocco.
At 30 June 2018, West Point Processors produced 234 745 (2017: 125 853) shrinks of pilchards from local fish and 1 613 242 (2017: 893 968) shrinks from imported cutlets. The profitability in the canned fish division has remained stable.

Industrial Fish

The total industrial fish delivered to West Point Processors' processing factory for the processing of fishmeal and fish oil equated to 37 438 tons (2017: 30 552 tons) as at 30 June 2018. Processed fishmeal has also been supplemented by buying in fishmeal and fish oil over the past years. Sales of 9 578 tons (2017: 5 845 tons) of fishmeal and 813 tons (2017: 913 tons) of fish oil were achieved.

The fluctuation in the Rand strengthening from an average rate of R13.16/USD in 2017 to R12.5/USD in the first half of 2018 contributed negatively towards the profitability of the division. However, this was negated by an increase in the USD selling prices of fishmeal and fish oil which substantially improved the profitability by some additional R1 000 per ton of fish meal sold.

Processing revenue for pilchards and industrial fish increased by 53% to R338.5m (2017: R221.1m) for the year under review. EBITDA was 120% higher at R38.9m (2017: R17.7m) and profit after tax for the period increased by 163% to R23.4m (2017: R9.2m).

SALDANHA SALES AND MARKETING

Saldanha Sales and Marketing (Pty) Ltd (SSM) is responsible for the marketing and selling of canned pilchards produced by West Point Processors as well as a limited amount of imported canned fish. It is estimated that SSM holds 10% of the current market share.

Management was able to secure a constant supply of imported raw materials resulting in an increase in sales from 823 158 shrinks in 2017 to 1 113 997 shrinks in 2018. An increase of 35%.

Revenue increased by 38% to R183.8m (2017: R133.4m) for the year under review. EBITDA was substantially higher at R7.2m (2017: R0.7m loss) and profit for the year was R4.1m (2017: R0.3m loss).

The group is pleased with the integration of Saldanha Protein into TerraSan and the resulting cost savings from the sharing of infrastructure and management skills at TerraSan Pelagic Fishery.

FUTURE PLANS

Management is considering the outsourcing of the Boiler and steam supply at the processing factory from 2019. This could yield substantial environmental improvements due to a proposed switch from coal to wood biomass as the main energy source.

A committee has been formed to prepare for the 2020 rights allocation process. Management expect the application forms to be issued by the Department of Agriculture Forestry and Fishing within the next 6 months. It is imperative that the Group reviews its overall commitment to transformation and job creation in order to ensure a successful application.

It is planned that the capacity of the fish oil separating and polishing plant will be increased to 40 tons per hour with the purchase of new equipment at an estimated cost of R6.1 million. This project will be completed during the 2018 year to be ready for the 2019 season.

An Environmental Impact Assessment (EIA) is currently underway at the West Point Processing Plant which seeks to obtain approval to increase fishmeal production capacity from its current level of 50 tons per hour to a maximum of 100 tons per hour. It is envisaged that the EIA process may take 16 months to complete.

ABALONE BUSINESS - AQUNION

Revenue increased by 20% to R77.5m (2017: R64.8m) for the period under review. Had the red-tide event not occurred in 2017, revenue would have decreased by 1% to R77.5m (2017: R78.3 m). The negative effect of a stronger rand was compensated for by higher international prices compared to the previous reporting period. Adjusted EBITDA was 2% higher at R22.2m (2017: R21.8m).

The reportable results of Aqunion included the unrealised profit in the fair value adjustment to biological assets, one-off and extraordinary items. These items are:

- the unrealised IFRS fair value adjustment to biological assets amounts to a positive adjustment of R32.6m (2017:R2.8m a positive adjustment) before tax and R23.5m (2017: R2.0m a positive amount) after tax;
- the net loss resulting from the red-tide event amounting to RNil before tax (2017: 27.3m) and (2017: R19.7m) after tax; and

- certain incentives received in respect of the expansion of Roman Bay Farm amounting to RNil (2017: R6.0m) before tax and (2017: R4.3m) after tax.

Including these items above, profit for the reporting period increased by 361% to R24.2m (2017: R9.3m loss).

Environmental conditions returned to normal during the reporting period with no abnormally high or dangerous levels of dinoflagellates (microscopic algae), commonly referred to as red tide. During February 2017 our Whale Rock farm suffered mortalities of 42 tons as alluded to in more detail in the December 2017 Chairman's Report. The red tide event created a shortage of South African abalone in the international market enabling Aqunion to increase its prices to partly combat the effect of lower volumes and a stronger Rand.

Management remains vigilant in the face of potential future incidences. Management has installed water reuse systems to reduce its reliance on the sea, if red-tide events should occur in future. The risk may also be mitigated by improving the geographic concentration risk. Management is actively exploring additional sites. During the prior year Aqunion acquired a new suitable site near Gouritz River Mouth. The site is still subject to an environmental impact assessment.

The lower volumes and pressure on cash flow forced Aqunion to re-evaluate production and processing techniques as well as cost and sales prices. Aqunion is aware that South African wages and electricity have and will continue to increase with more than inflation and sales prices will come under pressure from growing sales volumes. This will result in a narrowing of margins unless we farm more effectively or find ways to increase our prices. Aqunion Wholesome Foods has been created to place more emphasis on sales price growth and will focus on increasing the proportion of Aqunion's products which are sold in mainland China and in retail markets in Hong Kong. Aqunion's management team is developing a number of high-potential techniques for improving production and processing yields.

In order to reduce our carbon footprint and because it made economic sense Aqunion embarked on two energy saving initiatives at the Roman Bay Farm. Our turbine project whereby the sea water that is circulated through the abalone tanks is used to generate electricity when it flows by gravity back to the sea was completed in March 2018 at a total cost of R6.3m. A pilot PV system was also installed on the roof of our hatchery during 2017 at a cost of R800 000. Combined, the two initiatives will reduce Roman Bay Farm's annual electricity bill of R13 million by 18%.

Taking into account the above, Aqunion sold 114 tons (2017: 101 tons) of abalone representing an increase of 12% over the previous reporting period. The abalone biomass increased by 29.9 tons from 319.7 tons at 31 December 2017 to 349.6 tons, net of sales. The valuation of biological assets increased from R150.0m at 31 December 2017 to R181.9m on 30 June 2018. It represents an increase of R31.9m (2017: R3.5m decrease). The increase in biomass amounted to R15.6m (2017: R9.4m decrease). The balance of the increase of R16.3m (2017: R9.4m decrease) was due to changes in the net price, product mix, refinements in the valuation methodology and movements in the R/US$.

Aqunion's adjusted EBITDA margin increased from 28% to 29% for the period under review, mainly because of higher volumes. The increase in biomass and the resulted economies of scale as well as the savings in electricity alluded to earlier in the report enabled Aqunion to decrease production cost per kilogram biomass gain by 0.4%, compared to 2017, well below inflation. If this achievement can continue or be improved on, it bodes well for Aqunion's margin and continued sustainability. Phase 2 of the expansion of Roman Bay Farm from 230 tons to 385 tons commenced upon completion of the Rights Offer in 2015. The expansion is nearing completion and all the tanks are in position and will be commissioned over the next three months with spat from our hatchery.

Marifeed, our Abalone feed plant, in which we have a 51% share, is an integral and very important strategic partner of our Abalone business. Marifeed expanded its capacity from 1 350 tons to 3 000 tons in a phased manner during 2016 and the early parts of 2017. This was necessary because of the growth of Aqunion, particularly Roman Bay Farm, the business of its co-shareholder HIK Abalone Farm (Pty) Ltd, as well as the abalone industry in general sourcing abalone feed from Marifeed. It required R18.5m in capital expenditure which was funded from Marifeed's internal resources and bank finance.

The cost savings envisaged from the advanced technology materialised, and contributed to a profit after tax of R3.8m (2017: R1.7m).

Marifeed's sales of Abfeed increased by 14% from 650 tons to 739 tons for the reporting period. The increase was mostly due to an increase in local sales as the standing stock increased again after the red tide.

BLUE OCEAN MUSSELS

Revenue decreased by 21% to R14.5m (2017: R18.5m) during the reporting period, while adjusted EBITDA was 219% lower at R1.8m loss (2017: R1.5m profit). Blue Ocean Mussels' loss for the period under review was R2.6m (2017: R0.6m loss).

Operationally, Blue Ocean Mussels sold 320 tons (2017: 408 tons) of mussels either fresh or processed, 22% less than the same period last year. The decrease was mainly because of lower rope yields which has led to a decrease in product availability.

Blue Ocean Mussels' adjusted EBITDA margin decreased from 8% in 2017 to -12% in 2018. This is the direct result of lower volumes due to low rope yields which has negatively impacted factory yields and throughput. The low rope yields is a reason for concern as this is a natural phenomenon which is also experienced by our supplier Imbaza Mussels and all other mussel farms in the bay. Lower rope yields were experienced to a lesser extent in 2017 and were last at these levels in 2013, after which they normalised. Management regard this as a priority and continued farm trials are being conducted to see how this can be managed, mitigated or improved in the future.

The lower volumes and pressure on cash flow has forced Blue Ocean Mussels to re-evaluate production and processing techniques as well as all cost. Research and development is also being done to look at processing alternative products in the future to utilise the spare capacity brought on by either lower mussel volumes or increased factory capacity.

The renovations of the processing plant that started in November 2017 was completed during January 2018, with the final equipment being commissioned in May. The factory upgrade was completed at a total cost of around R7.5m, well below the initial approved budget. The capacity of the processing plant was increased threefold and will enable us to process the increased production from the farm expansion.

During 2016, 10 additional rafts at a cost of R3.8m were seeded, increasing the farm's capacity from 616 to 1 100 tons per year. In 2017, the number of rafts were further increased from 25 to 35 at a cost of R4.3m and the first of the rafts built in 2017 were seeded in December 2017. It is planned to increase the number of rafts from 35 to 45 in the near future, increasing production to 2 200 tons per year (normalised rope yields).

CAPITAL RAISE AND B-BBEE SHAREHOLDING

The purchase consideration of Saldanha Protein was fully funded from existing cash resources of TerraSan Group as well as debt provided by ABSA.

Despite having adequate committed funding for the transaction, the Board considered it appropriate to raise new equity in the form of a specific share issue to redeem the debt to levels acceptable to the TerraSan Group and to retain cash resources to fund business opportunities.

The Board acknowledges the importance of BEE shareholding in the regulated environment in which we operate. The Company is in an advanced stage to significantly increase its Broad-Based Black Economic Empowerment shareholding through facilitated funding. A notice explaining the TerraSan Group B-BBEE Shareholding Enhancement Transaction and the requisite approvals by shareholders will be sent to shareholders, shortly, when the details of the transaction are finalised. Shareholders will have the opportunity to consider and vote on the transaction at a general meeting on a date to be determined. If implemented, the Transaction will enhance the B-BBEE Shareholding in the Group significantly, simultaneously raising additional equity capital of which a significant portion is earmarked to reduce the ABSA term loan. The balance will be reserved for future expansion of the Group.

BOARD OF DIRECTORS

Ms Dikiledi Mosime was appointed to the board on 1 July 2018. Dikiledi is an entrepeneur with a degree in BA Economics and Political Science, a MBA and also has a number of diplomas. She has gained valuable experience in manufacturing and was also the international Sales/Exports Manager for one of South Africa's biggest food companies, Pioneer Foods. She is currently a full time entrepreneur, owning a promotional packaging business and has a vision to become a market leader.

OUTLOOK

The Group is grateful for the contribution of Saldanha Protein and all indications are there that they will meet the operational targets set by the board this year. The effect of Saldanha Protein on the group's results will become more pronounced over the next few years as the Absa debt of R350m is repaid with a resulting decrease in finance cost. They continue to position the business for sustainability and growth.

The last tanks of the Roman Bay 2 expansion at Aqunion are currently being stocked with spat (small abalone). Standing stock has already increased from 319 tons to 350 tons this year and sales volume is expected to increase by 50% over the next three years. We are confident that the increased volumes will have an exponential effect on profits because we do not expect a significant increase in fixed cost.

The board is concerned about the low rope yields experienced at Blue Ocean Mussels but take a bit of comfort from the fact that rope yields in 2013 was at a similar level and returned to above average in 2014. We have a pipeline of investment opportunities that we continue to evaluate. These include opportunities to expand existing business units and others that will complement our product and service offering to our clients.

The Company continues to focus on growing the group and to create wealth for its shareholders by providing consistent value and returns. We are confident in our ability to deliver value to our shareholders and other stakeholders. We reaffirm our confidence in all our businesses and management will continue to increase investment as opportunities arise.

The group has an excellent management team and it continues the investment in human capital which provides the required confidence for the growth path the group has embarked upon.

VOTE OF THANKS

To our clients, shareholders and all stakeholders, we appreciate your confidence in our business and continued support. Thank you to my fellow Directors for their hard work, insights and support.

I would also like to thank the management of the TerraSan Group for their continued commitment and enthusiasm and extend the appreciation of the Board to all the employees and their families throughout the group.

Prof ASM Karaan

Executive Chairman of the Board

15 December 2018