BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Dow Inc. (DOW) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are maintaining our rating of 3+ (Minor Concern)

DOW beat forecasts by 19-cents with adjusted EPS of $0.50. We are not overly impressed with the quarter's quality. First, DOW has been writing off its Sadara JV investment to the tune of billions of dollars. It is still committed to lending it more money to retire existing debt at Sadara. All the on-going write-offs were added back as one-time adjustments. Suddenly in 3Q, Dow reports a $104 million swing in y/y earnings from Sadara – which was worth about 11-cents in the quarter. While we understand COVID caused a short-term slowdown, we are also disappointed to see Dow report a new $617 million restructuring charge. This follows years of restructuring already and appears to cover areas that should have been part of past major overhauls of the business.

What got worse:

- A new restructuring charge amid COVID – but it comes after 5-years of heavy restructuring already and impacted some facilities that probably shouldn't have survived the past work.

- Sadara's refinancing still hasn't happened and DOW is on pace to send it another $400 million this year.

What got better:

- Sadara posted a profit in 3Q and generated an 11-cent swing for EPS based on tighter inventory situations helping out.

- Liquidity looks solid with low debt maturities through 2023.

- The list of other adjustments to EPS showed improvement with lower integration charges for the prior restructuring, a one-time gain, and early extinguishment of debt.

What to keep watching:

- If Sadara can be refinanced, it may stop the cash contributions from DOW to that JV and will remove the $3.8 billion debt guarantee DOW has on the JV's debt.

- Can Sadara earn money in more than one quarter?

- Does the latest restructuring move some wages up to a year in advance into the one-time charge being adjusted back?

- Over half the charge was related to severance and DOW expects to save $300 in costs, both only half the savings are forecast by mid-2021 and the rest by the end of 2021. We would expect COVID-related layoffs to happen very quickly not late in 2021.

Sadara Is Still Not Over – But May Be Soon

As a quick review, Sadara is a JV between DOW and the Saudi Arabian Oil Company. DOW sells Sadara products outside the Middle East for a fee.

- In 2017, DOW loaned the JV $735 million – but later converted it into equity.

- In 2018, DOW converted $382 million of JV Notes and Receivables into equity.

- In 2019, DOW loaned the JV another $473 million and converted $380 million of JV Notes and Receivables into equity.

We know DOW was making money by selling Sadara product – but it did not seem to be fully collecting the fees if it was running receivables with Sadara and then converting them to equity. That was especially true when at the end of 2019, DOW took a $1.755 billion impairment against its Sadara investment and wrote the value to zero. That impairment was added back as a one-time item, but it should have included some of the earnings DOW booked during 2018 and 2019 when the receivables were converted to equity.

In 2020, the JV has been carried at a negative value on DOW's balance sheet. It has continued to lend it new money to fund the business and allow it to retire other debts. The JV lost money in 1Q and 2Q. Suddenly the tide turns for 3Q during COVID?

Eq Income	3Q20	3Q19	2Q20	2Q19	1Q20	1Q19
Income	$60	-$44	-$95	-$15	-$89	-$14
Loans made	$44		$122		$114	
Carrying Value	-$103		-$105		-$92	

The reason given on the call was Sadara was able to take advantage of tight inventories and post better margins. We're not certain if that will repeat for long. The history is Sadara has had a tough time. We know Sadara was posting losses in 1Q and 2Q and suddenly had a $104 million y/y improvement in 3Q. That is worth as much as 11-cents in EPS and we are skeptical about sustainability given the past results. Also, DOW expects it may lend Sadara up to $400 million this year and has so far given $280 million in loans. Another positive is the $400 million estimate is down from $500 million earlier this year.

Finally, DOW still guarantees $3.8 billion in Sadara debt. The JV has finished several steps in project completion, which will enable Sadara to refinance its short-term debt with longer maturities. The refinancing would remove the debt where DOW has the guarantee. The operational testing was complete in December 2018. The remaining tests for Sadara to refinance without DOW were expected to be completed early in 2020. It's October and the company now says before December 2020 it should happen.

The goal is to get Sadara refinanced so DOW does not have to continually lend it more money every year. It would still recognize its share of Sadara losses and profits quarterly.

We are not certain that one profitable quarter amid tight inventories in the market is indicative of Sadara's future success. The company even noted that Sadara is still performing below average. We would think the remaining risks would be:

- Can Sadara fully refinance? Will banks/markets not value the company at a high enough level to justify the full amount expected. Will DOW have to cover some additional shortfall?

- If Sadara's margins and income remain weak, will DOW have to continue to support it perhaps by forgiving more receivables?

- DOW has an incentive to continue the JV – it earns a fee to market the products from Sadara. Sadara has been about 8%-9% of DOW Cost of Sales. It should be a generating income and a decent amount of sales for DOW too that occur in normal operations – not solely in the equity income from nonconsolidated affiliates.

Another Restructuring Charge and Boost to Accruals?

DOW went through a restructuring prior to merging with DuPont. The two companies divested more units and combined their two businesses into three separate units and restructured those. Many charges involved optimizing the footprint for manufacturing and cutting the workforce. In just the last 3-years, DOW has taken $6.2 billion of restructuring charges, impairments, and asset write-offs. Prior to that, it had charges of over $800 million in 2015-16.

In our original review, we praised DOW that the restructurings were over and the remaining integration charges were getting smaller – falling from $1 billion in 2019 to about $250 million in 2020 and would end. Thus, we were disappointed to see a new $575 million charge in 3Q20 as DOW eliminates some smaller uncompetitive facilities and lays off about 6% of the work-force. The question we always have is, "How were any uncompetitive facilities missed in the prior 5-years of massive restructuring?"

What also is questionable to us is laying people off generally means savings happen immediately. This charge has $297 million related to severance. It took the full charge in 3Q20 and added it back as a one-time item. However, the expected cost savings are forecast at $300 million per year with only half of that realized by mid-2021 and the rest by the end of 2021. So. are the employees going to remain in place for several more quarters? Are there some future wages in this restructuring charge that are being added back? That could inflate future earnings.

The wage aspect of the charge is about $0.32 per share that was added back to adjusted EPS. It also was added to accrued expenses. DOW notes that $166 million was added to "accrued and other current liabilities" and $211 million was added to "other noncurrent obligations." That should indicate much of this is going to be charged against reserves in more than a year. We know that's not the $197 million asset write-down as that has already been charged off against the reserve.

We have already voiced a concern that accrued liabilities and other noncurrent obligations have been rising at DOW. It has worsened in 2020:

Accruals	3Q20	2Q20	1Q20	2019	2018
Accrued Exp.	$3,408	$2,731	$2,811	$2,762	$2,732
Other N/C Obligations	$7,497	$7,404	$6,937	$6,547	$4,709

In our original EQ report, we talked about how DOW took a $399 million environmental charge in 2019 and added it back to EPS. The charge was accrued. In 2020, it added $56 million more to cover the facilities it will close to accruals. The other noncurrent obligations continue to rise this year. The current accruals didn't move much until 3Q and it seems to be wage and severance related as we found the following note in the 10-Q:

> *"Accrued and other current liabilities" were $3,408 million and $2,784 million at September 30, 2020 and $2,762 million and $2,233 million at December 31, 2019, for Dow Inc. and TDCC, respectively.* ***<u>Accrued payroll, which is a component of "Accrued and other current liabilities" and includes liabilities related to payroll, incentive compensation and severance, was $677 million at September 30, 2020 and $284 million</u>*** *at December 31, 2019."*

The danger of high and rising accruals is they can be reversed in future periods and help EPS. We will continue to monitor this.

With the exception of the new restructuring charge – the rest of the adjustments to EPS look cleaner for 3Q20:

	3Q20
GAAP EPS	-$0.04
Integration	-$0.06
Gain on asset sale	$0.26
Loss on early Exiting Debt	-$0.07
Restructuring	-$0.67
Adjusted EPS	$0.50

The list is much shorter and the integration charge continues to get smaller y/y. We see those as positives. The gain on selling railroad facilities is one-time and should be added back. Retiring debt early is not something we see as a bad thing either.

Liquidity Remains Strong, Inventories May Need to Rise

Coming out of 3Q, DOW had $4.5 billion in cash on hand and no debt maturities in 2020 remaining. Maturities range from $121-$250 million for 2021-23.

We would expect lower capital spending in 2020 to bounce back next year, but DOW is on pace to have free cash flow > $4 billion this year.

Inventories dropped in DSIs by 8 days sequentially and 4 days y/y. A $300-$400 million increase in inventory may be a drag on cash flow going forward may be necessary. Inventory declines added to cash flow by $540 million in 2Q and $158 million in 3Q. Some of that is lower commodity prices too.

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 Concerns"	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 may 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 the next quarter. 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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