BEHIND THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

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Ares Capital (ARCC)
Earnings Quality Update

We are maintaining our earnings quality rating of ARCC of 4+ (Acceptable).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

We thought there was a strong case to see ARCC's core EPS reach 60 cents after 3Q and it posted 63 cents in 4Q22. Higher interest rates continue to drive results as the bulk of loans are floating-rate and much of ARCC's financing is fixed-rate. Investors should continue to watch for these potential positives and negatives:

- Loans reset in a stair-step manner so there are likely still loans that completed 4Q without adjusting to interest rate increases in November and/or December, nor the latest increase a couple of weeks ago in now 1Q23. ARCC said this issue probably cost them 4 cents of

EPS in 3Q, and it may be about the same in 4Q too so there are still earnings baked in that have not been posted.

- The size of FED hikes may be getting smaller, but guidance is still for more to occur. 100bp change in rates should still be about 7 cents in quarterly EPS for ARCC, with 71% of loans variable rate. Debt rolls over slowly so even if the cost of funds increases for ARCC, it should be much more gradual. Only 31% of debt is variable-rate. Only 9% of the fixed debt rolls over this year.

- The company kept its regular dividend at 48 cents per quarter. It did not renew the quarterly 3-cent special dividend it paid during 2022. Part of that is ARCC came into 2022 with a 41-cent regular dividend and raised that to 48 cents. Another part is likely related to equity raises and an expected increase in some problem loans. There is still $1.27 in spill-over income to support the dividend and should the interest income continue to rise, a further dividend increase could follow.

- The primary issue to watch is ARCC is at the high end of its targeted Debt/Equity ratio range of 0.9x-1.25x. It ended 4Q at 1.26x. That does not allow ARCC to grow its loan portfolio at this time. The company completed three equity raises since the summer of 2022 to raise capital and enable it to also boost leverage to make more loans. The keys to this are: it raises the total dividend payment, it would dilute the amount of spill-over income per share via a higher share count, and it can only issue equity when the stock trades at a premium to book value. With the company at the high end of its debt ratio, the stock at nearly $20, and the book value at $18.40 – ARCC can issue more equity.

- The company has strong reasons to consider another equity raise. Primarily – market volatility is giving it 100-150bp greater spreads on new loans than in 2021. Plus, with banks pulling back from the market, they can make loans at larger spreads to companies with lower leverage and better documentation. So there may be more growth in the balance sheet in the near future.

- Even management expects to see some more stress on the portfolio from economic factors, but is still seeing sizeable EBITDA growth of 11% at this time and is not getting many requests for amendments.

Our conclusion is that ARCC is moving from almost all the levers moving in a positive way for them to a little more mixed. There are still positive levers, but they are getting smaller such as 25bp rate hikes vs 75bp or having wider spreads but needing to issue more equity to expand the portfolio. The margin of safety for the dividend has increased in our view with room too.

Becton, Dickinson and Company (BDX)
Earnings Quality Update

We are maintaining our earnings quality rating of BDX at 3- (Minor Concern)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

BDX reported non-GAAP EPS of $2.98 per share for its fiscal first quarter ending in December. This was 30 cps ahead of the consensus although the bulk of the beat was the result of a much lower-than-anticipated tax rate.

- **The adjusted effective tax rate was down to 6.2% in the quarter.** After the September quarter, the company was forecasting a 13.5%-14.5% rate for fiscal 2023 although management warned that "it would not be unusual for our rate to fluctuate above or below this range on a quarterly basis given the timing of discrete items." Regardless, the 6.2% was likely well below what analysts were modeling. A 13.5% rate would have shaved almost 25 cps off EPS.

- **BDX has increased the use of its receivables factoring program in the last two quarters.** DSOs adjusted for factored but outstanding balances increased to 52.1 from 48.6 in the previous quarter and 43.0 in the year-ago quarter. The company gave no explanation for the increase but we wonder if it could relate to its comment on the call that respiratory sales "benefitted from the timing of orders." The next quarter should be watched for signs of any sustained increase. Also, while cash flow benefitted from the increase in factoring, we doubt this can continue given rising rates making these programs more expensive. ***(See below for detail)***

- **Inventory DSIs are now above pre-Covid levels**. DSIs jumped 29 days sequentially and 33 days YOY. This was partly due to rising costs which have been capitalized in inventory and are now pressuring margins. It is also due to the company rebuilding inventory levels during supply chain slowdowns to ensure availability. Management indicated on the call that inventory components have been right-sized and inventory levels

are already down in January. Inventory should be checked in the next quarter to verify that the decline continued. ***(See below for detail)***

- **Prepaid expenses showed an unusual increase over the last four quarters.** The company gives no detail on the makeup of the account in its SEC filings and the only reference we saw was to cite the increase as being a material drain on cash flow. Such an unusual increase should be viewed with skepticism as it could be an indication of increased capitalization of expenses to the benefit of earnings. For reference, a $100 million deferral of expenses equals about 28 cps. ***(See below for detail)***

- **We continue to dislike the company's practice of adding back amortization of** intangibles to non-GAAP earnings despite the ongoing nature of its tuck-in acquisitions and the fact it benefits from R&D investments of the acquired companies.

- The company paid down $500 million in debt in the quarter and cited its net leverage ratio as being 3x. However, we estimate that after factoring in its $2 billion in legal accruals the leverage ration rises to 3.6.

Receivables Factoring Increased and DSOs Up

We have pointed out before that BDX utilizes a receivables factoring facility under which it sells receivables to third-party financing companies to accelerate the receipt of cash from sales. Activity in the program increased significantly in the last couple of quarters. Factored receivables are treated as sold so the transferred amounts are removed from the company's balance sheet. It is therefore necessary to add the receivables that have been transferred but are still outstanding back to the amount left on the balance sheet to properly analyze DSO trends. The following quarter shows these amounts for the last 7 quarters:

	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Sales	$4,586	$4,761	$4,641	$5,011	$4,995*	$4,849	$4,607	$4,907
Balance Sheet Receivables	$2,282	$2,191	$2,218	$2,303	$2,177	$2,350	$2,078	$2,118
B/S Receivable DSOs	45.8	42.3	43.5	41.4	40.1	44.6	41.0	38.8
Factored but Outstanding	$314	$323	$215	$237	$155	$118	$316	$311
Transferred DSOs	6.3	6.2	4.2	4.3	2.9	2.2	6.2	5.7
Adjusted DSOs	52.1	48.6	47.7	45.6	43.0	46.8	47.3	44.6

Note that the company spun off its Embecta dialysis unit as a separate publicly traded company on 4/1/2022. While the 9/21 quarter data has been restated to exclude Embecta results as a discontinued operation, the 3/22, 12/21, and 6/21 quarters have not. Note that while the 12/22 quarter's financials restated the 12/21 sales figure to exclude Embecta, we utilized the original sales figure including Embecta as a restated 12/21 balance sheet is not available. The absence of Embecta will impact the absolute trends in sales and receivables by approximately $250 million and $147 million, respectively. However, the difference in DSOs between results with and without Embecta is immaterial.

We can see that factored but outstanding receivables fell in the latter half of 2021 but have resumed their climb on a days of sales and absolute basis. Likewise, DSOs based on receivables left on the balance sheet also increased by more than 5 days YOY and 3 days sequentially. It looks as if some of the YOY growth in balance sheet DSOs could have been due to a timing in receivables collection between the 12/21 and 9/21 quarters. Still, the increase in receivables should be viewed with some caution and we wonder if it could be related to management's reference in the call that respiratory products "benefitted from the timing of orders."

We are more concerned by the increased use of the factoring program. This was likely an unsustainable benefit to cash flow growth in the last couple of quarters and rising rates must certainly be making it more expensive to utilize factoring facilities.

Receivables and use of the factoring programs should be watched in the next quarter for signs of a continuing increase.

Inventory Continues to Rise

BDX has been rebuilding its inventories to assure availability amid supply chain problems. Its inventory levels have also been increasing due to higher costs although this should be somewhat offset by the DSI formula which utilizes cost of sales in the denominator. DSIs have risen sharply in the last few quarters and are now well above their pre-Covid levels as shown in the following table. As with our receivables analysis, we used the original adjusted COGS figure for the 12/21 quarter rather than the figure given with 12/22 results which adjusts out Embecta's results. As with receivables, the 4/1/2022 spin-off of Embecta reduced inventory by about $120 million but we estimate that the impact on DSIs was only about a day.

	12/31/2022	9/30/2022	6/30/2022	3/31/2022
Adjusted COGS	$2,078	$2,268	$2,202	$2,250
Total Inventory	$3,604	$3,224	$3,163	$3,258
Total DSIs	159.6	130.8	130.7	130.3

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Adjusted COGS	$2,204	$2,379	$2,290	$2,264
Total Inventory	$3,035	$2,743	$2,946	$2,895
Total DSIs	126.7	106.1	117.1	115.1

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Adjusted COGS	$2,219	$2,162	$1,861	$1,929
Total Inventory	$2,815	$2,743	$2,946	$2,794
Total DSIs	116.7	116.7	144.1	131.8

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Adjusted COGS	$1,838	$1,969	$1,930	$1,874
Total Inventory	$2,760	$2,579	$2,629	$2,628
Total DSIs	138.2	120.5	124.0	126.2

Management noted in the conference call that gross margins are already under pressure from higher costs already capitalized in inventory. It expects these costs to work their way through profits in the first half of 2023 and noted on the call that inventories were down in January:

> *"Operating cash flow reflects an impact of approximately $300 million from higher inventory balances. The increase reflects the impact of inflation and our strategic investments in raw materials to optimize product delivery and meet customer demand. We've seen good progress in December and January on WIP and finished goods rightsizing with January inventory dollars down sequentially from December."*

Inventory balances should be watched closely in the next quarter to verify that the decline is continuing.

Unusual Jump in Prepaid Expenses

We noticed that the "Prepaid Expenses and Other" account has climbed noticeably in the last four quarters as shown in the following table:

	12/31/2022	9/30/2022	6/30/2022	3/31/2022
Prepaid Expenses and Other	$1,545	$1,559	$1,392	$1,256
Prepaid Expenses and Other Days	30.3	29.5	27.0	22.6

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Prepaid Expenses and Other	$1,040	$1,048	$1,207	$1,065
Prepaid Expenses and Other Days	19.8	19.5	23.6	19.5

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Prepaid Expenses and Other	$889	$891	$903	$1,156
Prepaid Expenses and Other Days	15.2	21.9	21.3	24.7

The company gives no detail on the makeup of the account in its SEC filings and the only reference we saw was to cite the increase as being a material drain on cash flow. Such an unusual increase should be viewed with skepticism as it could be an indication of increased capitalization of expenses to the benefit of earnings. For reference, a $100 million deferral of expenses equals about 28 cps.

Post Holdings, Inc. (POST)
Earnings Quality Update

We are maintaining our earnings quality rating of POST at 2- (Weak).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

POST reported 1Q23 (December) adjusted EPS of $1.08, which beat by 46 cents. Guidance rose for EBITDA from $990-$1040 million to $1025-$1065 million. We are not impressed. EBITDA came in below 4Q levels at $269.9 million and POST's guidance is below the annualized level of 1Q too. We do not think the beat is sustainable:

- POST picked up 3.3 cents from cutting advertising again.

- Costs it expects to be indemnified for appeared again. This was not an item that appeared in POST results until 3Q22. It added 1.4 cents to EPS.

- Depreciation & Amortization dropped $3.8 million, adding 4.4 cents to EPS.

- The biggest driver of EPS and EBITDA was POST taking pricing gains that far exceeded inflation on costs. Pricing rose $231.2 million, raw material costs rose $142.7 million and manufacturing costs rose $14.4 million – netting POST $74.1 million for the quarter or 85 cents in EPS. **(See Below).**

- The biggest drivers of that in 1Q23 $74.1 million were egg inflation (which is now down from $5.25 per dozen in December to $3.04 by the end of January) and a dramatic drop in freight costs which POST called out as $108.6 million for all of fiscal 2022, but were only $19.5 million in 4Q22 and were not called out at all for 1Q23. **(See Below).**

- Inventory levels still look too low at 47.6 days vs. normal levels above 50. Another issue here may be that finished products are up, but in the discussion of earnings, POST said it is seeing a shift to lower-margin private label sales. **(See Below).**

- POST announced this week it is buying some pet food brands from J.M. Smucker (SJM) for $1.2 billion. That includes $500 million in POST stock along with $700 million in cash. We are not thrilled by this deal on first review and see another low ROI project for POST of about 5.3%. **(See Below).**

What to Watch

POST Is Far Ahead on Taking More Pricing than Costs Justify

POST reports many of the costs it is trying to offset in its SEC documents. The pricing and volume changes often have some rounding that make it difficult to completely hit the breakdown between the two. Thus, some of these pricing figures may be +/- $1 million. But, we think the trend is obvious – POST has more than outpaced inflationary cost pressure with price hikes.

	1Q23	4Q22	3Q22	2Q22	1Q22
Pricing	$231.2	$234.8	$190.7	$85.1	$89.5
Raw Materials	$142.7	$111.7	$123.7	$51.6	$46.5
Manufacturing	$14.4	$20.6	$27.1	$23.7	$23.4
Freight	$0.0	$19.5	$27.4	$34.0	$27.7
Net Pricing	$74.1	$83.0	$12.5	-$24.2	-$8.1

POST was double the raw material inflation with pricing in some recent quarters. Plus, it was looking at increases in manufacturing costs and shipping. As we noted earlier – the $74.1 million of pricing exceeding all these inflationary costs – adding 85 cents to EPS in 1Q23. Several things point to this situation not continuing at these levels:

- Eggs are the primary driver. We discussed this in the last update and it continued in 1Q23. Foodservice, which is largely egg products, saw $142.6 million in price hikes or 62% of the full company. Refrigerated retail which has many egg products too was 10% of the full company's pricing increase in 1Q23 ending in December.

- Egg prices have dropped considerably in January and February. Looking at the *Trading Economics* website, we see that eggs ended September at $3.60/dozen and that holiday baking saw a seasonal increase that pushed eggs as high as $5.35/dozen. Eggs are now $2.60/dozen, down 50% from December. $2.60 is still high historically, $1.25-$1.75 is more common. Much of the egg-laying hen population has been restored and those hens are maturing now which boosts production more.

- We find it hard to believe that competitors will not lower prices and customers will keep paying POST based on $5 eggs. We already see that happening and POST is confirming it. Here are some statements from the earnings call and similar notes are in the 10-Q. POST is saying that more demand is coming from private-label products – which are cheaper. It is also saying that competitors are ramping up advertising to support their products:

  *"Post consumer brands maintained a branded dollar share position of 19.1%. Meanwhile, **our private label business grew 13.6%.** Interestingly, **we have seen a stepped-up level of competitor advertising intensity,** which we believe is constructive for the overall category."*

  *"Refrigerated retail continues to show mixed results. Our supply chain has markedly improved versus this time last year. That recovery supported 12% volume growth in our core side dish category. **We do see some expansion of private label distribution.** In this category, we do not make private label. We are leaning into heavier brand investment to support both expanded distribution and velocities."*

  *"Weetabix continues to be well managed in a challenging environment. The margin pressure from elevated energy prices, which we highlighted last year, developed as expected and will persist throughout the year. In addition to higher incremental costs, **the impact on consumers drives mix towards private label.**"*

- Remember, POST has been cutting advertising – that may become a headwind for earnings too.

- Looking at the other costs, inflated freight costs disappeared last quarter. Growth in manufacturing costs is seeing less inflation too. We know eggs drove the raw material hikes in 1Q23 and are already down. Other commodities like corn, wheat, and hogs are all down considerably off their highs in the spring of 2022. Lower corn also helps egg prices further.

- POST is in the period of transition from high costs to falling costs – that creates a windfall for a short time, just like rising costs before higher prices kicked in. We do not believe that between competitors and large customers of POST's like WalMart, Kroger, and food distributors – who all watch commodity prices – that POST will get to keep all the recent pricing that has far exceeded the raw material increases.

Inventory Levels Still Look Low

Post just ended 1Q23 with a DSI figure of 47.6 days. We still think there is ample evidence that it should be carrying stocks in the mid-50s.

Inv. DSI's	4Q	3Q	2Q	1Q
fiscal 22	42.6	41.1	45.2	46.9
fiscal 21	42.8	55.1	56.5	53.2
fiscal 20	56.3	61.8	49.2	54.5
fiscal 19	53.4	52.4	54.1	46.2

There are several other concerns we see with the inventory levels:

- If POST adds more inventory – it will hurt free cash flow. Normal levels of inventory would consume $100 million in cash for a company that just posted free cash flow of $46 million in 1Q23 and $127 million for fiscal 2022.

- POST uses FIFO accounting so all the inflation with price hikes is helping gross margin now. This is even helping as volume growth is slowing or turning negative in some units. If pricing rolls back down, and POST has reduced fixed cost absorption due to flat or down volumes, that does not set up well for a period when it sells higher cost inventory:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Gross Margin	26.5%	24.9%	23.9%	26.8%	25.1%	24.5%	29.5%	30.4%

  50bp of gross margin for most quarters is 9 cents of EPS. This could be an earnings risk during 2023.

- Also pressuring pricing as discussed above is POST repeatedly saying that private label products are taking share as consumers trade down.

POST Jumps to Pet Food

During Covid, pet food sales and vet visits saw strong growth as people adopted more animals and started buying premium food and care for them. We have followed this trend with SJM, Colgate-Palmolive, and General Mills for food and saw the vet care with Patterson Dental. The big news is the volume growth is gone. It is interesting that SJM's brands didn't get much of the bump here:

SJM Pet Food	22-Oct	22-Jul	22-Apr	22-Jan	21-Oct	21-Jul	21-Apr	21-Jan	20-Oct	20-Jul	20-Apr
Pricing	16%	20%	10%	6%	4%	0%	0%	-2%	-1%	-2%	-2%
Volume	-3%	-3%	0%	-7%	2%	2%	-6%	8%	1%	5%	8%

SJM specifically called out weak sales for *Rachael Ray* and *Nutrish* – two of the premium brands POST is buying for the April 21 and April 20 quarters. SJM took an impairment charge of $150 million on *Rachael Ray* and converted *Nutrish's* brand name intangible asset from indefinite to finite so it would be expensed. SJM acquired a group of pet foods through Bigheart Pet Brands. It has taken $465 million in impairments here too and includes brands that POST is buying – *Kibbles & Bits, 9-Lives, Nature's Reserve*, and *Gravytrain.* Also, in some of the discussion, SJM said those negative figures were due to the pet food being offset by the pet snacks in the portfolio. SJM is keeping the pet snacks like *Milk-Bone* and *Pup-peroni.*

Here are the results for CL's Hills division which is a premium brand for the same period:

Hills	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20
Pricing	13.5%	11.0%	12.5%	9.0%	6.0%	8.0%	4.5%	4.0%	3.5%	4.5%	3.5%
Volume	0.5%	-3.5%	5.5%	4.0%	7.0%	11.0%	10.5%	0.5%	11.0%	6.5%	2.0%

Hills saw much better volume gains and held them during this run. Both companies are reporting higher sales due to raw material prices being up, but we know that is already starting to come down now. SJM could not gain nearly as much traction competing against the larger players here and now POST gets to try it.

On financials, we have been critical of POST's acquisitions because they have low ROIs that don't seem to grow revenues or improve ROI under POST. Plus, their biggest source of earnings gains comes from cutting marketing. SJM says the acquired brands should produce about $1.5 billion in sales and simply pulling them out of SJM's umbrella will cost SJM 45 cents in annualized EPS. That assumes no offset from the proceeds SJM will receive paying down debt, buying something else, or collecting dividends. The 45 cents becomes $48 million in earnings, SJM's tax rate of 24.4% makes operating profit for the collection of brands $63.6 million. POST is paying $1.2 billion giving this deal an ROI of 5.3%. We should add that SJM has already discussed how it reduced marketing for these brands, so POST may not fully have that lever to pull.

We doubt these brands will maintain double-digit pricing growth, which could hurt profitability. This unit for SJM was seeing strong y/y decay in profits until pricing hit 10% in the April 2022 quarter. POST is a B+ credit. B+ bonds are yielding over 8% now and they were yielding 5.5% last year. POST will need to boost operating income here by 50% to earn 8% on the deal.

Sealed Air (SEE) Earnings Quality Update

We are maintaining our earnings quality rating of SEE of 2- (Weak).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

Sealed Air reduced guidance after the 4Q22 was complete, but before results were announced so it could claim it beat forecasts. We're not so sure about that- after 3Q22, guidance for 4Q22 was $0.94-$1.04 (vs. $1.12 in 4Q21). On January 17, it cut guidance to $0.89-$1.04 – then claimed its $0.99 beat by 1 cent. This is a recurring event for SEE and just on the surface we can see how it should have been raising guidance due to some easy factors:

- Guidance for 2022 after 3Q expected 148 million shares. Share count was 147.4 million – which added 1.2 cents to 4Q22 EPS.

- Guidance after 3Q22 was for a 25.5% tax rate, which came in 10bp lower than that – which added another 0.5 cents.

- Operating costs had been a headwind all year until 4Q, when they added $10 million to EBITDA – that was worth 5 cents in EPS.

- At the time, SEE likely knew some other costs combined to have little impact on EPS overall for 4Q22:

    - Depreciation/Amortization was up all year, but suddenly fell $2.9 million in 4Q adding 1.5 cents to EPS. Forecasts are for a huge increase in Depreciation/Amortization in 2023.

    - Share-compensation and profit sharing fell by $1.3 million adding 0.7 cents to 4Q22 EPS.

    - Adding back 3rd party consultant fees was another 0.5 cents.

    - Inventory obsolescence jumped to $6.4 million in 4Q, and y/y by $4.8 million which cost SEE 2.4 cents.

    - We cannot see what bad debt expense did in the period yet – but these other items are nearly a wash.

What to Watch

- Guidance for 2023 looks weaker at first glance. Removing the Liquibox deal from the forecast, organic growth could be negative to 0% for a company touting its high-demand products and its higher pricing already in place continuing. EBITDA would be down to basically flat even with the multi-year restructuring continuing. Plus there are likely some of the $30 million of expected synergies from Liquibox added in too. (**See Below).**

- We question if SEE can keep all its pricing. Management is pointing to weakness on volumes and it expects to take market share. Volume losses exceeded pricing gains in 4Q EBITDA. Raw material cost inflation/deflation is supposed to pass through to customers and net to $0 over time. We think SEE may be $200 million ahead of the curve there and historically this is something where they get ahead or behind by $20-$30 million. The 4Q saw the weakest gain in this area by a wide margin compared to the rest of 2022. **(See Below).**

- Pricing has also benefitted by taking large increases to offset FX losses in Latin America. That is losing steam too. SEE was getting quarterly $169 million hikes in the America's region early in 2022 against almost no FX hit. In 4Q, this region only booked $54 million in pricing against $11 million of FX losses. Historically, the FX losses exceed the pricing and that remains the case for Europe and Asia at SEE. If Latin America returns to the norm, this is big tailwind that could go away for SEE. **(See Below).**

- **We think investors should watch for pressure on pricing and margins from high inventories too. DSIs are normally 60 days in 4Q and 70 days in other quarters. SEE is 20 days higher than those norms.** It also uses FIFO accounting and the raw material prices are going down now. They could find themselves selling inventory acquired at higher costs at lower prices going forward. We also think investors should weigh excuses that supply-chain shortfalls are still negatively impacting sales when they've managed to grow inventories so much.

SEE's DSIs	4Q	3Q	2Q	1Q
2022	81	92	87	81
2021	63	68	72	68

- Free cash flow is forecast to rise from $376 million - which missed forecasts badly largely due to inventory building up – to $475-$525 million with a big tailwind from reducing working capital. If SEE is planning to lower excess inventories into a market that is destocking as they noted on their earnings call – that would seem to also indicate pricing may not hold. Negative volume just exceeded pricing's gain for EBITDA in 4Q.

- Is the depreciation/amortization forecast of $275 million in 2023 an easy way for SEE to "beat" guidance? Having this area drop in 4Q gave SEE 1.5 cents toward its 1-cent beat. Now it sees it rising from $185 million to $275 million. It blames higher capital spending in recent years, but that does not begin to explain the $90 million forecasted jump. We don't know the allocation for the Liquibox deal yet, but it seems likely much of that will go into goodwill and not be expensed. To get to $90 million, we needed an average life of acquired PP&E and intangibles of about 4 years. But, SEE uses average lives of at least twice that period for most similar assets. **(See Below).**

- The interest expense forecast also looks high at $275 million for 2023, up from $162 million in 2022. Much of the debt is fixed-rate and should be flat y/y. SEE issued $775 million in 6-1/8% bonds early in 2023 used to pay for Liquibox and retire some 4.5% bonds due in September. The net change there is about +$30 million for the year. Even if it borrowed $1.3 billion at floating rates this year vs. $500 million last year, the difference there would be about +$60 million. There's still another $23 million that may not occur. We saw that SEE was finding it more expensive to factor receivables at this point, but that doesn't look big enough to make this leap to $275 million either. This may be another lever to pull to "beat" guidance in 2023.

- A potential positive is SEE has had an IRS dispute over a settlement SEE made in the Grace bankruptcy several years ago. The IRS was disallowing SEE's ability to record this loss for tax purposes and the dispute involved as much as $525 million in taxes that SEE would need to pay. SEE noted in the 4Q that a tentative deal was reached but not outlined. There was a large increase in other taxes in the period. We will need to see what disclosure there is about this in the 10-K.

Guidance for 2023 Is Worse than It Looks

If we look at what SEE just reported for 2022 in results, investors should be incredulous over 2023 guidance:

	Revenues	EBITDA	EPS	Free Cash Flow
2022 Results	$5,642	$1,210	$4.10	$376
2023 Guidance	$5.85-$6.10b	$1.25-$1.30b	$3.50-$3.80	$475-$525

Keep in mind that SEE is adding in 11 months of Liquibox to the equation. That company was forecast in late December to have results in 2022 of $362 million in sales and $85 million in EBITDA. Plus, SEE is forecasting $30 million in synergies for Liquibox within 3 years, so some of that should appear in 2023 too. Simply adding the two companies together should get SEE near the high point of revenue and EBITDA guidance with only $5-$7 million of synergy.

That means SEE, which continually talks about a rising CAGR for results, is projecting almost no organic growth for 2023 and 6% growth from Liquibox. It still says it will expand in geographies and take market share too in 2023. We wonder if SEE isn't building in some lower guidance so it can announce again throughout 2023 that it is "beating" forecasts.

Don't forget how 2022 played out for earnings. SEE came into 2022 forecasting adjusted EPS of $3.95-$4.15. Actual results were $4.10 in adjusted EPS – yet it reported that it beat EPS forecasts by a combined 33 cents through the year. Plus, they picked up 3 cents from having the tax rate come in below forecast and another 7 cents from having fewer shares outstanding than forecast. Justing looking at initial 2022 guidance and the end result – does this look like a company that grew and beat forecasts by 33 cents?

EPS for 2023 is expected to fall by 30-60 cents y/y. The give and takes for 2023 that we can quantify are:

- Including 11 months of Liquibox EBITDA with no synergy adds 39 cents

- $7 million of planned $30 million of synergy adds 4 cents

- A lower forecasted share count for 2023 adds 4 cents

- A higher forecasted tax rate costs 6 cents
- Depreciation/Amortization is expected to rise by $90 million and cost 45 cents

- Interest expense is expected to jump by $113 million and cost 57 cents

All of that is a headwind of 61 cents and gets to the low end of guidance. Other than Liquibox, all of those give-and-take items are below the EBITDA line. The reason we say guidance is worse than it looks is SEE said it expects to see more pricing power in 2023 and hold the price increases already in place. That's a very powerful driver of EBITDA. But after posting $1,210 million in EBITDA – guidance is now $1,172-$1,222 million without Liquibox.

Will SEE Keep All Its Pricing?

We have talked about this for some time, but SEE's pricing is largely designed to be a pass-through of raw material inflation and deflation that nets out to zero. We noted that SEE was running far ahead of this in 2022 and that was really helping drive EBITDA and EPS. This moves like a rubber band – it stretches and contracts. Look at how far it's been stretched. We've shown this table before:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Price/Cost EBITDA	$114	$98	$36	-$18	-$36	-$18	-$7	$9

Last quarter, SEE changed this presentation without any discussion of why and it was still a huge benefit to 3Q22 results. Now, look at 4Q22 coming in at only $25 million. Every $10 million that pricing exceeds cost inflation is worth about 5 cents in EPS. Adjusted EPS rose by 55 cents in 2022 to $4.10 from $3.55.

	4Q22	3Q22	2Q22	1Q22
Net Price Realiz	$25	$71	n/a	n/a
Price/Cost			$114	$98
Higher Op. Costs			-$58	-$30
Net Pricing	$25	$71	$56	$68

We know resin prices have been falling since July, kraft paper prices are down, and other chemicals that make up different plastics are all down in price too. It looks like this is an area that drove SEE's 2022 and is now starting to reverse. Four more points to make here:

- 4Q22 results would have looked even worse on EBITDA and EPS if SEE had not picked up $25 million here as this was about 12 cents in EPS. So keep in mind that higher pricing exceeding inflation is a very sizeable part of EPS, which makes it tough on SEE if they cannot sustain it.

- Throughout 2022, SEE had reported that this area was being offset by higher other operating costs, and from 1Q-3Q, that was a combined headwind of $37 million against this net pricing. In 4Q22, the other operating costs were a positive $10 million to EBITDA and added 5 cents to EPS. Again, they only beat by 1 cent.

- SEE is also taking huge pricing in Latin America where FX normally offsets the pricing. We have talked about this before too. Remember, SEE pulled South America out of Latin America, then rolled both into a division called Americas in recent years which clouds this. We see them picking up excessive pricing here still vs. other foreign markets – but even this is starting to drop off noticeably:

	4Q22	3Q22	2Q22	1Q22
Americas Pricing	$54.2	$129.1	$169.0	$169.1
Americas FX	-$10.6	-$10.6	-$4.5	-$3.3
EMEA Pricing	$36.8	$35.8	$35.9	$28.2
EMEA FX	-$32.5	-$40.0	-$32.5	-$22.2
APAC Pricing	$12.5	$11.5	$9.6	$6.3
APAC FX	-$24.2	-$20.0	-$14.8	-$9.0

- SEE is getting killed on negative volume, which should deleverage some of its operating margin. The company sees these headwinds continuing in the first half of 2023 and then they should have easy comps again. But, this is another area where excess pricing has been saving SEE until 4Q:

	4Q22	3Q22	2Q22	1Q22
Net Pricing	$25	$71	$56	$68
Volume/Mix	-$58	-$32	-$17	$0

The 2023 Forecast for Depreciation/Amortization Looks Very High

In 2021, SEE reported $186 million for depreciation/amortization and that fell slightly in 2022 to $185 million. We noted above that the sudden drop in 4Q of $2.9 million gave SEE 1.5 cents in EPS in a quarter where it beat by 1 cent.

For 2023, SEE is guiding to depreciation/amortization of $275 million – that is a 45-cent headwind for EPS coming into the year. That seems very high even with an acquisition. When asked about this on the earnings call, the CFO responded:

> *"Sure, Larry. Let me address your kind of the D&A related question, and then we will get into the growth aspect. So first, **as it just relates to the D&A, really, a reflection of the investments, incremental investments we have made in our business. As you know, we have increased pretty meaningfully the CapEx profile in our business**. So, the jump in D&A is primarily driven by those investments in the amortization."*

We do not see this in depreciation and capital spending trends. We do not have the 2022 10-K yet, but depreciation and capital spending have not seen that much growth:

	2022	2021	2020	2019
Depreciation	$148e	$148	$137	$127
Capital Spending	$237	$213	$181	$190
Net PP&E	$1,276	$1,232	$1,190	$1,142

Capital spending dropped during Covid and bounced back. SEE is guiding to $260-$280 million in capital spending for 2023 – but that doesn't come close to justifying a $90 million increase in depreciation.

We're not sure intangibles can justify it either. The last big acquisition was in 2019 for $453 million. Of that, SEE allocated $247 million to goodwill, which is not amortized. It put $86 million in PP&E, which bumped up depreciation as seen above and it put $81 million into intangibles that are amortized over largely 6-13 years. Amortization was $38 million in 2020 and $39 million in 2021, and was forecast to drop to $34 million in 2022 and to $31 million in 2023 before Liquibox.

Liquibox cost $1.15 billion and we don't have the allocation table yet. But, this is an operating business with equipment. If 50% of it goes to goodwill and about 37% goes to PP&E and intangibles similar to 2019 – it would add $425 million in assets to be expensed. SEE will only have this expense for 11 months in 2023, so annualizing $90 million becomes $98 million. That means SEE would have to expense the new intangibles and PP&E over 4 years. SEE depreciates the bulk of machinery and equipment over 5-10 years now and intangibles over 6-13 years.

This looks like an area where SEE could report positive "surprises" for earnings in 2023.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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