BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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LyondellBasell Industries (LYB) 2Q20 Update
Maintain BUY

We are maintaining our BUY recommendation on LYB after it missed 2Q20 forecasts by 1-cent on depressed earnings caused by large drops in volume. The overriding long-term advantages have all returned at this point and this company should see earnings and cash flow recover going forward – with some headwinds in 3Q.

- US natural gas liquid feedstocks have a cost advantage over foreign oil-based chemical feedstocks.

  "When naphtha-based [oil-based] costs became favored during March and April, some speculated that the curve would have remained inverted, and eliminating the U.S. shale gas advantage. ***<u>As economies began reopening during May and June, the cost curve quickly began slow and reasserted the advantage of Middle East and North American feedstocks</u>****.*

  <u>North America has an abundance of ethane and other natural gas liquid resources</u>*. While events may occasionally depressed oil prices, and temporarily invert the cost curve,* ***<u>we continue to believe that North American producers will typically have advantage for the foreseeable future."</u>***

  Also, in the call, LYB noted that there are still 500,000 barrels of ethane being rejected at this point in the US as supply exceeds demand, and wells that were drilled and not fully completed early this year are starting to come online.

- China is the higher-cost producer and the incremental source of demand – and pricing for products is rising again. Inventories in the channel are at 5-year lows.

- LYB is seeing volumes return and retaining COVID related volumes for medical items and single-use bags along with more packaging. The biggest laggard was auto-related products where production has now resumed. LYB expects to operate key facilities at 90%-95% of capacity in 3Q vs. about 75% in 2Q.

- Volumes are also key to producing more co-products that are sold at high margin. Having the production rate increase 20-percentage points should help those earnings to return.

- 20%-25% of the business is tied to fuel usage which is picking up and should be one of the faster businesses to recover.

- LYB is committed to its dividend of $350 million/quarter and continues to have sizeable liquidity of $5.8 billion. Capital spending is expected to be lower in 2020 and 2021. Its largest growth project will delay its completion from 3Q21 to 3Q22.

There are still some negatives to sort through in the coming quarters:

- A big part of cash flow in the 1Q and 2Q came from falling feedstock prices and running at lower volumes. That released a sizeable amount of working capital into cash flow as higher-priced inventory and receivables were replaced with lower levels of cheaper product:

LYB Cash Flow	2Q20	1Q20
Cash from Ops	$1,292	$542
Chg. from A/R	$483	$4
Chg. from Inv.	$342	$121
Chg. from A/P	-$250	-$235
Chg. in Other	$280	-$356
Work Cap Chg.	$855	-$466

So, $1.3 billion in cash from operations in 2Q looks impressive, but two-thirds came from releasing cash from working capital. We would expect that as volumes are increased again, selling prices are increased, and feedstock prices have bounced off the lows that working capital will need to be rebuilt.

Also, LYB noted that the income figure will have some transition too with volumes higher, but feedstock costs rising faster than price increases take hold – which could crimp operating margins in 3Q.

- Hedges also helped cash flow in 2Q. While not part of operating cash flow, LYB entered new hedges in 1Q that cost $238 million, while in 2Q, they exited others that resulted in $346 million in cash payments. Derivatives also added $91 million to operating income in 2Q in sales and COGS vs. -$12 million in 1Q. That seems likely to reverse in 3Q and 4Q so that creates and earnings headwind too.

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.

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.

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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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