BEHIND THE NUMBERS
Quality of Earnings Analysis
February 5, 2021

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LyondellBasell Industries (LYB) Earnings Quality Update

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

We are initiating earnings quality coverage of LYB with a 5+ rating.

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

Summary

We are discontinuing our process of buy/sell ratings in favor of utilizing our quarterly focus list to highlight our highest conviction and timeliest long ideas and sell recommendations. As such, we are retiring our buy rating on LYB and initiating earnings quality coverage with a 5+ (Strong) rating.

LYB beat estimates handily by $0.86 as its markets are seeing a surge in demand world-wide, capacity utilization is already high, and raw material pricing remains benign and is not in short supply. LYB should see cash flow remain elevated as a result of these factors and its capital spending budget should decline. We expect working capital to build further, but there should be considerable cash flow to retire debt, support the dividend, and perhaps grow the dividend as well.

In terms of earnings quality, we consider LYB very strong. It has only one recurring non-GAAP adjustment to EPS – a non-cash charge to mark inventory values to the lower of cost or market at the end of each quarter. There have been modest integration charges after the A.Schulman deal that were not adjusted for in non-GAAP earnings nor was the impairment charge on the refinery in 3Q20. In 3Q20, LYB wrote off $582 million of the value for its Houston refinery. That was understandable for two reasons: Lower driving and flying reduced demand for gasoline and jet fuel significantly plus the refinery is set up to buy heavy crude at a discount and realize a higher margin per barrel and with less oil demand and less heavy crude, that discount level has narrowed. LYB is running the refinery. This write-off will add 3-5 cents to quarterly EPS going forward from lower depreciation. That is our largest criticism of earnings quality.

What is strong?

- Much of the working capital has been built back. We noted that in 2Q, LYB reported cash from operations of $1.3 billion but $1.4 billion came from releasing working capital. The price of raw materials plays a role here too, but we estimate that 4Q saw cash flow hit by about $0.6 billion as working capital grew on the balance sheet. Historically, receivables are $3.5 billion and currently sit at $3.4 billion while payables are normally just over $3 billion and sit at just under $3 billion now. We follow the inventories most closely and LYB has seen these rebuild also:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Inventory	$4,344	$4,005	$3,768	$3,973	$4,588	$4,446	$4,685	$4,496
COGS	$6,712	$5,885	$4,894	$6,868	$7,044	$7,269	$7,542	$7,446
DSI	59.1	62.1	70.3	52.8	59.4	55.8	56.7	55.1

- **As demand is strong, LYB is having a tough time keeping some inventory on hand. It was noted on the call that polypropylene levels are at all-time lows. We expect that working capital could remain a headwind on cash flow.** However, offsetting is rapidly rising EBITDA. Also, LYB said that price increases in January are flowing through and February may see more pricing.

  Earnings and cash flow have improved rapidly post 2Q20.

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Income w/o LCM	$763	$427	$226	$495	$637	$965	$1,003	$817
Cash Opers	$743	$827	$1,292	$542	$1,242	$1,876	$1,186	$657
EBITDA	$1,266	$888	$664	$1,065	$1,205	$1,513	$1,579	$1,428

The big surge in CFO in 3Q19 and 2Q20 came from working capital being released. We could envision another $200-$300 million of headwind in 1Q21 as a result of continuing to rebuild. However, the growing inventory and accompanying increase in payables may offset much of this.

- **New investments are also expected to be lower than in past years.** LYB believes its maintenance spending is about $1 billion per year and it intends to spend another $1 billion on growth projects such as the Channelview PO/TBA plant expected to open in 2023. Thus, $2 billion in annual capital spending for 2021-23. This should lighten up cash needs for LYB considerably:

	2020	2019	2018
CapX	$1,947	$2,694	$2,105
Acquisitions	$2,472	$0	$1,776
Dividend	$1,405	$1,462	$1,554
Total	$5,824	$4,156	$5,435

Even with all the Covid problems that hurt results in 2020, LYB still posted enough cash flow to cover all its planned capital spending and dividends for 2021 without a rebound in operations that is already showing signs of beginning.

- The integration costs for the Schulman acquisition – now called Advanced Polymer Solutions – were not added back to adjusted EPS and were actually fairly minor. We give LYB high marks for earnings quality here. They also noted that they finished it. Compared to some other companies we follow where restructuring programs only seem to grow with time, it is refreshing to see one actually end.

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Integration	$0	$7	$16	$14	$38	$43	$19	$16
EPS	$0.00	$0.01	$0.03	$0.04	$0.08	$0.10	$0.04	$0.03

This is a company that was making $10-$12 in EPS per year before Covid. They were not spending a fortune on integration.

What is weak?

- The dividend is $1.4-$1.5 billion so LYB needs $3.4-$3.5 billion in cash flow to cover its needs. Last year, cash flow was impaired heavily in 1Q and 2Q – 2Q was essentially a zero if it had not released so much working capital. The results come in at $3.4 billion in cash from operations. This is compared to most years of $5.0-$5.5 billion. EBITDA is normally $6-$7 billion as well and came in at $3.9 billion in 2020. They have three units that are still underperforming. The refinery, which is the smallest part of the business, intermediates & derivatives, and technology – together, these three units were $1 billion of the lower EBITDA in 2020.

   - Technology is normally lumpy and 2020's drop of $87 million in EBITDA was largely due to not reaching revenue milestones. It seems likely to bounce back in 2021.

   - The refinery is being hurt by lower driving, less air travel, and a weak crack spread. Results here bounce around, but are normally small numbers – positive $150 million to -$100 million. We do not expect a recovery here in the near future even with higher driving as the crack spread is about half normal levels still. However, the drop of $224 million in 2020 is likely as bad as it can get.

   - Intermediates fell $714 million. A big part of this is tied to gasoline additives. Lower driving in Covid meant less gasoline usage and excess supply of these chemicals pushing down margins along with volumes. The rest of the products are basic materials for plastics and liquids like pesticides – demand there is not impaired. LYB believes this should see a bounce in 2021's 2H as the economy opens more and people return to driving. It does not require a return to air travel. From the 4Q call, *"So as driving recovers, we don't even need air travel to recover back to the original or pre-COVID levels. If driving recovers with vaccinations and more domestic travel, we could really see both Refining and Oxyfuels contribute in the second half."*

What to watch

- Several new projects are now in place that should add to results in 2021. In 3Q21, LYB spent $472 million for a 50% interest in a Chinese chemical cracker JV. This already contributed to equity income in the 4Q21. It is expected to produce $150 million in EBITDA. In 4Q21, LYB spent $2 billion for a 50% interest in a Lousiana chemical plant that is expected to add $300 million in EBITDA. In 2018, LYB bought A.Schulman which has a larger share of sales to the auto industry. The integration of that purchase is now complete and LYB is reporting it has $200 million of synergies in place that should be evident as auto production and other markets rebound. This unit saw sales fall almost $1 billion in 2020, but EBITDA only fell by $46 million. The better margins are evident in 3Q and 4Q:

APS unit	4Q20	4Q19	3Q20	3Q19
Sales	$1,108	$1,067	$1,004	$1,186
EBITDA	$152	$54	$157	$102
Margin	13.7%	5.1%	15.6%	8.6%

The JVs should appear in equity income and it has already starting to rise with only modest contributions from the new JVs:

	4Q20	4Q19	3Q20	3Q19
Eq Income	$133	$46	$62	$51

These areas of new earnings/cash flow growth should offset weakness in the fuel markets. These represent about $650 million in new EBITDA and the work is already done.

- Debt is elevated after the two JV acquisitions at $13.5 billion. On 2020's Covid impaired EBITDA of $3.8 billion – the debt ratio is 3.5x. The company is planning to pay down debt with excess cash flow after capital spending and the dividend. As EBITDA recovers and 4Q20 was up y/y and the awful 2Q20 is replaced, the ratio should decline too. The debt ratio is 2.4x based on 2019's non-Covid's results without JV contributions. Getting under 2x may require about $1 billion in debt reduction.

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
EBITDA	$1,266	$888	$664	$1,065	$1,205	$1,513	$1,579	$1,428

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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