BEHIND THE NUMBERS
Quality of Earnings Analysis
May 7, 2021

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Iron Mountain Incorporated (IRM)
Earnings Quality Update- 3/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating of IRM at 1+ (Weak).

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

Summary

IRM beat forecasts for FFO by 7-cents and the company raised the high-end of guidance by essentially 1% in all areas such as Revenue, EBITDA, and AFFO. The higher guidance is being driven by acquisitions. The FFO beat includes 4-cents added back from stock compensation, under IRM's newly changed definition of FFO. It had another 4-cents from not adjusting for financing lease principal payments also.

We also see that IRM benefited from some expense lag of returning to normal operations post-Covid with items like transportation being down $8.1 million y/y as they actually saw the service side of records management start to normalize later in 1Q and sales commissions were up. There are still furloughed employees starting to come back so labor was down $14.5 million but should likely grow going forward. Every $4 million of costs like this is worth about 1-cent in FFO. Even Information Technology Costs grew during Covid in 2020. In 1Q21, those costs were down $1.8 million. According to IRM – it expects to see margin pressure of 200-300bp in 2Q and 3Q and then deliver a back-loaded benefit in 4Q to hit forecasts. 200-300bp of margin is 6-9 cents of pressure on quarterly FFO. That guidance would seem to indicate that many of these timing differences between returning revenues and costs should reverse from 1Q21 through the fall.

Overall, we still believe IRM is touting growth – but ignoring the costs to get that growth including picking up and delivering data files, commissions paid to bring in business, buying out existing contracts at competitors, offering below-market rates as initial inducements and low maintenance capital spending. The cash flow statement shows many of these extra ongoing costs and paints a much weaker picture than the REIT stats IRM uses.

What is weak?

- All the sale-leasebacks IRM has done with property is starting to show up as rent expense rising faster than revenues. In 1Q21, operating lease expense rose 7.6% y/y after growing 8.7% in 2020. That is outpacing storage revenue of 3.5% and 2.7% growth respectively. IRM completed $565 million in asset sales like this in 2020. IRM only had $12.5 million in 1Q21 but guided to $125 million for 2021.

- Covid slowed cash outflows to acquire new customers. Despite this and pulling cash in from asset sales, and securitizing receivables ($257 million of a $300 million limit) – debt is up and that is before looking at higher lease costs. Where is the cash coming from to chase new customers in a non-Covid world?

	1Q21	2020	2019
Net LT Debt	$8,867.6	$8,592.3	$8,557.9
Cash from Operations	$68.8	$987.7	$966.7
Cash flow from Wrk Cap	-$159.3	$134.4	$8.8
Capital Spending	$145.5	$438.3	$693.0
Acquisitions	$0.0	$118.6	$58.2
Acquired Customers	$0.9	$4.3	$46.1
Inducements to Customers	$1.5	$10.6	$9.4
Fulfillment Costs	$16.7	$60.0	$76.2
JV Investments	$6.5	$18.3	$19.2
Finance Lease Payments	$12.4	$47.8	$58.0
Free Cash Flow	-$114.7	$289.8	$6.6

Capital spending is expected to rise in 2021. Working capital will likely be rebuilt but was 14% from cash from operations in 2020. And fulfillment and inducements will likely rise too. In 2020, IRM brought in $565 million from asset sales, but that's only forecast to be $125 million in 2021.

- The dividend is $725 million, where is that cash coming from in 2021? Free cash flow and asset sales will not do the job. IRM wants to tout its AFFO guidance of $1 billion for 2021 as covering the dividend easily. We believe the ongoing expenses that AFFO ignores will amount to more than $200 million in 2021. These include the principal payments on financing leases that should be over $50 million and stock compensation also about $50 million. Then there are withdrawal fees paid to poach customers, commissions paid to third parties to pull in customers, and other acquisition and inducement costs paid to customers. These are all recurring costs and they are seen on the cash flow statement. Maintenance capital spending was $143 million in 2020 and $64 million in 4Q20 – it came in at only $29 million in 1Q21. We think a realistic figure is much higher and that also would reduce AFFO. And there are the continual restructuring costs that consume cash as well. IRM will likely borrow the shortfall. The problem is while debt to EBITDA is 5.5x under the company's definition – the interest expense and principal payment on financing leases would cut their forecasted EBITDA by over $70 million and the inducement costs are also being ignored. We can see the debt figure being over 6x a more realistic EBITDA already.

- Restructuring continues into another year. We are going to voice our same concerns as in the past. The largest cost of the plan is supposed to be severance from eliminating employees and managers. Yet, the total percentage spent on severance fell to only 25% in 1Q21. Two-thirds of the $450 million total budget has been expensed at this point, years into this program. Why wouldn't Covid have been the time to accelerate lay-offs? The much larger source of payments is going to internal costs to develop and implement the restructuring and professional 3rd party consultant fees. Internal costs sound like an area where ongoing wages, travel, etc. could be pulled out of normal G&A costs and assigned to restructuring that gets added back in adjustment figures. If a manager looks at closing a facility, but visits 3 other locations on the same trip – do all the wages and other expenses get assigned to restructuring? We also remind investors that the bulk of the restructuring is to pull costs out of the old-tech business of paper storage. We're still curious how many consultants there are who know more about that business than IRM? But the bulk of the restructuring is coming in those areas - $36 million in 1Q21 or roughly 9-cents in FFO.

Sealed Air Corporation (SEE)
Earnings Quality Update- 3/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are raising our earnings quality rating on SEE to a 2+ (Weak).

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

Summary

SEE beat forecasts by 6-cents and boosted guidance. We think the beat was helped by SEE not increasing expectations after it gained volume from Covid vaccine shipping containers in 4Q20. That seems to account for much of the outperformance and we would question how sustainable that is. That was 2-cents in 4Q and may have been more than 4-cents in 1Q. We also think the price/cost headwind was lighter than many expected at $18 million in 1Q. Another $5 million would have cost SEE 2-cents in EPS and SEE is still +$160 million with customers in this area. SEE also reported another 3-cents from paying third-party consultants on the restructuring and added that back.

The increased guidance is why we moved it to a 2+ rating vs. a 2-. We think vaccines will post strong volume in 2Q21 and SEE has very easy comps from 2Q20.

What is strong?

- Vaccine Rollout packaging appears to be carrying the surge in volume. In 3Q20, the Protective unit had 4.4% volume growth and the company guided to that declining in 4Q20. Instead, it grew by 7.4%. The roll-out of Covid vaccines was the reason given. We estimate that the difference between 7.4% growth and 3.4% growth was about 2-cents in EPS for 4Q20. In February, SEE guided to 3%-5% growth for the protective unit. It came in at 13.0% on volume for 1Q21. We again suspect the vaccine rollout was a key here as SEE noted that demand in that area was accelerating at the end of 4Q and just from the news, we know more vaccinations happened in 1Q21 than 4Q20. Every 100bp in volume gain in this area is 0.44-cents in EPS. So if 400-800bp of gain is in this area, that's in the range of 2-4 cents in incremental EPS.

- Volume growth also came against very easy comps in Asia/Pacific (-2.4%) and EMEA (1.1%). Asia/Pacific saw 13.4% growth against 1Q20 and EMEA saw 6.5% growth. Looking at 2Q20 – SEE has the easiest comp coming for 2Q21. The disaster of 2Q20 gives SEE a 3.5% comp for Asia, -4.8% for Europe, and -5.8% for the Americas. 3Q21 is where we would expect to see the dual problem of declining vaccine volumes and tougher comps.

What is weak?

- Where are the food sales? Food products are still a larger percentage of sales than protective packaging and e-commerce at basically 60% vs. 40%. Food is also higher margin. This area continues to disappoint in our view and SEE blames a lack of demand in the food service industry due to Covid. Y/Y comps are going to be skewed because of Covid in our view so we looked at sequential growth for the last three quarters for not only SEE, but several other big players in food service. This is looking at dollar sales and the only company NOT showing much improvement is SEE. Sysco, Tyson, Brinker, Darden are all seeing some strong growth:

Sequential $ Sales Growth	1Q21	4Q20	3Q20
SEE's Food Unit	-7.3%	7.5%	4.7%
Sysco	2.2%	-2.1%	32.6%
Tyson	up	-8.7%	14.4%
Brinker	9.0%	2.5%	31.7%
Darden	4.6%	8.5%	20.2%

All of these companies are still down y/y, and Tyson has not reported calendar 1Q21 results yet but gave guidance to sales being up. If SEE is going to continue pointing to Covid hurting restaurant sales – why are the others seeing much more recovery already?

- Price/Cost continues to point to future problems for SEE. In the 1Q21, price/cost was a -$18 million headwind as costs increased more than price hikes. This was an 8-cent headwind to EPS. On the earnings call, SEE pointed out that it has already taken three price increases since 4Q. It even guided to more price/cost headwind for 2Q. We still think this will be a negative issue that is larger than many expect:

- Costs are increasing more quickly than SEE can negotiate. LYB that supplies plastic to the base economy noted that it has seen prices rise $950/ton from May 2020 to March 2021. Almost half of that happened since November and there is $300/ton more coming in May.

- LYB further noted that many competitors will have longer downtime of facilities in 2021 which will hurt supply volumes. Also, they cannot fulfill all demand now and exports which were about 40% of sales are basically zero now given the high demand in the US. That should hurt SEE's foreign cost structure. On top of that, the only thing helping some customers get some supply is the microchip shortage is stalling the production of cars and other appliances. As that corrects, there will be other areas looking to boost plastic purchases.

- SEE is getting price increases on a lagging basis – so we expect Price/Cost to continue as a headwind on EPS and margins at the same time SEE is boosting forecasts, which assume this headwind stops after 2Q.

- Price/Cost is designed to net out to zero over time and SEE is still over $160 million ahead on this process with its customers over the last three years. We believe SEE will have a tough time getting larger increases in price ahead of costs in 2021.

- As we predicted, combining South America's hyperinflationary price hikes into the North America unit for 1Q21 did allow North America to suddenly see pricing gains. That is not something the happens often and had not the prior two years. This is also why we think Price/Cost is a headwind SEE will have a tough time overcoming. North America is about 60% of total sales (now 65%) and even when the company was getting price/cost tailwinds for all of 2019 and all of 2020 until 4Q, North America was still posting negative pricing the entire time:

America's Pricing	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19
North Am. Price	1.2%	-1.4%	-1.5%	-0.2%	-2.0%	-1.0%	-0.8%	-0.4%
North Am. FX	-1.3%	-0.3%	-0.7%	-1.3%	-0.3%	1.2%	-0.2%	-1.1%
South Am. Price		9.4%	16.0%	18.8%	16.4%	18.3%	17.9%	24.8%
South Am. FX		-24.2%	-28.9%	-33.3%	-26.4%	-22.2%	-16.3%	-28.4%

South America is about 5% of total sales and we have been pointing out that the huge price hikes are driving SEE's total organic growth rate because the FX hit is left out of organic growth. We considered this very misleading as it gave the impression that the strongest region of the world was South America, when in fact it has been the weakest.

The deteriorating currency was the reason for the price increases and looked at compared to the FX hit, the price increases more than vanished. When we look the past two years, only 4Q19 would the combined entity have posted a minor price hike net of FX.

Remember, as part of SEE's restructuring it separated South America into its own unit starting in 1Q19. Now as part of the same restructuring, SEE rolled South America into North America starting in 1Q21. Call Siegfried and Roy – suddenly there's magic happening. North America – the largest percentage of sales just realized a price increase! But also note, the FX hit wiped out the entire North America price hike too. Combining the units, we saw the same thing happen in 2019 and 2Q20 – South America's price hike would allow the combined Americas unit to post positive pricing comps. However, the FX hit wiped it out. That continues to overstate SEE's reported organic growth.

What to watch

- SEE reported that some of the surge in volumes at the Protective Unit came from customers buying new automated equipment for future use. The company did not quantify this change in sales mix. This should ensure some future sales for the various bags/envelopes the equipment uses. However, this also sounds like a razor and blade type of sales occurrence. A customer buys a razor for $10 and then buys a new blade for 50-cents every month. The first month, the sale is $10.50, and every month thereafter the sale is 50-cents ($6/year). This could create some sales that are tough to top going forward. We did not see enough information from SEE on this to elaborate more but will watch this more.

- The tax issue with the IRS wanting to disallow a $1.49b loss from prior taxes is moving to the appeals process and the IRS asked for more information before starting. SEE continues to point out this could have a material impact on results within the next 12-months. It would be a $525 million cash item, or about 6-months of EBITDA so it could be significant.

Macquarie Infrastructure Corp. (MIC)

We are maintaining our BUY rating on MIC and not an EQ rating as the company is in the process of selling itself.

Summary

MIC's 1Q21 showed improved performance at the two operating subsidiaries. It raised 2021 guidance for both as each is showing improvement in demand. The largest news item is MIC said it is pleased with the interest it is receiving for the sale of Atlantic Aviation in particular and MIC Hawaii. **It expects to have an agreement to sell Atlantic Aviation in 2021 and still expects the regulatory issues to push MIC Hawaii's sale into 2022.**

As this moves forward, MIC has begun to unwind the shared services operation it has and get both companies set up as stand-alone entities. That should reduce overall corporate expense during 2021 too. **With the stock at $33 – we have a few tweaks to the expected valuation to be received after the sale of both entities and think the value could be as much as $45:**

- MIC has purchased the bulk of the $403 million in 2% notes. There is only $32.5 million outstanding at the end of April and it is reserving that amount of cash to resolve the remaining notes. There was a $126 million capital gain on IMTT's sale and MIC also reserved enough cash for that payment in April 2021**. That left it with $359.5 million in excess cash. Some of that retired $100 million of notes at MIC Hawaii along with $4.7 million in costs. The end result is there is $2.90 per share in cash net of debt.**

- Given that Free Cash Flow was forecast at $130-$160 million for 2021 and **MIC has now raised EBITDA forecasts for Atlantic Aviation by $20-$25 million and MIC Hawaii by $5 million and interest expense should decline with more debt retired and corporate costs reduced. We think the Free Cash Flow can exceed the $160 million target. That is another $1.80 in cash per share.**

- **MIC Hawaii** was being valued as having just over $190 million in debt, with the retirement of $100 million in notes, it only has $93.5 million in outstanding term loans. At 10x normal EBITDA less some taxes – **it should be worth about $5.00 per share instead of $3.50 in our prior forecasts.**

- Atlantic Aviation did $276 million in EBITDA in 2019 – Pre-Covid. Guidance is now $245-$260 million for 2021. **We believe MIC will be able to get a multiple of Pre-Covid**

figures as the business is recovering and cost savings are evident. Signature Aviation was sold for 16x 2019's EBITDA. **That would value Atlantic net of $1 billion in debt at $39.00 per share.**

- The result is this stock may be worth as much as $45 per share net of a $3.40 fee to management. Also, with the IMTT sale which was signed on November 9, 2020 – shareholders were paid the $11 dividend two months later on January 8, 2021. **So if a sale of Atlantic occurs in 2021, a large part of the cash is likely to be received in less than 12 months and the rest in under 24 months.**

Sum of the Parts	**A.A. at $276**
IMTT sale net of debt	$989.0
Atlantic Sale at 16x EBITDA - debt	$3,414.0
MIC Hawaii at 10x EBITDA - debt - 21% tax	$421.5
Total Proceeds	$4,824.5
Management Fee	$295.0
Net to Shareholders	$4,529.5
Value per share	$51.70
less $11 already received from IMTT	$11.0
Remaining Value per share	**$40.70**
Cash on hand after bond tender and Hawaii debt payment	$254.8
Expected 2021 free cash flow	$160.0
Potential extra cash per share	**$4.70**

Colgate-Palmolive Company (CL)
Earnings Quality Update- 3/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

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

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

CL's 3/21 quarter adjusted EPS of $0.80 beat consensus estimates by a penny. We are positive on the fact that the company has wound down its restructuring program and the quarter was free of any non-GAAP adjustments. However, we are reluctant to raise our earnings quality rating yet as organic revenue growth continues to benefit significantly from ignoring the negative FX impact in Latin America and inventory levels remain elevated.

- Similar to other companies we follow with a Latin American presence, CL's organic sales growth is receiving an artificial boost from removing the negative FX impact in the region but keeping the benefit of inflation-driven price increases that contributed to the negative FX decline. In the case of the 3/21 quarter, reported Latin American organic growth of 9.5% was the product of a 1% increase in volume and an 8.5% increase in pricing and trade incentive activity. However, the negative 7.5% impact of deteriorating Latin American currencies is not considered. If Latin American organic revenue growth had mirrored the 1% volume increase, total company organic growth would have fallen to 3.2% from the reported 5%.

- Inventory DSIs rose to 88 from 72 in the previous two March quarters. CL's inventories steadily tracked in the 70s before the pandemic but jumped to the high 80s/low 90s range to satisfy the COVID-driven demand for personal care products and pet food.

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Cost of Sales	$1,707	$1,681	$1,613	$1,528
Total Inventory	$1,676	$1,673	$1,578	$1,524
DSI	88.4	91.6	90.0	90.8

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Cost of Sales	$1,632	$1,601	$1,612	$1,558
Total Inventory	$1,301	$1,400	$1,371	$1,322
DSI	72.5	80.4	78.2	77.2

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Cost of Sales	$1,597	$1,558	$1,576	$1,585
Total Inventory	$1,278	$1,250	$1,245	$1,254
DSI	72.0	73.8	72.7	72.0

Management warned in the first quarter conference call that it is more cautious for the outlook in developed markets and that its categories had deteriorated more quickly than it anticipated. It expects that trend to continue in the short term. While it is more excited about emerging markets early in the year, the current COVID outbreaks in Brazil, Mexico, and India could change the outlook there. The company admitted that raw material prices were rising faster than it anticipated and it is raising prices to help offset this. For the first quarter, pricing added 170 bps to gross margin, but cost inflation was a 310 bp drag. CL indicated it will continue to drive pricing. The higher inventories coupled with the fact the company utilizes FIFO (first-in, first-out) accounting for 75% of its inventories could have delayed the worst of the impact of higher costs if CL was realizing higher prices in revenue while expensing older, lower historical cost inventories. This could catch up to the company as it begins to replenish inventories at higher costs and those goods work their way to the income statement.

- Other expense fell to $28 million from $40 million in the year-ago first quarter. Last year's amount included $2 million from acquisition-related costs. After that adjustment, the decline still added about a penny per share to EPS in the quarter. We saw no discussion of what drove the decline. While a small amount, we believe it is worth mentioning as without it the company would have not reported an earnings beat.

- On the positive side, CL's non-GAAP adjustments disappeared in the 3/21 quarter with only a minor adjustment for debt extinguishment in the 12/20 quarter. The Global Growth and Efficiency program wound down at the end of 2019 with only minor amounts charged in the 9/20 quarter. We view this as a positive development for earnings quality.

Kimberly-Clark Corporation (KMB)
Earnings Quality Update- 3/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are reducing our earnings quality rating on KMB to 3- (Minor Concern).

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

Summary

KMB's reported non-GAAP EPS missed the consensus estimate by 12 cps in the 3/12 quarter. In addition, sales fell more than $200 million short of targets. The company is facing difficult comps through the first half of the year and rising input prices which it hopes to combat with more cost cuts. Meanwhile, the restructuring program continues to increase in size.

- KMB is facing higher costs in 2021 but is planning on limiting direct pricing increases and relying more on keeping promotional activity low. Remember that promotion spending shows up in results as a reduction to net revenue and is reflected as part of the net pricing impact when analyzing the components of sales growth. Note that the company received an unusually high pricing boost in its Consumer Tissue segment in the 12/20 quarter due to trade promotion activity falling well below the level the company had accrued for earlier in the year. While the company did not quantify the impact, it can be seen in the 6% boost to Consumer Tissue segment sales in the 12/20 quarter in the company's sales growth components disclosure. This 6% boost followed 0% and 1% figures in the 9/20 and 6/20 quarters, respectively. We estimate that if Consumer Tissue pricing had remained flat in the 12/20 quarter, it would have cost the company about $90 million in pretax profits or about 21 cps. This will make for difficult comps in the 12/21 quarter.

- The company also hopes to limit price increases by absorbing some of the inflationary pressures with more cost cuts. In addition to the 2018 Global Restructuring program, KMB regularly reports significant cost reductions through its FORCE program. The FORCE program is essentially a permanent cost reduction process that has been going on for

years. For example, the company claimed $455 million in cost savings from the FORCE program in 2020, $260 million in 2019, and $375 million in 2018. For 2021, the company is projecting $340-$360 million in FORCE savings in 2021. On the positive side, the company does not add back charges related to the FORCE program to non-GAAP results. These are simply excess costs that the company has found to cut. However, we find it amazing that every year they amount to around 3-4% of the company's total operating costs and are incremental to the $465 million in annual cost savings reportedly achieved so far by the 2018 Restructuring plan.

- On the subject of the 2018 Plan, according to commentary in SEC filings, KMB expanded the estimated cost of the program in the 12/20 quarter. Before the 2020 10-K, the company's disclosures indicated it expected to complete the restructuring program in 2021 with total charges coming in at the high end of its $1.7-$1.9 billion estimated range. However, in the 12/20 10-K, the company amended this to between $2.0-$2.1 billion. In the 3/21 quarter, the company incurred $34 million in pretax charges with $30 million of that allocated to the "other exit costs" category. The extension of the program size with most of the increase occurring in an open-ended category make it, in our opinion, more likely that costs that should be viewed as ongoing were included in the charges and added back in non-GAAP results.

- We note that a decline in "other expense" added about 2.3 cps to earnings in the quarter while a decline in "nonoperating expense" added more than a penny. We saw no explanation for these changes.

Dentsply Sirona Inc. (XRAY)
Earnings Quality Update- 3/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating of XRAY at 3+ (Minor Concern).

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

Summary

XRAY reported adjusted EPS of $0.72, which beat forecasts by 16-cents. As we predicted several tailwinds resulted in the impressive results. The first item was inventory reserves which hit $126 million in 3Q20. This reserve fell $9 million in 4Q20 and now $22 million more in 1Q21 – which generated 8-cents in EPS for the quarter. This reserve is now much closer to the normal 25% of finished goods and we do not see nearly as much tailwind for XRAY's earnings from this source going forward. A lower tax rate added 2-cents. Also worth noting is XRAY guided to $45 million in higher R&D for 2021 vs 2020. Yet, 1Q21 only came in $3 million higher. We estimate that added 2-3 more cents to EPS in the period.

SG&A overall came in 350bp lower. Some of that is leveraging higher sales and some is cost savings. In total, that was $36 million. XRAY admitted on the call that some of this was also due to it being slower than expected in rolling out new marketing, boosting sales incentives, and probably still saw lower travel costs from the prior year. We're not going to say XRAY picked up 13-cents in all short-term items here as expense growth lagged. However, we do think the company added at least 3-5 cents in this area. They are guiding to a ramp-up in marketing and promotions and guiding to higher shipping costs going forward. XRAY is also going to emphasize a retail marketing program to appeal directly to consumers.

Essentially, we believe the entire EPS beat can be explained in just these items and none of them look likely to repeat. Bad debt reserves had been declining to help EPS in the last two quarters, but were flat in 1Q21 for no EPS help.

Inventories remain low at 102 days of sales, up from the lowest figure in years at 83 days. Normally, DSIs are over 120 days. We think this along with low inventory reserve charges still point to a strong gross margin in 2Q21. The company still sees some acceleration of sales – but warned that a shortage of chips could negatively impact its technology sales. There was still no accrual or resolution to the $546 million deduction the IRS wants to disallow and is going through the appeals process.

LyondellBasell Industries (LYB) Earnings Quality Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of LYB at a 5+ (Strong).

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

Summary

LYB beat forecasts by 54-cents in 1Q21. Much of that is continued rising demand that is outstripping supply, resulting in higher pricing for LYB's product. The Texas freeze in 1Q resulted in more capacity going off-line for periods of time too. A large amount of the US chemical production footprint is behind on orders and inventories remain low. Many competitors delayed maintenance in 2020 and will see more downtime in 2021. LYB does not have that issue in the near future. We would expect earnings to continue to ramp upward. The only earnings quality issue with LYB is the recurring adjustment to inventory marks to the lower of cost or market – and with prices increasing, LYB did not have that adjustment in 1Q.

What is strong?

- Earnings and EBITDA are recovering rapidly. Purchasing into a producing JV in Louisiana during December is already boosting earnings too. Even with the refinery not clicking yet, LYB is likely to see EBITDA recover above an $8 billion annual run rate.

- LYB continues to maintain a solid balance sheet. It spent $2.5 billion on acquisitions for the JV deals in 4Q20, which boosted net debt by $2.0 billion to $13.5 billion. LYB is on pace to pay down debt to about $12.0 billion this year – giving it a debt/EBITDA of only 1.5x. Debt reduction was $500 million in 1Q21, another $500 million in April, and LYB guided toward total debt reduction of $3+ billion in 2021.

- **Inventories are low. LYB should be able to produce at high operating levels and leverage fixed costs in producing as much as possible.** It needs to build inventories back, but lost time from the Texas freeze in 1Q and competitors having capacity offline for maintenance may make that tough. According to LYB on the call, *“It will likely require quite some time before North American polyethylene industry can fulfill backlogs, satisfy domestic demand and return to last year's pace of selling 40% of production into the export market to serve global demand. And this scenario of replenishing inventory over the course of 2021 does not factor in an additional wave of demand that is likely to arise in the second half of this year from restocking and increased activity in the travel, leisure, and hospitality sectors as vaccines provide for increased mobility.”*

	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19
Inventory	$4,632	$4,344	$4,005	$3,768	$3,973	$4,588	$4,446	$4,685
COGS	$7,678	$6,712	$5,885	$4,894	$6,868	$7,044	$7,269	$7,542
DSI	55.1	59.1	62.1	70.3	52.8	59.4	55.8	56.7

What is weak?

- Cash Flow is being hit by rising working capital in the form of higher priced produce working through the balance sheet as well as sales and cost of goods on the income statement. Income is rising too, and LYB thinks it will be able to build inventory in terms of DSIs in the near future. We’re long past when higher-cost goods were being replaced at lower prices like 2Q20 and working capital was being released:

	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19
Income w/o LCM	$1,070	$763	$427	$226	$495	$637	$965	$1,003
Cash Opers	$571	$743	$827	$1,292	$542	$1,242	$1,876	$1,186
EBITDA	$1,585	$1,264	$888	$664	$1,065	$1,205	$1,513	$1,579

  During 1Q21, working capital was a $626 million headwind, which was twice our forecast. But income is rising rapidly and EBITDA is back above a $6 billion run-rate already.

- We believe LYB can make its goals of $2 billion in CapX and a Dividend of about $1.5 billion. **However, retiring $3 billion in debt may be tough to reach in 2021.** We envision at least another $700 million in working capital growth this year too. Depreciation for the next three-quarters is just over $1 billion and net income could top $4 billion for the rest of the year for $5 billion in cash from operations + $571 for 1Q21 less $700 million in working capital for net $4.9 billion in cash from operations. That leaves $1.4 billion for debt reduction and would put the company in position to have debt of about $12 billion.

- The refinery business is still being hurt from a combination of issues – lower spreads on heavy crude vs. brent crude and still below normal consumption of jet fuel. In the 1Q, LYB's refinery was also hit by the Texas Freeze that cut power and led to a shutdown period too. The refinery posted -$110 million in EBITDA.

The Hershey Company (HSY)
Earnings Quality Update- 3/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are upgrading our earnings quality rating on HSY to 5+ (Strong)

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

HSY reported EPS of $1.92, 12 cps ahead of consensus. Sales came in over $180 million above consensus.

- Earnings received a 2 cps tailwind from lower write-downs of equity investments (included in other income). This was not adjusted out of non-GAAP results.

- The effective adjusted tax rate returned to a more normal 22.5% compared to 19.1% last year. This cost the company over 8 cps in EPS growth in the period.

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.

Disclosure

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