BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Sealed Air (SEE)- 1Q19 Update
Maintain NEUTRAL

We are maintaining the Neutral rating on SEE and reducing the EQ Rating to a 3- (Minor Concern)

We understand why people own Sealed Air. It has sizeable exposure to e-commerce, which is growing at double-digit rates worldwide as well as exposure to perishable food with the world eating more protein. At 16x 2019 EPS and just under 11x EBITDA – the stock looks cheap against that macro tailwind.

What is becoming tougher to ignore is why doesn't it grow as a result of all these fast-growing tailwinds? Moreover, cash flow is under pressure and one of the primary sources of EPS growth is share repurchases, which are declining as free cash flow falls. Working capital has already been stretched to produce more cash flow too. Debt may not be problematic, but it is also rising following another acquisition. We are supposed to accept that the new restructuring plan will boost margins and revenues. However, we will refer

readers to our January 2019 report on SEE that describes our issues with this new plan and noted the company has been restructuring since 2015 with little to show for it in terms of sales growth or margin gains. More importantly, the last restructuring appeared much more extensive than the current plan, yet the current plan is now expected to produce greater results and add more tailwind for the stock price. We always consider multiple restructurings a red flag – especially when later ones are expected to outdo prior ones when there would have been low-hanging fruit to pick. We also consider it a red flag when companies change the make-up of their key metrics such as Price and Volume and changing what units are in which divisions to cloud comparability.

We see a company where volume growth is weak to negative, where constant currency revenue growth is being skewed by huge price hikes at a division representing only 5% of sales that essentially vanishes after accounting for FX. Free cash flow is falling, the debt level is above its target level after the latest acquisition, and share repurchases cannot be counted on to help much on EPS growth.

- **Where is the Free Cash Flow Going? Less than one year ago, Free Cash Flow guidance was $400 million for 2018. It finished the year at $311 million. Guidance for 2019 is for only $250 million** even though it expects higher capital spending and higher restructuring charges that put it closer to $190 million adjusting 2018's $311 million as a starting point.

- **Free Cash Flow still looks overstated to us because acquisitions are routinely part of the growth plan, not the occasional event. It just announced another one with the purchase of Automated Packaging Systems. In addition, working capital has already been stretched to boost cash flow** and that may be tougher to continue. We see issues with receivables, payables, and inventories.

- **A key source of EPS growth is share repurchases, which we see stalling to almost zero this year.** That source of growth was juiced with the $2.15 billion sale of the Diversey unit in 2017. Now, debt is rising again, free cash is falling, and EPS growth from share repurchases is shrinking. In 4Q18, SEE was already at the share count it is guiding to for 2019.

- **SEE could overcome some of these issues if it actually grew but is not showing much at all. It's not as though e-commerce just began last year. It has been disrupting traditional retailing for over a decade and the market is showing double-digit growth rates in volume. SEE is posting negative volume.** The conference call was full of

questions about how SEE will hit guidance and the answer given most had few details and came down to "we think our 2nd half will improve."

- **Changing the definition of volume, price, and moving countries to different divisions is part of the latest restructuring – why? We're not certain how that boosts margins, but it does cloud comparability of past results to future results.** When we see things like that we think of Newell – which is going for Kilauea's 35-year continuous eruption record in clouding results. SEE is nowhere near that level but this is a red flag for us.

- **Pricing seems to be the primary source of growth** and yet SEE is selling a commodity product in many cases. When it offers a premium product, it may often have higher raw material costs such as plant-based or recycled components. Also, SEE's customers are focused on reducing fulfillment costs.

- **Despite the increase in price, gross margin is flat.** The company said it enjoyed a windfall for profits as it took pricing against resin costs that came in below forecast. We believe customers will push back against this.

- **Investors should be aware that FX is a sizeable variable here. SEE already cut guidance only 7-months ago due to FX pressures. We think the bigger issue with the FX problem is it can effectively boost SEE's prices to customers, and they lose the sales. That can have a bigger impact on results than changes that occur in the translation of foreign currencies back to dollars. It's showing the weakest results in Europe and Asia at getting pricing increases and holding them.**

- **South America looks to be overstating the company's constant currency growth rate. South America is less than 5% of sales, yet it has been the greatest source of price increases.** SEE looks at that figure in reporting constant currency growth. The FX loss at South America effectively wipes out all its growth, but that is occurring below the constant currency line. **Backing out South America from results, SEE's 4%-5% growth becomes less than 3%. It would have been negative in 1Q19.**

Free Cash Flow Is Falling with Latest Restructuring

When we first started following Sealed Air, we were not concerned about its dividend being cut. It only consumes about $100-$105 million in cash per year and with the yield only 1.4% we did not think many investors were buying SEE for the income. We still doubt, it faces much pressure, but free cash flow here is falling rapidly:

	1Q19	1Q18	2018	2017	2016
Cash from Ops	$65.1	-$33.7	$428.0	$424.4	$906.9
Capital Exp.	$49.4	$43.4	$168.6	$183.8	$275.7
One-time adj	$0.0	$14.0	$52.0	$181.0	$0.0
Free Cash Flow	$15.7	-$63.1	$311.4	$421.6	$631.2

The one-time adjustments relate to charges from the one-time sale of Diversey. We still do not think this shows the full picture because the company routinely makes acquisitions and it routinely has negative cash costs for FX and settling hedges.

	1Q19	1Q18	2018	2017	2016
Free Cash Flow	$15.7	-$63.1	$311.4	$421.6	$631.2
Acquisitions	$0.0	$0.0	$68.0	$119.0	$6.0
FX charges	$4.0	$0.0	$11.0	$71.0	$46.0
Adj. FCF	$11.7	-$63.1	$232.4	$231.6	$579.2

After the first quarter, SEE paid $510 million for another acquisition. Also, the company has started its latest restructuring program. That is expected to cost $225-$255 million in cash, and the forecast is for $115 million to hit in 2019. This new restructuring is expected to add $10 million to capital spending and total 2019 capital spending is forecast at $200 million – up $31 million from 2018.

There may be some tax savings from the $115 million in restructuring to make that closer to $90 million. **Already, the 2019 forecast of $250 million looks suspect to us because last year's $311 million less another $90 million in restructuring costs and another $31 million in capital spending is $190 million in free cash flow – not $250 million.** We already know they spent $510 million that will boost interest expense as well and there is not a provision for FX yet in the mix.

The restructuring charge won't be a one-time event either. The new plan is expected to cost $225-$255 million in cash so another $110-$140 million will hit in 2020 and 2021 and hurt free cash flow again. Further acquisitions will also crimp cash flow in later years.

We also question if working capital can provide much more cash flow or if it will become a greater drain on cash from operations:

Acct Rec	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
DSOs	38.1	34.3	39.1	39.1	37.5	41.1	43.6	26.5

At first glance, trade receivables look fairly steady to down. On closer examination, SEE has securitization programs in place to sell receivables, At the end of 2017, there was no balance. At the end of 4Q18, there was $83.9 million and the end of 1Q19, there was $75.0 million. That adds 6 days to the figures. Suddenly, DSOs aren't dropping from 41 to 34 looking at 4Q to 4Q – they are actually 41 to 40. In 1Q19, the figure rises to 44 days.

Also, SEE sells other receivables in factoring deals. They do not list amounts outstanding at the end of periods but disclose what was sold over a period of time. We know that $181 million was sold in 2017, $250 million in 2018 and $73 million in 1Q19. So, these amounts are rising from $500,000 per day in 2017 to $680,000 per day in 2018 to $800,000 per day in early 2019. If these factored receivables are being collected at the same 44-day timeframe – that would effectively add about 2.9 days to DSOs in 2019, 2.3 to DSOs in 2018 and 1.8 to DSOs in 2017. At best we can say total DSOs are flat or may be increasing slightly.

What we do know is that receivables have been a tailwind for Cash from Operations in 1Q after becoming neutral in 2018.

	1Q19	2018	2017	2016
A/R Impact	$18.2	-$0.9	-$81.4	-$33.9
Cash Ops	$65.1	$428.0	$424.4	$906.9

What if SEE cannot sell or factor receivables at rising rates going forward? These programs are already producing a decent amount of cash flow. Right now, receivables of $464 million may have another $110 million essentially off the balance sheet. For a company forecasting only $250 million in free cash flow, a change of $10-$20 million in receivables could be meaningful.

Also, cash flow is being helped by stretching payables to offset higher inventories. There appear to be problems here as well:

	1Q19	2018	2017	2016
A/P Impact	$5.1	$42.6	$154.1	$228.0
Inv. Impact	-$54.0	-$61.2	-$55.4	-$17.1
Net change	-$48.9	-$18.6	$98.7	$210.9
Cash from Ops	$65.1	$428.0	$424.4	$906.9

Cash flow has faced a drain from inventory and offset that by boosting payables. That stalled in 2018, the same time working capital essentially started to get help by selling receivables. The payables impact appears to be losing steam as a cash source, yet days outstanding continue to rise:

Acct Pay	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
DSPs	93.9	81.1	86.2	91.1	88.0	77.2	92.1	81.2

Y/Y the increase has been 4-5 days the last two quarters. On the cash flow statement, this is already showing signs of becoming a headwind. This is a $770 million account on the balance sheet. If DSPs actually fall by 4-5 days, it would consume about $40 million in cash flow. Again, this company is starting at closer to $190 million for free cash flow based on the forecast for restructuring and capital spending compared to guidance for $250 million. If payables become a headwind – it could become even tougher to hit guidance.

Inventories are rising too.

Inventory	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
DSIs	72.9	57.7	67.3	66.9	68.0	54.1	64.9	66.8

These are rising about 4-5 days Y/Y as well. If the company can slow this or reverse it, it may help cash flow. We're only skeptical because after restructuring for years, it has continued to be a headwind. Moreover, most companies already have a goal of running with less inventory and SEE isn't showing improvement.

We are most concerned with payables becoming a headwind. If that costs SEE $40 million in cash flow against what already looks like an aggressive forecast of $250 million in free cash flow, where does the rest come from? Growth? Please read on.

These Cash Flow Issues Are Impacting Share Repurchases and Debt

We have talked about this in the past, but forecasts on EPS of $2.65-$2.75 in 2019 against 2018's $2.50 look modest. That's only 6%-10% growth. In recent quarters, EPS growth has far exceeded that. But, much of that came from share repurchases:

	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
Repurchases	$18	$49	$126	$96	$312	$545	$452	305.0
Share Count	155.4	156.1	158.0	160.6	165.3	175.9	188.9	194.8
EPS Growth from Repo	6.4%	12.3%	19.6%	21.3%	18.4%	11.5%	4.1%	1.8%

The company used proceeds from the Diversey sale to hyper-charge the share repurchases. They are now well past that and the impact of share repurchases on growth is slowing considerably. Looking at the adjusted free cash flow after acquisitions and FX issues above, plus the fact that cash flow has been raised by selling receivables and boosting payables, it is clear the SEE cannot afford to buy shares levels seen in the past. The forecast is average shares outstanding to be 156 million for 2019. They've already been there for two quarters at this point. EPS growth from repurchases will only be 3% in 2Q and 1% in 3Q and 0% in 4Q based on current figures and forecasts.

We further do not expect the share repurchases to pick up because free cash flow is falling and expected to decline further as noted above. Moreover, the company wants to maintain debt to EBITDA between 3.5-4.0x.

They just spent $510 million on another acquisition. That will either lower cash or raise debt – either way net debt should increase by $510 million. Net debt on March 31, 2019 was $3.33 billion. It should be $3.84 billion after the deal. Forecasted EBITDA for 2019 is $925-$945. That would put the net debt to EBITDA ratio at 4.06-4.15x. That's overstating it a bit because their guidance does not yet assume any results from Automated Packaging Systems which has sales of $290 million vs. $4.7 billion for SEE. It would need to produce over $20 million in EBITDA kept the debt ratio at 4x.

Also keep in mind the working capital issues above, the fact that cash restructuring charges will also be heavy in future years and now the debt issues – we do not see the tailwind of share repurchases driving EPS growth going forward.

Where Is the Growth?

When we first wrote on Sealed Air, we were actually shocked to see how little growth there is here compared to end markets. Every grocery store, restaurant, and food company are touting “We have to get more fresh food to customers, that’s all they want.” The company making fresh food containers should be doing well. Then we see Sealed Air posting negative growth and blaming it on Brexit in the 1Q. So, the world is eating less because they are stressed over Brexit?

E-commerce is everywhere it has hurt shopping malls and traditional retailers. Now those retailers are posting double-digit growth with online sales. The economy is getting stronger too as seen in the GDP numbers. Amazon reported its shipping costs rose 21% y/y last quarter. MercadoLibre in South America had a 19% y/y growth in orders shipped last quarter. SEE also touts electronics packaging and Best Buy saw comp sales of 3% last quarter and 5% last year. Its online sales had y/y growth for the quarter and year of 9% and 10% - that should actually mean two sets of packaging – what the product came packed in and then the mailing envelope/box and its protective shipping materials. Against this tailwind, Sealed Air is complaining they had a tough comp of 3% they had to match against and posted a -4.4% figure for Product Care.

When key end markets are going at 10%-20% for product care – shouldn’t SEE be doing better than this:

SEE Growth	2018	2017	2016	2015
Food Vols	2.2%	3.8%	0.9%	1.3%
Product Vols	0.3%	5.7%	1.4%	-1.9%

SEE Growth	1Q19	4Q18	3Q18	2Q18	1Q18
Food Vols	0.4%	2.3%	3.0%	2.0%	2.0%
Product Vols	-4.4%	0.6%	-2.0%	0.3%	3.0%

First quarter comments included:

- "While organic volume was declined 1% in the quarter, this was against macro headwinds that impacted our business particularly in the industrial sector and a tough y/y comparable and protective packaging."
- "We're working hard to recover volume the remainder of the year"
- "Our strategy for Sealed Air is to grow faster than the markets we serve"
- "Food Care EMEA was down 2% due to market softness elevated by Brexit concerns"
- "Our confidence on the 2H of the year is we do think we have some volume that was short in 1Q we think we can make up in the 2H"
- They pointed that market headwinds are offsetting new customer volumes and that mailers were an area of weakness

Another small area worth pointing out is South America where MercadoLibre had 19% growth in shipping volume – SEE posted -0.1% volume change.

For all the focus on one quarter or "things will improve in the 2H of 2019" – this has been a multi-year problem. The economy has improved noticeably in recent years. The end markets are still growing rapidly. And yet, SEE never sees volume growth that reflects these improving conditions.

Another Issue – Changing the Definition of the Metrics

For us, it has always been a red flag when a company changes how it reports figures. Products move from division to division and the changes are not quantified is one example of this. Companies that did this continually like Newell and Sunbeam where one year they have 4 divisions, then 7 then 9 then 4 again makes it tough to fully break out what is happening. Sealed Air used to report Product Mix changes as part of pricing in the past and now has made that a change in volume starting in 2019.

They did not give proforma figures for prior years to quantify what this change means. So, when we see the change in 1Q19 on volumes, it is unclear if this change in presentation had a meaningful impact positive or negative.

Also, geography presentations changed. Mexico and Central America are now grouped with North America leaving South America as its own small geographical unit. This was broken out to adjust the figures in the presentation. The reason behind this was its part of the

restructuring plan to save money and boost growth. We're perplexed how this achieves that goal, but that is the explanation.

We are pointing these changes out because it reduces comparability of results in our view.

Pricing Is the Primary Growth Source

We noted in the August 2018 that SEE did not have a great history of taking pricing. Much of what it sells is commodity type things made from readily available raw commodities such as bubble wrap from resin and mailers from kraft paper/plastic resin.

SEE Growth	2018	2017	2016	2015
Food Price	2.9%	0.0%	0.3%	2.6%
Product Price	3.1%	0.6%	-1.8%	1.3%

In 2018, the company actually took some pricing as petroleum costs rose. Those have started to flatten out at this point.

SEE Growth	1Q19	4Q18	3Q18	2Q18
Food Price	3.0%	3.8%	3.0%	3.0%
Product Price	0.9%	1.3%	4.0%	5.0%

We see several problems with this for sustainability of results. The first is FX is often a headwind for sales and the US Dollar has become stronger than many other currencies in the last 2-3 years. When people talk about FX losses, they are referring to the costs of hedging and translating sales overseas into dollars. What is impossible to quantify is a rising dollar makes US goods more expensive in other local currencies. That effectively raises prices for US goods and the US company may end up losing sales altogether. That should be a larger problem of losing 100 cents of the dollar rather than losing 1-cent on the dollar in the final translation. **This makes it tough for US companies in this situation to continue boosting price AND getting an FX price hike too. Looking at where SEE's weakest pricing has come from – it's been from overseas**

Price chg	1Q19	4Q18	2018
EMEA	0.6%	1.9%	1.4%
SA/LA*	25.1%	19.0%	11.1%
APAC	0.1%	-0.6%	-0.4%
Nor. Am	1.4%	1.4%	3.1%

- Latin America lost Central America and Mexico to North American unit in 1Q19

The company gets 21.2 % of sales from Europe/Middle East/Africa and 15.3% from Asia Pacific. Those currencies have weakened against the dollar and SEE was unable to push through or sustain pricing anywhere close to what the US accepted.

South America and Latin America get special treatment as those areas were selling based on US dollar-linked terms. The FX translation has been a significant loss below the reported organic growth line:

SA/LA*	1Q19	4Q18	2018
Price Growth	25.1%	19.0%	11.1%
Vol Growth	-0.1%	-1.6%	5.7%
Total $ Growth	$14.7	$20.1	$69.0
FX	-$18.9	-$25.8	-$62.6

Here's why this is a big deal. Sealed Air reports its results on a constant dollar growth/decline rate. **In looking at the net impact of the currency against total growth at South and Latin America – it clearly is a unit showing negative growth** – the FX losses exceed the income growth from price hikes and volume growth is negative too. **However, before the FX translation, this 4.9% bit of sales looks like it is growing like a weed. In fact, this is a huge part of SEE's reported constant currency growth:**

Constant $ growth	1Q19	4Q18	2018
SA/LA	$14.7	$20.1	$69.0
Total Company	$8.8	$53.7	$200.7
Total Growth Rate	0.8%	4.4%	4.5%
Adj Growth Rate	-0.5%	2.7%	3.0%

Investors are hearing revenue is growing at 4.4%-4.5% figures before FX. However, taking out just 5% of the business where FX is a huge issue, the actual growth rate is closer to 3% and was negative in 1Q19.

Raising prices with rising raw materials is not helping gross margin either. Gross margin was down to 32.8% in 1Q19 vs. 33.1% in 1Q18. In 2018 and 2017 Gross margin was 31.7%. So, SEE has taken some pricing, but we would not be surprised if some of that revenue is lost to competition and customers asking for price relief. On the 1Q call, they noted that the company enjoyed some higher resin pricing even though resin costs came in below forecast. For the quarter, sales fell $11 million with a $25 million boost from price hikes. EBTIDA rose $11 million with $22 million from price hikes.

This looks like another potential area of disappointment to us. They are having a tough time pushing and holding price hikes in foreign markets. They claim they had some windfall resin related EBITDA in the quarter due to price hikes – those situations tend to balance out in our view. And the South American situation using constant currency results appears to be overstating the full company's growth.

Ocean Yield (OCY.NO, OYIEF) – 1Q19 update

We are maintaining the NEUTRAL rating on Ocean Yield. Very little has changed since our last update from February 14, 2019.

- FPSO under option to Aker as it finalizes its deals to develop the fields in Ghana that require an FPSO. Appraisal drilling tests are complete and Aker has sent final plans to Ghana authorities for approval.

- FPSO is earning about $1.5 million per month in 2Q19 from the option, that may be extended shortly until the deal with Ghana and Aker is complete. The goal is to finalize a long-term deal for the FPSO after that that could boost the $1.5 million per month to something closer to $60-$70 million per year as oil production begins in 2021.

- The *Farstad* vessels return to generating revenue and EBITDA on June 20 and the *Connector* vessel has had short term contracts in 2Q with more interest for additional work. Both of those situations produced no cash flow in 1Q.

- Looking at sources and uses of cash for the next 12-months, Ocean Yield has the cash flow plus cash liquidity to meet obligations plus the dividend. To maintain the dividend, Ocean Yield will likely need to see the potential long term deal for the FPSO signed during the next two quarters.

The largest issue remains the FPSO vessel that has left India and is in Sri Lanka being repaired and readied for redeployment. Aker has it under an option contract through May 2019 that will likely be extended soon paying approximately $1.5 million per month. Aker would use the FPSO in Ghana under a long-term contract if that field is developed and the vessel would likely be modified during the early phase of the deal. Aker announced in late April that it completed its appraisal drilling in the area and remain committed to developing the field. It also sent some changes to Ghana's authorities to finalize drilling plans and is awaiting their final approval.

Ocean Yield has maintained its dividend and cited the possibility of a long-term deal for the FPSO as the reason. The structure of a deal should include Aker taking over the operating costs and paying daily rate as the vessel is modified during the initial work and drilling if the Ghana project moves forward. The revenue level should then rise as oil is delivered,

which is currently planned for 2021. The lack of revenue and operating costs for both the FPSO and *Connector* was a -$11.8 million impact in 1Q19. In 2Q19, both received revenues and the FPSO costs were transferred to Aker.

The revenue waiver for the *Far Statesman* and *Far Senator* concludes on June 20, so that impacted 1Q19 and will impact almost the full 2Q19. That revenue will return in 3Q and 4Q.

The *Connector* vessel has been on a short-term charter in 2Q that may go into mid-June. Ocean Yield is seeing more requests at this point and some are looking for longer deals. The company believes it will benefit from the market getting stronger and is delaying taking a long-term contract until pricing firms more.

The company produced EBITDA of $67.8 million in 1Q. That will grow in 2Q with revenue from *Connector*, FPSO and the start of the revenue deferrals ending in late June as well as moving the FPSO operating expenses. More new vessels continue to come online as well. The company only owes $27 million on funding for remaining ships on order and has $139 million in liquidity. Total net debt due in the next 12-months is $89 million ($105 million is expected to refinance):

So total cash needs and sources are:

Cash needs	Next 4Qs	Cash sources	Next 4Qs
Interest Exp.	$100.0	1Q EBITDA x4	$271.2
Cap Ex	$27.0	FPSO $1.5/mth	$18.0
Debt Maturities	$89.0	Farstad 3Qs	$21.0
Dividends	$122.0	Cash/Liquidity	$139.0
Total	$338.0		$449.2

In addition to the cash sources listed above, any work the *Connector* receives will add to that total as will the additional ships scheduled to arrive in the coming months. While the company eventually needs to get the long-term future for the FPSO and the *Connector* determined and have them contributing more to the cash inflow – we believe Ocean Yield has already factored this situation in when it paid the dividend the last three quarters. Only the *Farstad* situation changed for 6 months of deferring revenue. Based on discussions from 4Q, Ocean Yield would be looking at the FPSO generating about $60-$70 million in EBITDA per year if the Aker deal is finalized. That makes this situation work long term.

Kraft Heinz (KHC) EQ Update- Detail from 8-Ks

We currently have a 2+ (Weak) rating on KHC from our review of the 9/18 quarter. We will postpone updating the rating given the continued delay in the filing of the 10-K and now the first quarter 10-Q.

It is tempting to look at KHC's forward PE of under 12 and its 4.9% yield (adjusted for the recent cut) and conclude that when all the noise surrounding the SEC investigation and the massive write-off dies down that the stock will prove to be cheap. However, investors should not forget that the write-down stems from a deteriorating outlook for the company's business. Organic sales growth in the US in 4Q18 was only 1.1% as pricing and increased promotional activity are taking their toll on growth and margins. The company has a decades-long history of acquiring brands, booking huge goodwill and intangibles balances, and then taking massive write-offs. We are skeptical that the latest fiasco will be the last. Now, the newly-appointed CEO's time will be taken up dealing with the fallout of all the bad news rather than dealing with the company's growth problems. Debt exceeds sales, payables have been stretched to 90 days, and the receivables securitization program has been wound down. Therefore, we believe KHC is far from out of the woods.

Our 3/1/19 overview of goodwill highlighted that KHC's 12/18 quarterly results included a massive write-off to goodwill and intangibles as well as the disclosure of an October 2018 SEC subpoena. The company has been delayed in releasing both its 10-K filing for 2018 as well as its 10-Q filing for the first quarter. We pieced together the following timeline since the beginning of the year from a series of 8-K filings.

- On 2/21/2019, KHC announced in its earnings press release for the 12/18 quarter that it was taking a $15.6 billion write-down to goodwill and intangibles. In addition, it disclosed that it received a subpoena from the SEC in October of 2018 pertaining to its accounting policies, procedures and internal controls related to its procurement function including agreements, side agreements and changes or modification to its agreements with vendors.

- The company also announced in its 4Q results that it had launched an internal investigation into its procurement processes as well as recording a $25 million increase to 4Q cost of sales as "an out of period correction" as the company determined the amounts were "immaterial" to the fourth quarter of 2018 and its previously reported 2018 and 2017 interim and year to date periods.

- On 2/28/2019, the company filed an 8-K declaring that it would not make its deadline for filing its 10-K for the 2018 fiscal year. In addition, it disclosed more details pertaining to the goodwill and intangibles write-downs mostly as a result of declines in sales and margin forecasts. Key write-downs included in the $7.1 billion reduction in goodwill included an almost 40% reduction in goodwill associated with the key US Refrigerated Foods segment and a 50% reduction in the Canada Retail Segment. The $8.3 billion write-down to intangibles included a 26% reduction in the carrying value of the *Kraft* brand name and a 50% reduction in the *Oscar Mayer* brand name. We have long criticized the company's ongoing cycle of high-priced acquisitions followed by charges and write-offs. Keep in mind that even after the write-off, the company has almost $70 billion in goodwill and intangibles remaining on its balance sheet.

- On 3/15/2019, KHC filed an 8-K disclosing that it had received notice that the late filing of its 10-K put it out of compliance with Nasdaq listing rules. The company has 60 days to submit a plan to regain compliance with Nasdaq and could be granted another 180 days from the original due date if the plan is approved. With the internal investigation largely complete, we would expect the 180 days to be adequate time to complete the 10-K.

- Similarly, on 3/22/2019, KHC filed an 8-K revealing that JPMorganChase had granted it a waiver for the deadline to file its 10-K under the company's senior revolving credit agreement. The deadline was extended to 5/14/2019 which is fast approaching. KHC had no outstanding borrowings under the agreement as of 12/2018, so even if KHC missed the deadline it would not appear to have an immediate impact on near-term liquidity. However, this poses a headline risk and demonstrates the complications that the situation with the SEC brings with it.

- On 5/6/2019, KHC filed an 8-K disclosing that the company will be restating its annual financial statements for 2016 and 2017 as well as the quarterly financial statements for 2017 and through September of 2018. This will result in the company missing the deadline for filing its first quarter 10-Q. Its internal investigation into its procurement area is now substantially complete. KHC revealed that "several" employees in the procurement area (none were in senior management) were engaged in misconduct which resulted in misstatements from the incorrect timing of recognition of cost and rebate components related to complex supplier contracts and arrangements. The restatements will involve increases to previously-reported cost of sales to reflect the recognition of supplier rebates over time rather than up front. In

addition, KHC identified that certain of the arrangements in the contracts were improperly classified as embedded capital leases. The correction of these errors did not impact 2017 net income and resulted in a decrease to 2018 net loss of $2 million. However, 2017 adjusted EBITDA will be reduced by $2 million and 2018 EBITDA reduced by $33 million.

- In addition, the company revealed in the 5/6/2019 8-K that it made errors in the calculation of impairment losses it reported in the 2/28/2019 8-K. While the net correction resulted in only a $13 million increase in the total impairment, the offsetting amounts were huge. Errors in the allocation of forecasted cash flows resulted in an increase in the impairment loss associated with intangibles assets of $278 million, while errors related to goodwill reduced the impairment by $173 million. Also, the corrections related to the supplier rebate misstatements reduced the goodwill impairment by another $92 million. All combined, these adjustments led to the $13 million increase in impairments. We find it remarkable that such large positive mistakes essentially offset a large negative. It is worth considering that the estimation of the value of goodwill involves considerable management judgment and is sensitive to the estimation of future growth rates and the selection of hurdles rates. It was disclosed in the 5/6/2019 8-K that the SEC issued another subpoena requesting not only more information on the procurement area but also information on the impairment charge. We would not be shocked to see future adjustments to the impairment charges.

- Management has stated multiple times that the misstatements were "immaterial" to any of the periods in question. However, the total amount of required adjustments related to the timing of recognition of rebates and expenses on supplier contracts totaled $208 million. The 3Q17 adjustment totaled 60 bps of sales and the 4Q18 adjustment totaled almost 40 bps of sales. If analysts at the time had been told that gross margins were actually lower by 40-60 bps, we believe they would have considered the impact to be material.

- The company will also be reporting two or more material weaknesses in its internal control over financial reporting in its 10-K. We pointed out in our 9/27/2018 earnings quality review that KHC has already identified material weaknesses in internal control in the 9/17 quarter related to the improper classification of cash flows from receivables securitizations as operating cash flows which led to restatements of the 3/17and 6/17 financials to the tune of several hundred million dollars.

- As noted above, the latest 8-K also revealed that the company received another subpoena from the SEC on 3/1/2019 which is associated with its impairment of goodwill and intangibles and also requests documents related to the procurement area. Our main concern here is further headline risk and the potential fallout of delays in future filings.

Air Products & Chemicals (APD) EQ Update-3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
4+	3-

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

We increase our earnings quality rating to a 4+ (Acceptable) from a 3- (Minor Concern).

- Our biggest earnings quality concern with APD in the last quarter was the benefit from the change in estimates for contracts accounted for under the percentage of completion method. However, there was no benefit from this source in the 3/19 quarter which is the main reason for the increase in our rating.

- Inventory DSIs jumped by more than 4 days over the year-ago quarter. The change to 100% FIFO for all US inventories two quarters ago likely drove much of the increase along with higher costs. We are not overly concerned by the increase but will monitor it going forward.

Procter & Gamble (PG) EQ Update- 3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

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

We maintain our earnings quality rating at 3- (Minor Concern)

- The company continued to warn in its 10-Q for the 3/19 quarter that the fair value of the Shave Care goodwill and Gillette intangibles is eroding and remains susceptible to impairment. The combined carrying value was $35 billion as of March 2019. Disclosures show a 25 bps change in either discount rate or short-term and residual growth rate estimates could reduce the fair value for 6%.

- Advertising expense as a percentage of sales fell on an absolute basis and by 50 bps as a percentage of sales. The company indicated this was due to scale and savings an agency compensation, but also due to new accounting requirements that resulted in certain marketing costs now being classified as a reduction to sales rather than SG&A expense. This has the effect of decreasing advertising as a percentage of sales even if the amount of spending remained flat.

- Days payable jumped over 4 days versus the year-ago quarter partly driven by a continued extension of supplier payments terms.

- Our ongoing concerns with PG include ongoing restructuring charges and free cash flow not covering the dividend and the buyback. When including cash generated by the exercise of stock options, the shortfall is more than covered, but we consider this an unreliable source of cash flow. Interestingly, the number of shares declined by only 0.3% year-over-year in the 3/19 quarter due to an increased number of shares issued to satisfy stock options.

Explanation of EQ Rating Scale

Rating	Explanation
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.

Disclosure

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