BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH
BTN Research
November 6, 2020
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LyondellBasell Industries (LYB) 3Q'20 Update
Maintain BUY

We are maintaining our BUY recommendation on LYB after EPS of $1.27 beat forecasts by 14-cents. Earnings are clean as well. Because LYB deals with petrochemicals that have volatile prices it marks them to the lower of cost or market every quarter. It removed a 40-cent benefit for LCM in the quarter. It also took an impairment on its refinery and it did add that charge back. That's the extent of the adjustments. Volumes were basically flat y/y for 3Q so demand is strong at this point and growing.

- We expect inventory to increase still. LYB is acknowledging this also after 3Q. The DSIs actually look high at the moment, but that is due to low cost of goods. It appears that LYB is light by about $500 million in inventory:

	3Q20	2Q20	1Q20	4Q19
Inventory	$4,005	$3,768	$3,973	$4,588
COGS	$5,885	$4,894	$6,868	$7,044
DSIs	62.1	70.3	52.8	59.4

	3Q19	2Q19	1Q!9	4Q18
Inventory	$4,446	$4,685	$4,496	$4,515
COGS	$7,269	$7,542	$7,446	$7,728
DSIs	55.8	56.7	55.1	53.3

Rebuilding some inventory should consume some cash flow going forward. We noted that LYB had enjoyed cash flow from having working capital drop in 1Q and 2Q – it became a cash drain for 3Q:

	3Q20	2Q20	1Q20
Cash from Ops	$827	$1,292	$542
Chg in A/R	-$335	$483	$4
Chg in Inv	-11	342	121
Chg in A/P	$395	$280	-$356
Chg in Other	-$51	$280	-$356
Work Cap. Chg	-$2	$1,385	-$587

When asked if LYB would have a seasonal slowdown that often happens is 4Q and the CEO noted inventory building would likely happen under that circumstance as demand is too strong for the level they are carrying now, *"likely if there's some slowdown in demand, certainly, we, as a company, **will take the opportunity to rebuild some inventory. We're at very, very low levels today and really kind of hand to mouth on many products**."*

- **We had speculated that rebuilding inventories and higher demand may crimp margins a bit as it could mean higher raw material prices. LYB is actually seeing that raw materials remain in overabundance.** It noted that 500,000 barrels of ethane are still being rejected by the market so supply exceeds demand. Further, if natural gas prices increase with winter, it could stimulate more drilling and thus NGLs would rise too.

  At the same time, demand is growing and the industry is low on inventory. Demand in China is exceeding its production and imports are up there. That should help margins with firmer pricing. Gross margins in 2018 were 15%-17%, they bottomed in 1Q20 at 8% and has been 12% and 13% in 2Q20 and 3Q20. **The margins are not getting squeezed as demand rises at this point.**

- **The impairment of the refinery is understandable. LYB marked down the value of the refinery by $582 million to a carrying value of $560 million.** This is due to a lack of heavy sour crude. Normally a larger part of the profits per barrel at LYB's refinery comes from buying heavy crude at a discount to light/intermediate crude. There has been a shift in supply with the latter exceeding demand and pushing down the price while there is less new drilling for heavy sour crude – pushing up its price. The spread is much smaller.

  Also, while miles driven is recovering, demand for jet fuel remains much lower than pre-COVID. That is also hurting prices and revenues for the refinery. We have discussed in the past that this is the smallest part of LYB's business. This

impairment was the primary adjustment to reported EPS. **Going forward, LYB will benefit from lower depreciation on the refinery. We estimate that will add 3-5-cents to quarterly EPS.**

- LYB acquired 50% of two JVs of existing properties. One is in China – Bora deal for $472 million. The second is in Louisiana – Sasol for $2 billion that should close in 4Q. The rationale for both deals is adding capacity in a quicker manner to deal with rising demand and avoiding the various pitfalls and delays that can come from building new assets with capital spending.

  - The net result is to expect capital spending to decline and Free cash flow increase from that along with the cash flow of these projects.
  - LYB will focus on its dividend but will devote cash flow that would have gone toward share repurchases to rapid debt repayament from the Sasol deal.
  - Debt is $11.6 billion and will become $13.6b when the Sasol deal closes. Trailing EBITDA is $3.6 billion so the debt ratio is 3.8x before adding in any JV income.
  - Pre-COVID EBITDA was normally about $5.5-$6.0 billion, which would be a 2.5x debt ratio returning to those days and volumes were flat y/y in 3Q already.
  - The Bora deal will retire debt at the JV level first – so LYB does not expect to receive dividends from Bora for two years.

- The PO/TBA project has been delayed until the end of 2022 – about one year. That delay preserved cash during COVID. Also one of the big uses for the TBA products is for fuel additives. That is a market that is depressed with COVID so the delay makes sense. The downside is that is adding to construction activities and tariffs have added to the cost of the project as well. LYB is estimating this project could come in 30% over initial projected cost. That will reduce the ROI to about 10%. That could set LYB up for a future impairment on this project.

Explanation of EQ Rating Scale

Rating	Description
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.

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