BEHIND
THE NUMBERS
Quality of Earnings Analysis
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LyondellBasell Industries N.V. (LYB)
Focus List –Add to Top Buy

It seems that each year, LYB has a 20% sell-off at some point which makes little sense to us, but it provides a great entry-point. In our view, the valuation is compelling. At $100 per share, LYB is trading for 5.9x EBITDA of $8 billion. It has a 4.5% dividend yield, and the $1.13 quarterly dividend was increased by 7.6% in 2021.

The cash flow model is easily sustainable. LYB expects $2.0 billion in capital spending with half being maintenance and the other half generating growth. The dividend is $1.5 billion. Against the $3.5 billion in outflow, cash flow from operations is normally > $5.5 billion. LYB intends to pay debt down further from the current $14 billion (1.75x EBITDA) to $12 billion (1.5x EBITDA) before resuming share repurchases.

Why the recent sell-off?

The increase in natural gas prices is the primary reason. LYB has the flexibility to use feedstocks from natural gas or oil. Natural gas feedstocks have a competitive edge over oil when oil is priced at more than 8.5x natural gas. The current ratio is 20-1. However, the market is looking at natural gas rising from about $2.50 to $3.75 in 2021 against oil rising from $50-$75. The ratio has been 20-1 the whole time. The fear is rising feedstock costs will hurt LYB margins.

What the market is missing?

- Demand is exceeding supply in plastics. This is allowing LYB to boost prices. LYB noted that contract prices on polyethylene rose $950/ton from May 2020-March 2021. Another $300/ton price of increases were coming in April and May of 2021.

- China is the marginal higher cost-producer and sets the prices. China imports much of its raw materials including 40% of its polyethylene. Demand in that area is up 23% post-Covid and the supply going to China is dropping:

  - Demand is also growing in the US and absorbing more of the supply
  - The Texas Freeze shut down power and chemical feedstock supply and resulted in lost supply.
  - LYB noted that spot market sales were down to zero in April, inventories are very low, and they are on allocation to meet contracted orders. Shipments to China have fallen considerably.

- Also, EBITDA moves more based on heavy maintenance schedules or lack of them – as well as LYB's refinery. From 2015-today – gas and even more oil prices have moved widely. Yet, LYB's EBITDA has been +/- $7 billion during that time. In years, 2019, 2018, and 2016 – maintenance was heavier and that meant lower volumes produced with downtimes. The key is LYB does not have a heavy maintenance schedule in the next couple of quarters and several of its competitors do. That should also keep supply below demand.

	2020	2019	2018	2017	2016	2015
Total LYB EBITDA	$3,883	$5,725	$6,867	$7,134	$6,631	$8,081
Refinery EBITDA	-$289	-$65	$167	$157	$72	$519

The LYB refinery is set up to buy heavy/sour crude at a discount and refine it into gasoline. There are times when the spread between heavy and intermediate crude narrows and that impacts the profitability of the refinery. Obviously, Covid meant less driving and flying so that hurt fuel demand too.

We would argue that LYB has seen oil range from $30 to $100+ and at a range of 15-40x natural gas and has posted very consistent results.

What is Different Now?

- LYB's underlying business is probably more of an $8 billion enterprise. It added two new operating businesses in 4Q20 and 1Q21 that will add $1.0-$1.2 billion to base EBITDA
- The refinery should only have upside at this point from the 2020 lows.
- LYB is building projects that will generate another $1.0 billion in EBITDA that will be added to forecasts for 2022 and 2023.

- LYB pulled over $200 million in costs out of its Schulman acquisition. A big part of those sales go to car manufacturing as part of the advanced polymer unit. The cost savings are hidden from view because manufacturing was down for so much of 2020 that lower volumes didn't leverage fixed costs. Schulman should generate higher EBITDA too with Covid recovery.

- The company's cash flow is returning and LYB is focused on retiring debt. It paid down $500 million in 1Q21 and another $500 million in April 2021. Every $1 billion in lower debt adds $3 to the stock price without changing EV/EBITDA multiples.

- LYB has a history of repurchasing shares, paying a high dividend and growing it, even paying special dividends, and maintaining low leverage. As they meet their goal of reducing debt to about $12 billion, the higher EBITDA and cash flow should allow for share repurchases to resume.

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.

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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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