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Sealed Air – 2Q Update
Downgrade to SELL

We are lowering our EQ rating on SEE to a 2- (Weak) and cutting the recommendation to a SELL after 2Q19 earnings. The company missed revenue by $10.4 million but beat Adjusted EPS forecasts by 16-cents. We see several items that account for that beat that may not repeat. More importantly, we continue to see little growth here at all beyond benefiting from hyperinflation on pricing in South America. We also question how much of new guidance is actually a stealth cut since the forecasts beat in both 1Q and 2Q and the company is adding another acquisition for five months. Yet, targets have not been boosted very much. The company's SEC investigation appears to be getting larger in scope too.

- **Without South America, is there any growth here at all?** We have talked about the short-comings of booking huge price hikes in adjusted constant currency growth but ignoring the very large FX losses. SEE lost on FX in every region. Without South America's inflation pricing, sales growth basically disappears at SEE. The company

is also adding in acquired sales to boost the constant currency growth figure. That was another 2.5% of the total.

- **Forward revenues face more headwinds. Receivables and DSOs already appear very high** and the company has been securitizing more of them along with boosting its factoring activities. **That may have already pulled some sales forward. Brazilian volume growth in 2Q may have come against a very easy comp against the trucking strike in 2Q18.**

- **Sealed Air is attractive to investors as a way to play e-commerce growth. SEE is cutting forecasts for its product care unit from 1.5% to negative 3.0%.** This is due to major customers seeking to reduce the amount of packing materials in shipments. It does not sound like a short-term headwind.

- **Price Cost Spread came in much higher than forecast and helped sales and EBITDA. Essentially, SEE enjoyed lower prices for raw materials, but still pushed through stronger pricing.** This was called out as a big success of its Reinvent SEE program. However, going forward **even SEE admits that customer pricing will more closely track raw materials** and this windfall will shrink. **High inventories also point to pressure on selling prices and margins going forward.**

- **We question if SEE actually raised guidance at all**. It acquired a company with $290 million in sales, which should add $120 million in 2019, yet raised sales guidance only $50 million. EBITDA forecasts rose $15-$25 million, yet the acquisition will add $10-12 million and the price cost spread may have already added $20 million above plan. Adjusted EPS guidance rose 5-cents, but beats in 1Q and 2Q already are 18-cents and they expect another 2-cents from a lower share count now.

- **Free Cash Flow forecasts were reduced as SEE has additional one-time payments the 2H19. However, we think it may be worse than that because to reach targets it will need to see working capital become a sizeable source of cash flow in 2H19.** Also, the company does not include acquisitions in free cash flow but has already spent $473 million on more this year, which more than consumes the $180 million FCF target.

- **The company beat on EPS by 16-cents, but we can find several items that total that amount that should be one-time in nature or are a low-quality source of earnings.** These include reversing a Brazilian tax overpayment valuation, adding back professional fees paid to the 3rd parties not related to restructuring, a drop in stock

compensation, the pricing from South America, the unexpected price cost income windfall…

- The **SEC investigations may be expanding after the company fired the CFO.** We put the new and prior language side by side. It's $1.49 billion tax dispute also continues.

Revenue Still Being Driven by South America Pricing

SEE reported 1% revenue growth in 2Q19 but 4% on its constant currency adjustment. We think both figures are overstated by rounding and acquisitions. Here is the basic report per Sealed Air:

SEE 2Q Sales	Px	Vol	Acq	FX	GAAP	Organic	SEE - CC
components	1.0%	0.5%	2.5%	-3.5%	0.5%	-1.0%	4.0%

Sealed Air reported 0.5% sales growth under GAAP due to a large FX negative. That is still with acquisitions adding 2.5% to growth. It defines Constant Currency growth as Price + Volume + Acquisitions to reach 4.0%. With over 40% of sales from overseas, including part of North America – FX is a constant issue for SEE. We do not believe the company should be viewed as though FX is not part of the equation here. It often dictates pricing too as it must compete on local currency terms just to make the sale before the FX translation of that sale is taken into account.

More importantly, we think hyperinflation in Argentina as part of South America is delivering over 100% of the pricing that SEE is posting as sales growth. South America is less than 5% of total sales, but look at the impact it is having:

SEE 2Q Sales	No. Am	EMEA	So. Am	APAC	Total
Price	-$2.7	$0.7	$13.7	$0.2	$11.9
Volume	$10.9	-$1.4	$2.9	-$7.1	$5.3
C-C Growth	$8.2	-$0.7	$16.6	-$6.9	$17.2
FX impact	-$1.1	-$15.2	-$15.7	-$8.8	-$40.8
Net	$7.1	-$15.9	$0.9	-$15.7	-$23.6

SEE lost money in FX at every unit. Look at the pricing gain taken in South America vs the size of the FX hit. South America does not look that strong when considering the full

impact of what is happening there. Stripping out South America means Pricing becomes a negative figure at -$1.8 million and Volume is cut by more than half to $2.4 million. Net organic growth before FX falls to a mere $0.6 million, which is 0% y/y vs. 1.5%. So basically, all the constant currency growth at SEE was produced by South America. The company would have still had a -2.3% hit from FX and 2.5% positive from acquisitions. That means its only source of constant currency growth by its definition would be from acquired sales. Nothing internally generated would have helped.

More Problems for Revenues

Receivables are already very high too, which may be an indication that SEE cannot pull more demand forward as easily. We noted last quarter that DSOs were 38.1 and they were the same in 2Q19. However, the company securitized $78.5 million of receivables at the end 2Q19 vs. $75 million at the end of 1Q19 and $62.4 million in 2Q18. That is worth about 6.2 more in DSOs now vs. 4.9 days last year. Then, we already noted that SEE has been selling larger amounts of receivables via factoring deals. We do not know the amount of those receivables outstanding but they sold $84.5 million during 2Q19 and $72.9 million in 1Q19. This continues to grow vs. $181 million in all of 2017 and $250 million in all of 2018. They are now selling about $930,000 of receivables per day vs. $500,000 per day two years ago. Even with that, the on-balance sheet DSOs are starting to tick up from late 2018.

In summary, SEE only grew sales by $5.8 million y/y for 2Q19. That's with acquisitions too. A/R on the balance sheet is down $10.3 million, securitizations are up $14.1 million, and it appears factored receivables are up about $22 million as a rough estimate. Sales growth of 1% is about $11 million, and it appears they are growing receivables faster than that.

We focused above on South America producing more than 100% of the pricing power at SEE before giving it all back as FX losses. Under actual GAAP – this is a nice headwind for revenues. **During the call, SEE pointed out that South America also benefited from 15% volume growth in Brazil. We know from Mondelez that a trucking strike in Brazil helped drive results there in the y/y comp. We believe that would have helped SEE as well.** The strike lasted 10-days in 2Q18 and stopped the volume of traffic and shipping by shutting down highways. SEE also listed a stronger export market and equipment sales in Brazil y/y. To the extent Brazil was helped by the absence of a strike in 2019, we'd view that as a one-time event. Remember, total company volume growth was only $5.3 million before FX and $2.9 million came from South America.

Product Care is about 38% of total sales at SEE. This is where e-commerce would be primarily located. SEE just posted -2.5% volume growth for 2Q19 and -3.4% for 1H19 in this unit. Pricing was also not very strong. The company believes this will be hurt by product transition among customers, decelerating growth rates, and trade issues:

Jim Sullivan CFO

> ***"For product care organic sales growth, we have revised our forecast to be down approximately 3% compared to our previous expectation of up 1.5%.*** *This revision is largely due to the slowdown we've been experiencing in the industrial sector particularly in North America and China."*

Asked about Amazon's initiatives to optimize box size and is that a negative for product care and how long, Ted Doheny CEO responded:

> ***"As they go to package zones container, they're looking for less stuff in the package,*** *and also driving automation. So, the issue is can we drive an automated solution that's actually loading the package automatically.* ***So that transition will take over time, it will take time…So the transition is in place. It is showing up in our business and what we've lost in the product care business.*** *But we feel pretty confident that over time, and hopefully sooner rather than later, we'll get some of that business back and more."*

The company also noted that African Swine Fever would impact some of the fresh protein volumes it depends on. It should help South America and North America volumes – however, there are trade issues between the US and China of course. It also believes there will be volumes lost as the trade occurs with whole frozen carcasses rather than wrapped fresh protein. They have less to do with frozen and this could be a headwind too.

Price/Cost spread we will discuss below as the company breaks it down as a net figure that helps/hurts EBITDA not revenue. We know all the pricing came from South America in 2Q, but **the company benefited from lower raw material costs, which should have taken pricing down even further in other markets. Guidance would indicate that issue is still coming too.**

The stock popped after the earnings beat reported for 2Q19. Underneath that, revenue growth was very poor in our view driven almost entirely by hyperinflation pricing in South America. However, there are also signs of some mild channel stuffing given the rise in

securitized and sold receivables; the growth in Brazilian volumes may be short-lived growth off an easy comp; SEE just reduced its forecast for product care revenue growth by 450bp and it is now a negative growth rate; the transition to less packaging materials sounds like it is more than a short-term issue; and there may be some negative impacts on fresh protein too.

How Real is the Guidance Raise?

After 2Q19 results, SEE raised guidance for revenue, adjusted EPS, adjusted EBITDA and cut Free Cash Flow:

SEE Guidance	Sales	Adj EBITDA	Adj EPS	FCF
Original	$4.80b	$925-$945	$2.65-$2.75	$250.0
Now	$4.85b	$950-$960	$2.70-$2.80	$180.0

On sales, the company still expects 5% constant currency growth and a -$130 million impact from FX in both sets of guidance. **It is forecasting sales up $50 million. Acquisitions have become a larger part of the deal with the APS purchase. APS was doing $290 million in sales and finishing the last five months should be worth about $120 million.** On the surface, they cut sales guidance by about $70 million in our view. We think that stems from the issues discussed above about Product Care. We also think the higher receivables could play a role here.

On EBITDA, SEE held its same -$25 million impact from FX. **The $15-$25 million forecasted improvement comes from two areas. APS is expected to add $10-$12 million.** That is hardly organic and it cost over $500 million to add it. What the company has really touted is its Reinvent SEE restructuring program for driving this as it produced $69 million in higher EBITDA in the first two quarters of 2019 and came in over projections. The bulk of this is actually coming from the price/cost spread. This is supposed to be the result of buying more cheaply and squeezing out higher profits:

SEE Restructuring	1H Food	1H Product
Restructuring	$17.0	$11.0
Price/Cost	$26.0	$15.0

The company picked up $41 million in EBITDA from lower raw material costs and pushing through better pricing. This came in better than expected. With the APS purchase and this windfall – that is basically the increase in EBITDA guidance. The company is only forecasting about $20 million from this area in the 2H19.

We believe this could actually be a headwind going forward for several reasons. First, the company doesn't think it is sustainable. They agreed with a caller about taking advantage of a benign raw material situation in the quarter. The CFO also pointed out "*However, **keep in mind our formula pricing and Food Care is expected to be more aligned with raw material cost**. So, we are assuming less contribution from price cost spread in the third and fourth quarters."* They also expected more volume over that time, and it does not sound like SEE is forecasting that to bounce back soon so that could further hurt EBITDA with lower volumes and less price cost spread.

Also, inventories continue to rise at SEE.

SEE Inv.	2Q19	2Q18	1Q19	1Q18
DSI	69.5	66.9	72.9	68.0

Their inventories are rising at the same time they may be unable to take pricing at the same rates. Also, SEE really didn't take much pricing anywhere except South America. If the channel has been stuffed a little, the company has too much inventory and is facing lower volumes – that points to lower pricing for the price cost spread. We think SEE could miss forecasts here as it is still forecasting a positive $20 million for the 2H19.

EPS has been raised by $0.05 per share and we would argue this is actually a stealth cut just like sales after reporting a beat of 16-cents in 2Q and 2-cents in 1Q. The company reduced the number of shares for its EPS forecast from 156 to 155 million – that alone adds 2-cents for the year. There was a Brazilian tax valuation that reversed in 2Q19 and added 3-cents in the quarter, the higher price cost spread so far in 2019 is double what the company is forecasting in the second half. Let's say 10-cents was a windfall. Against that, they see a 7-cent headwind from APS and its inventory step-up charge plus higher depreciation should be largely tied to APS too. Just on the surface, EPS forecasts should be higher by 13-cents (+2 in 1Q, + 16 in 2Q + 1 for half a year of lower share count – 7 for APS) instead of 5-cent raise in guidance. Either this is a way to simply try to beat forecasts handily or it looks like a stealth cut.

Free cash flow is where the bigger issues are. The company has boosted several places for spending outflow and has other cash spending that should increase in the second half. In addition, can they continue to pull money out of working capital?

SEE FCF Guide	2019e	1H19	2H19e
EBITDA	$950	$453	$497
Interest	$190	$86	$104
Restructuring	$115	$49	$66
Taxes	$115	$29	$86
CFO pre WC	$530	$289	$241
APS deferral	$20	$0	$20
Novipax	$59	$0	$59
CapX	$210	$94	$116
FCF pre WC	$241	$195	$46
Guidance	$180	$75	$105
W/C plug	-$61	-$120	$59

This is a long table but we know 2019 guidance and 1H19 results. So 2H is essentially the difference. The company expects $44 million in higher EBITDA for the 2H19, but its outflow should be $193 million higher too. The APS payment of $20 million represents a deferred pay liability it will make in the 2H and the Novipax settlement was announced already and will be paid in 2H. The working capital and changes in other assets/liabilities were headwinds of $120 million in the 1H19. That will need to become positive in the 2H19 to reach this guidance. They lowered expected tax payments by $15 million, and added $59 for Novipax, $20 for APS deferred pay and $10 to CapX for a net change of -$74 million. So again, after glowing results and a big windfall in EBITDA from price cost and accretive EBITDA from the APS deal – Sealed Air only boosted guidance by $6 million? Plus, that requires that inventories fall, receivables fall and perhaps even payables rising again.

We also question that SEE can hit the interest expense target given it has made $473 million in cash acquisitions this year that are not in the table above. We also question this method of disclosure as the company makes acquisitions frequently as a matter of course which should be pushing up operating cash flow. Yet, by ignoring the purchase cost in free cash flow, they are essentially saying that incremental cash flow required no investment. They can't have it both ways. The $473 million in cash costs for deals will make the $180 forecasted FCF already nearly a -$300 million figure for 2019 and higher borrowing for SEE.

Factors that Impacted EPS in the Quarter

The company beat on adjusted EPS by $0.16 in the quarter. We think the following items helped there quite a bit. We are going to use the forecasted tax rate for the year of 26% to adjust these items:

- Pricing in South America. This was $13.7 million and pricing should drop mostly to the bottom line. Perhaps some wages are inflated with it, we will give them 80% of the hike. That is 5.2 cents in EPS.

- SEE reversed a $4.8 million tax valuation allowance related to overpayment of taxes in Brazil in the quarter. It lists this as recorded on a net basis into other income. That added 3.1 cents to EPS.

- We know that SEE is forecasting $115 million of restructuring charges in 2019 and it only spent $49.2 million in the first half. However, the total restructuring charges being added back is $89.4 million in the first half. That also includes a third line for something called Special Charges – which are fees related to professional services but were not grouped with other restructuring charges. This was $7.3 million in the quarter and sounds like it may be related to ongoing operations. That added 3.5 cents to adjusted EPS.

- Stock-based compensation fell from $8.4 million in 1Q to $4.8 million in 2Q. That would be 1.7 cents to EPS.

- The company sees itself at least $5 million (and it may be $20 million) ahead of forecast from the price cost issue offsetting other weakness in the business. Just the $5 million would have added 2.4 cents to EPS.

- SEE also added back an FX loss for Argentina which is driving the pricing. This was $1.3 million and boosted adjusted EPS by 0.6 cents.

We would consider much of this to be unexpected sources of income that will not repeat like the Brazilian tax credit allowance or price cost windfall. The rest looks like low-quality sources of income such as raising prices in hyperinflation and or adding back charges that may not be one-time in nature.

The SEC and Tax Issues May Be Expanding

In the 10-K, the company noted the following language:

> *"On June 25, 2018, the Company received from the staff of the SEC a subpoena for documents, including requests concerning the Company's accounting for income taxes, its financial reporting and disclosures and other matters. We are fully cooperating with the SEC on this matter and cannot predict the outcome or the duration of the SEC investigation."*

Six months later in the 10-Q, Sealed Air is saying this:

> *"The Company has received from the staff of the SEC subpoenas for documents and requests for information in connection with the SEC's previously disclosed investigation. Those subpoenas and requests seek documents and information regarding the Company's accounting for income taxes, its financial reporting and disclosures, the process by which the Company selected its independent audit firm beginning with fiscal year 2015, the independence of that audit firm, and other matters.*
>
> *Following the announcement on June 20, 2019 that the Company had terminated the employment of William G. Stiehl as Chief Financial Officer, the Company received a Grand Jury subpoena from the United States Attorney's Office for the Western District of North Carolina (the "U.S. Attorney's Office") seeking documents relating to that termination and relating to the process by which the Company selected its independent audit firm beginning with fiscal year 2015.*
>
> *The Company is fully cooperating with the SEC and the U.S. Attorney's Office and cannot predict the outcome or duration of either of those investigations."*

Sealed Air continues to point to the IRS intending to disallow a $1.49 billion tax deduction from 2014. It still refers investors back to this text in the 10-K:

> *"We are currently under examination by the IRS with respect to the deduction of the approximately $1.49 billion for the 2014 taxable year for the payments made pursuant to the Settlement agreement. The IRS has indicated that it intends to*

disallow this deduction in full. We strongly disagree with the IRS position and are protesting this finding with the IRS. The resolution of the IRS's challenge could take several years and the outcome cannot be predicted. Nevertheless, we believe that we have meritorious defenses for the deduction of the payments made pursuant to the Settlement agreement. If the IRS's disallowance of the deduction were sustained, in whole or in part, we would have to remit all or a portion of the refund of taxes previously received and such disallowance could have a material adverse effect on our consolidated financial condition and results of operations."

LyondellBasell Industries – 2Q19 Update
Maintain BUY

We maintain our BUY recommendation on LYB after 2Q19 results. The company missed forecasts by 9-cents due to the refining operation posting a larger loss than expected. It hit the low end of EBITDA forecasts at $1.58 billion. The total loss by the refinery was 24-cents vs. the 13-cent loss in 1Q. The macro events that drove the loss have good reason to reverse toward the end of the 3Q. Historically, the way LYB operates the refinery is different than much of the industry as it is designed to provide more cost-advantaged feedstock for its operations. Thus, a short-term profit squeeze in one of the smaller units is unlikely to derail the over-riding positives of LYB.

There are some headwinds for car sales and the trade situation. Also, some car sales will be under pressure based on emission standards. Given some weakness there, LYB is still seeing stronger consumer demand elsewhere offset that and is still hitting cash flow numbers in its expected long-term range.

It is our belief that LYB is no longer a boom/bust cyclical company as a high-cost producer against cheaper labor markets in Asia. That equation changed with lower feed-costs in the US 10-11 years ago. The market has still not fully embraced the idea of non-cyclical status, which is why the stock has a 5.5% yield growing at 5% and the dividend only uses about one-third of free cash flow. The market also trades it up and down on moving oil prices making the ratio of cost-advantaged feedstocks higher or lower – but they remain comfortably in the golden zone at a 17x ratio of oil/gas vs. breakeven at 8x. The stock is only 8x EPS too. After buying back 9.5% of its stock in July, liquidity remains over $5 billion.

- **The refinery is another source of flexible feedstock and a minor part of LYB's operation.** It is set up to take advantage of the discount between heavy crude and the light crude. The refinery has frequently been one of the more volatile parts of LYB and likely will remain so.

- **There is a solid reason to expect the refinery to recover by the end of the 3Q.** Heavy crude has been in short supply after Venezeula left the market, at the same time light crude from the Permian Basin has been in large supply – cutting the heavy/light spread in half. However, new sulfur rules for bunker fuel in shipping will influence

production in 3Q. That will require more light crude and less heavy – which should help the spread widen again and return the refinery to a profitable state.

- **Overcoming the cyclical label for LYB has taken longer – but many of the cyclical fears have been disproven.** The ratio of oil/gas prices has changed, but not left the range where profitability remains strong. New chemical plants have not driven up the price of gas and NGLs as the pipeline companies have opened up new supply to the plants. New plants have not cut plant utilization as Asia remains the high-cost producer and price setter as demand has for chemicals has accelerated.

- **The cost-advantage in feedstocks is more than just NGLs vs oil at LYB. The company has the ability to interchange different types and grades of various NGLs.** If the price of ethane is low, use that. If the next quarter, ethane is high – but not propane – use propane. Much of this ability to have flexible raw materials is also helping profitability and removing more of the cyclical nature for LYB.

The Refining Operation Remains the Wild Card

As we talked about in earlier reports, LYB's refinery operation has several issues the make it respond differently than other refineries. First, crude oil is refined into naphtha and then into gasoline and other fuels in most cases. However, LYB is using its naphtha as another feedstock option to make chemicals so it doesn't refine fully into gasoline. That means that the industry benchmark Maya spread has less impact on results. Second, they process more heavy sour crude, which normally trades at a discount on the market and buy from some smaller sources. Much of the local market is refining light crude coming from the Permian Basin. The changes in the heavy/light discount have a larger impact than the Maya spread. Third, refineries undergo maintenance, which impacts the volume being processed at times.

Here is a longer view of the refinery operation and the last three quarters:

Refining	2018	2017	2016	2015	2014
EBITDA	$167	$157	$72	$342	$65
Maya	$19.85	$20.56	$19.24	$22.30	$24.43

Refining	2Q19	1Q19	4Q18
EBITDA	-$66	-$15	-$84
Maya	$18.99	$13.55	$10.89

Maintenance had large impacts on reducing volumes in 2016 and late 2018. What has happened of late is the supply of heavy crude has fallen as Venezuela has gone offline. Also, some heavy crude arrives by rail, which costs more than shipping via pipeline. At the same time, there has been a surge of light crude coming to the market. The result is the discount between heavy and light has shrunk. Bob Patel of LYB noted on the call that the spread between heavy and light was about $5 in July when it normally is $8-$10.

The company has some flexibility here and can process up to 10% light crude in its refinery and it is the light crude growing in supply. However, it does not want to convert away from heavy sour as new regulations on sulfur will start kicking in late 3Q for the new production cycle in 2020. The new rules are IMO2020 – which requires ships to emit much lower levels of sulfur dioxide. One way to do that is to install scrubbers on the ship – which is a heavy investment and often tied to the age/value of the ship to determine whether that is an option. The other way is to burn low sulfur fuel, which costs more.

Currently heavy crude is a cheaper way to create bunker fuel so there is still demand for it at the same time the supply of heavy crude has fallen. What LYB and others envision is many ships will not install scrubbers and will need low sulfur bunker fuel distilled from light crude oil. Thus, the expectation is the demand for light crude will rise and help offset the pricing pressure from the growing supply of light crude. At the same time, they expect demand for heavy crude to fall as less is refined into bunker fuel, which should remove the push in pricing from lower supply. That should help the refinery situation at LYB normalize again at a higher heavy/light spread.

The forecast for LYB long term is to produce $1.5-$2.0 billion in EBITDA per quarter. There are changes in spread every quarter plus FX and other variables. But, the diverse portfolio of operations should generally be working in a positive manner and combine to reach that level of total EBITDA. In the 2Q, it was the refining side that hurt results. EBITDA was $1.58 billion with refining at a -$66 million. Historically, refining can be $50-$60 million in

a quarter so a return to that level puts LYB at $1.7 billion. There is also a tailwind from new facilities coming online in the 2Q19 and the repurchase of 9.5% of the stock.

Fears of New Supply and Bottlenecks Have Proven Unfounded

As we have discussed in prior reports, there are three basic parts to this long term growth story: 1) Natural Gas feedstocks have a cost advantage in chemical production over oil when Oil Prices are more than 8x Natural Gas prices, 2) Asia is not as cost-competitive and sets the price for chemicals, and 3) demand for chemicals is rising driven by more 2nd and 3rd world citizens joining the middle class.

One of the fears that is always happening with LYB is the stock price is positively correlated to oil prices. Yes, if oil is $54 and gas is $3, the ratio of 17x is less then when oil is $60 and the ratio is 20x. However, the underlying profitability comes from having the ratio above 8x. If the speed limit is 55mph and at 17x you're driving 80 instead of 84 when the ratio was 20x – you're still going really fast.

The other fear was that there were too many chemical plants under construction especially in the US. That was going to use up all the natural gas and NGLs being produced and the prices would rise and hurt the feedstock cost advantage of gas over oil. At the same time, it would create more chemical supply and hurt pricing and plant utilization rates would fall. None of that has happened either. As more oil has been drilled, more natural gas and NGLs have been byproducts of that process. The pipeline companies have been building new infrastructure for years and more of continues to come on-line every quarter. Thus, the feedstock supply has kept up with chemical plant demand.

LYB has also shown the capacity utilization rates which are another key to chemical pricing have stayed very high as the industry has absorbed higher capacity. LYB noted in its presentation that demand growth has accelerated with more capacity. Also, utilization which was expected to fall to about 90% - has remained above 95% during the whole time.

Conference calls continue to be filled with questions of "what are you going to do – ethane prices may rise?" Answer – "we'll use butane." What if the price of naphtha squeezes your margin in Europe?" Answer – "we'll use propane." This is a little simplistic, but if the conference call prints out to 20 pages in a given quarter – this type of discussion will consume 5-6 pages every quarter. The bigger picture here is LYB has a long term cost

advantage and it comes not only from lower feedstock costs, but feedstock flexibility to be able to quickly take advantage of what is cheapest. Here is what Bob Patel the CEO said on the call:

> "***We continue to optimize our cracker feedslate to benefit from lower NGL prices*** *in our U.S. Gulf Coast system. We've previously spoke about how much of our ethylene production was produced from NGLs.* ***It may be more useful to understand the composition of our feedslate.***
>
> ***In the second quarter, we found advantage in low propane and butane prices. More than 25% of the raw materials used in North American crackers were propane- or butane-based and more than 55% was purely ethane****. We continue to increase our utilization of mixed Y-grade NGLs as an advantaged ethylene feedstock. During the second quarter, mid single-digit percentages of our North American cracker feedslate was composed of Y-grade."*
>
> *"So first of all, your question on butane really we should think about propane and butane together.* ***We can crack up to 40% - or 40% of our ethylene can come from propane and butane. 40% of our feedslate can be propane and butane.*** *Yes, indeed, it did benefit our oxyfuels as well especially here in the U.S. So, I think there was – again, it highlights our feedstock flexibility and our ability to be resilient in a range of energy price environments.*
>
> *In terms of Y-grade, we're continuing to increase our demonstration of our ability to crack Y-grade. So soon, we'll have demonstrated on four of our crackers on the Gulf Coast that we can crack Y-grade.* ***So, when ethane prices were a bit higher, Y-grade made a lot of sense for us. Today with where ethane is, ethane is far better from an economic perspective. the way to think about Y-grade is that it's one more lever in our ability to flex feedstocks to maximize value.*** *And I think now we're very confident that we can do this at meaningful rates."*

Starwood Property Trust – 2Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on STWD and this was another solid quarter. If anything, the level of safety is improving here on a number of fronts. We will highlight some of those in a brief update:

- STWD is one of the few investments that sees rising EPS if LIBOR rises or declines. The company has 94% of its loan investments as floating rate tied to LIBOR. However, on the downside, there are also interest rate floors. STWD did a stress test in December when the volatility was wild and found that it could survive marking all investments down based on an instant 20% drop in property values and a 250bp wider spread on all loan valuations. It would not need to raise capital and would have plenty of liquidity to take advantage of the bargains in that situation

- STWD has improved its situation further. LIBOR moving up or down makes it more money now as a result of diversifying away from bank warehouse lines for funding along with the floors on loans. Here is what the change in LIBOR meant in 4Q18 and after 2Q19:

STWD EPS	Libor -200bp	Libor -100bp	Libor +100bp	Libor +200bp
4Q18	-$0.01	-$0.04	$0.07	$0.15
2Q19	$0.12	$0.03	$0.05	$0.11

In our view, this is a nice situation to have amid some of the recent volatility in the market on a stock paying over 8% cash dividend yield.

- The company has actively diversified its funding sources away from heavy reliance on bank warehouse lines that can be off-balance sheet. This includes a CLO financing that was priced very attractively and boosted returns over bank lending without the risk of recourse or credit marks. A-Notes also remove some of those risks and as well as helping on term matching the investment to the borrowing. As Barry Sternlicht noted, banks have a nasty habit of calling short loans in tough times.

- STWD is diversifying more internationally. The book is 16% International now vs 8% in 2018. LTV remains low. We listened to a call from Brookfield Infrastructure Partners on Real Estate last week too and they highlighted several areas of real estate based on its historic valuation range and where it sits now – numerous areas of cheaper real estate were overseas from their analysis. Specifically, Brookfield cited many tech companies wanting a larger Asian physical presence but not in China or Hong Kong as something helping Asian real estate. Also, Europe e-commerce is a big laggard vs. the US at less than 8% of retail sales vs. more than 15% in the US. Yet, the real estate to serve e-commerce is about 1/3rd the supply per capita in Europe vs. the US.

- Both STWD and Brookfield cited slower economic growth helps real estate values by restricting new supply and allowing rents to rise, pushing down cap rates and boosting real estate values. STWD still believes the confluence of macro-events regarding interest rates and trade pose greater volatility risks and has thus taken down its risk profile as described above.

- It should also be noted that STWD continues to out-earn its dividend with core EPS of 52-cents and the dividend of 48-cents. Much of the dilution we talked about in prior updates due to convertible securities is now past. So, lower risk profile overall and greater safety on the dividend that exceeds 8%.

- Book value is penalized by $1.24 per share for depreciation. It also does not reflect an estimated $2.50 per share in unrealized gains on property investments where cash rents just rose another 6%. It was noted that as these are affordable housing units, when the rent increases, it represents the new floor for income on these properties. The company may refinance at a lower rate and further drive the return and pull out some cash to invest elsewhere and also help income. Book value is listed at $16.49, but realistically could be $20.23 given this background.

Ball Corp. (BLL) EQ Review-6/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

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

We are maintaining our earnings quality rating to 2- (Weak)

- DSOs calculated on trade receivables and unbilled receivables on the balance sheet fell by 1.7 days versus the year-ago quarter. However, when we add back the outstanding sold receivables, DSO increases by 7 days. The bulk of the increase in receivables on the balance sheet is coming from unbilled receivables which may be the result of rapid sales in the aerospace segment. However, even if we completely remove unbilled receivables from the DSO calculation, we still get a 3-day YOY increase in DSOs which is a red flag.

- Contract liabilities (deferred revenue) fell versus the year-ago period which could indicate slower bookings or more aggressive revenue recognition. Like unbilled receivables, we suspect contract liabilities are more related to the aerospace business than the base packaging business. Aerospace sales rose by more than 30% which makes the decline in contract liabilities look even more peculiar.

- Trailing 12-month cash from operations declined to $1.39 billion from $1.69 billion. While the company contributed about $60 million more to its pension plans in the six months ended 6/19 compared to the year-ago period, this would have been more than compensated for by the rapid increase in receivables sales.

- Free cash flow after the dividend and accelerated buyback was a deficit of more than $360 million. The 3.7% reduction in share count was a huge boost to the 10.3% growth in adjusted EPS.

- Pension cost declined by $8 million (1.8 cps) due to lower service cost and lower recognized actuarial loss.

Adjusted DSOs Continue to Climb

We have highlighted the company's accounts receivable factoring program under which the company sells its receivables to accelerate the receipt of cash. These receivables are removed from the company's balance sheet at the time of sale, so to get a true picture of how much the company is extending credit to its customers, we must add back the sold but still outstanding balances to the balance sheet receivables. The amounts and the calculation of days sales outstanding (DSO) are shown below for the last six quarters. The 6/19 and 3/19 quarters are adjusted for China beverage packaging receivables which had been designated as held for sale while the 6/18 quarter is adjusted for US food and steel aerosol receivables that were designated as held for sale.

	6/30/2019	3/31/2019	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Sales	$3,017	$2,785	$2,803	$2,946	$3,101	$2,785
Gross Trade Receivables	$1,017	$958	$812	$1,052	$1,259	$1,332
Gross Unbilled Receivables	$503	$477	$478	$359	$390	$429
Held for Sale	$107	$100	$0	$0	$78	$0
Allowance	$9	$9	$10	$11	$9	$10
Net Trade & Unbilled Receivables	$1,618	$1,526	$1,280	$1,400	$1,718	$1,751
Outstanding Sold Receivables	$1,092	$1,008	$1,022	$942	$838	$589
Trade and Unbilled Receivable DSOs	48.9	50.0	41.7	43.4	50.6	57.4
Outstanding Sold Receivable DSO	33.0	33.0	33.3	29.2	24.7	19.3
Adjusted DSOs	82.9	83.0	74.9	72.5	75.2	76.7

We can see that net trade & unbilled receivables DSOs have been declining on a year-over-year basis. However, we see that DSOs calculated on just outstanding sold receivables balances jumped by most than 8 days which drove the total adjusted receivable DSOs up from 75.2 to 82.0. We have noted in previous reviews that the company's receivable patterns could be impacted by the disproportionate growth in the company's aerospace business which could generate more in receivables. We note that the increase in unbilled receivables is likely related to the growth in revenue under long term contracts in the aerospace division. However, even if we take the unbilled receivables balances completely out of the DSO calculation, we still get a 3-day increase in DSOs. The company does have some long-term contracts in its aluminum packaging business so it is possible that some of the increase in unbilled receivables could be coming from that area. Therefore, we believe it is reasonable to assume that at least half of the increase in adjusted DSO is coming from receivables generated by the base business.

Deferred Revenue Down

Another minor red flag in the area of revenue recognition is the decline in contract liabilities (deferred revenue.) Contract liabilities include cash received from customers that has not yet been recognized as revenue. Current and non-current contract liabilities are shown below along with the days of sales of total contract liabilities:

	6/30/2019	3/31/2019	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Current Contract Liabilities	$52	$57	$45	$67	$65	$52
Non-Current Contract Liabilities	$9	$10	$8	$8	$6	$6
	$61	$67	$53	$75	$71	$58
Days of Sales	1.8	2.2	1.7	2.3	2.1	1.9

A decline in contract liabilities is an indication that either the company is booking less revenue, or it has become more aggressive in recognizing its deferred revenue balances. Like unbilled receivables discussed above, the contract liabilities are likely disproportionately attributable to revenues from the aerospace business. The fact that aerospace sales are growing much faster than the base business makes the decline in contract liabilities look even more peculiar.

Baxter International (BAX) EQ Review-6/19 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 are maintaining our earnings quality rating of 3- (Minor Concern)

- The adjusted 6/19 quarter's tax rate of 10.8% was better than management's expectations due to a favorable tax ruling and stock compensation deductions. Management did not quantify these impacts, but we note that its previous estimated effective tax rate for the full year was 18%. This implies as much as a 7 cps benefit to adjusted EPS in the quarter or almost all of the 8 cps beat.

- R&D adjusted for unusual items fell to 5.0% of revenue versus 5.8% last year. The 10-Q states that the decline was due to the "timing of project-related expenditures compared to the prior year" and favorable currency translation. However, in the call, management attributed the decline in adjusted R&D to "benefit from our efforts to enhance our processes and optimize our R&D organization while prioritizing strategic investment in our innovative pipeline." Management had indicated in previous calls that it expected an increase in R&D spending in the remainder of 2019. This is the second quarter of more than 3 cps in tailwind from lower adjusted R&D and we doubt that tailwind will last the year.

- BAX discloses contract assets in its footnotes. These represent unbilled receivables and are mostly related to its contract manufacturing and software products where work is done or products are provided ahead of billing. Disclosure began with the adoption ASC 606 in 2018 so we only have a few quarters of data. Over that time, the balance has tracked closely to $80 million but jumped to $89 million in the 6/19 quarter versus $79 million last year and $73 million in the 3/19 quarter. Such a sudden jump in unbilled receivables can indicate the company has become more aggressive in recognizing revenue in the current period. This is admittedly not a material increase, but it is an area to keep an eye on in future periods.

- The company took a $31 million impairment charge related to a developed technology intangible asset due to declining market expectations. This amount was removed from the adjusted EPS figure.

- The year-over-year climb in inventory DSIs moderated to just 3 days in the 6/19 quarter. Management has been candid in admitting this was a problem area it was looking to fix and reiterated that it expects inventory to return to a "normal level" by the end of the year.

- The company noted in the 10-Q that the quarter ending 9/19 will benefit from the recognition of $40 million of insurance proceeds related to Hurricane Maria.

Stryker (SYK) EQ Review-6/19 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 are maintaining our earnings quality rating of 3- (Minor Concern)

SYK reported strong acquisition-volume growth across all of its product segments in the 6/19 quarter and topped EPS targets by 4 cps. Our overall level of concern for the company's earnings quality is not high, but there are still some minor points to take note of. A jump in receivables DSOs and a decline in contract liabilities constitute a decline in the earnings quality for the quarter, prompting us to reduce our rating to 3- (Minor Concern) from 3+ (Minor Concern).

- Accounts receivable DSOs in the 6/19 quarter jumped by 2.8 days over last year's second quarter. SYK's receivables generally stay very consistent and the DSO increase of more than 2 days is unusual. SYK had a strong performance in revenue growth in the quarter with the top line solidly beating the consensus estimates. Regardless, we are somewhat concerned that the jump in receivables could be signaling that disproportionate amount of sales could have fallen at the end of the quarter which could be a drag on revenue in the 9/19 quarter.

- The company discloses its contract liability balances in its footnotes which represents cash received from customers at the inception of contracts which is recognized as revenue over the contract term, typically less than a year. The balance fell to $321 million from $337 million last year and $331 million in the 3/19 quarter despite the increase in revenues. The year-over-year decline represents 1.2 days of sales. This looks out of place as the company experienced strong acquisition-adjusted volume growth in all its product segments. While this could be due to the timing of contract signings in certain businesses, it could also be indicating an acceleration of revenue recognition in the quarter. For perspective, if contract liabilities had remained constant on a days of sales basis, it would have taken approximately $50 million off of revenue in the quarter.

- SYK continues to supplement its R&D spending by acquiring smaller companies. In March, SYK paid $110 million for OrthoSpace with another $110 million in future

milestone payments possible. The company specializes in orthopedic biodegradable technology for the treatment of rotator cuff tears. The company booked $114 million in goodwill in the deal (which will not be amortized). This follows the November acquisition of K2M for $1.38 billion. Of that deal, $788 million of the purchase price was booked as goodwill (not amortized) with another $475 million booked as developed technology and patents with the related amortization added back to adjusted non-GAAP EPS. While the booking of the intangibles is the proper treatment under GAAP, we have always believed this overstates results since the company would have had to expense the R&D if it had developed the technology in-house. SYK's decision to add back the amortization of acquired intangibles to adjusted EPS is common in the industry but nonetheless leads to an unrealistic impression of the company's real earnings, in our opinion. For perspective, the company's adjusted EPS of $1.98 for the 6/19 quarters includes $0.26 per share of amortization of acquired intangibles expense added back.

- Growth in prepaid expenses days of sales leveled out in the quarter after several quarters of year-over-year increases in the 2-4 day range. We were uncertain of the source of increases in the past, but the moderation of growth in the 6/19 quarter alleviates concern that results benefitted from the increased capitalization of expenses.

- Inventory DSIs jumped by 9 days over the year-ago quarter, continuing a string of increases. We realize that medical device companies carry large inventory balances to facilitate the fulfillment of orders or various sizes and models of its products. We also understand that the release of new products requires a rapid buildout of inventory to prepare to provide the necessary sizes of products as needed. Nevertheless, the current DSI level of 230 compares with 221, 204 and 182 for the 6/18, 6/17 and 6/16 quarters respectively. We have seen similar trends with other medical device companies which may simply be an indication of a secular increase in working capital needs for the industry as well as rising raw materials costs.

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.

Disclosure

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