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Sealed Air (SEE) 3Q'19 Update
Upgrade to NEUTRAL

We are moving the recommendation on SEE back to NEUTRAL with the stock down 15% from our warning in August. We continue to see several problems – most notably volume growth is negative for its packaging division, which serves the rapidly growing e-commerce market. On top of that, it now sells automation equipment to help customers lower their e-commerce costs. We used to follow Pitney Bowes where the end market (mail delivery) was posting negative volume and yet still had growing demand from customers buying automation equipment to reduce their costs. SEE has a growing end market where customers are increasing their focus and it posts a negative volume figure? The company's goal is to grow faster than its end markets, we know the end markets are likely rising faster than 1.9% in food care and -5.0% in product care.

A low valuation is about the only thing causing us to change the rating to NEUTRAL from SELL. It is selling for under 14x 2019 EPS and 10x adjusted EBITDA. Should the stock rally at all, we will consider cutting the rating again. If we adjust for some margin compression issues – the stock would still be only 16x EPS and 11x EBITDA.

- We will need the 10-Q to see if there is a change in status to the SEC investigation and the subpoena from the US Attorney's Office. We will need the 10-Q to see if there has been any movement on the IRS dispute regarding disallowing a $1.49 billion settlement payment in 2014. The 10-Q is also necessary to see the full changes in working capital as the company securitizes and factors receivables.

- What growth is here? Sales rose 2.8% in the quarter and 0.6% YTD. Acquisitions were 5.2% and 3.4% of that growth. Volume was -0.8% and -0.6%.

- SEE continues to tout organic growth before FX as the standard to judge results. On top of negative volume, all of the pricing power came from South America where

hyperinflation is skewing the numbers. FX continues to be a material drag too. We see across the board negative growth in pricing and volume serving markets that should be increasing.

- SEE is also taking more in pricing than costs justify. Guidance last quarter was for this windfall to get smaller and it rose further in 3Q. We believe that leads customers to opt for competitors with better pricing and we also think there will be push-back on SEE as well. Taking excess pricing out of the mix would strip about 200bp out of the EBITDA margins.

- Adjusted EPS and EBITDA look weaker with some low-quality items removed. SEE has also stopped buying back shares which removes a past source of EPS growth. Shares have been flat at 155 million all year. Working capital is also seeing payables decline and consume cash.

Once again – Hyperinflation in South America Is the Only Source of Growth

We have discussed this situation quite a bit with MDLZ and SEE. We consider the presentation of constant currency organic growth to be of very low quality at SEE because the FX hit is so large. In 3Q19, investors are again shown a picture that a division at less than 5% of total sales and widely regarded as one of the weaker regions in the world economically is actually the engine driving SEE:

3Q19 Growth	North America	EMEA	South America	APAC	Total
Volume	-$12.7	$2.2	$1.5	-$0.4	-$9.4
Price	-$5.8	$0.0	$10.0	$0.3	$4.5
Org. Sales Growth	-$18.5	$2.2	$11.5	-$0.1	-$4.9
FX	-$1.3	-$9.6	-$9.1	-$4.7	-$24.7

Not only was South America all of the pricing growth – it almost the only positive place for organic growth at all. Only when FX is added does South American growth look remotely realistic. This $10 million in constant currency pricing gains in South America is poor quality earnings in our view. The company reported adjusted EPS of $0.64 in the quarter, we think $0.05 came from the hyperinflation of South America.

Acquisitions Provided Most of the Reported Growth

If South America shouldn't be viewed as real growth – then what about acquisitions? We do not consider those to be real growth either. Yet, look at the impact on 3Q and YTD:

Sources of Growth	Volume	Price	Acquisition	FX	Total
3Q19	-$9	$5	$62	-$25	$33
YTD19	-$20	$41	$117	-$118	$20

We also think the lack of volume growth in the product care unit should be alarming for many investors. As we noted after the 2Q19, more customers are trying to reduce the amount of material used in packing. That headwind looks to be continuing and taking a toll on SEE:

Volume	3Q19	2Q19	1Q19
Product Care	-5.1%	-2.5%	-4.4%
Food Care	1.9%	2.4%	0.4%
Total SEE	-0.8%	1.5%	-1.4%

We will need the 10-Q to review how much of the receivables are being securitized or factored. That was increasing in 2Q19. On the surface, trade receivables on the balance sheet declined from $485 million to $449 million in the 3Q. We feared that the higher receivables balance after 2Q would hurt sales growth going forward. Payables also fell from $753 million to $713 million in the 3Q consuming $40 million of cash flow.

We Question How Long SEE Can Boost Prices More than Cost Inflation

One of the other trends in the industry for SEE is customers looking for more recycled product, and other forms of packaging that are more durable. That is effectively boosting some of the raw material costs for SEE and it is passing them through to customers. We don't have a problem with that. However, SEE is also taking pricing in excess of the cost increases and that is a key part of the recent margin expansion:

EBITDA Changes	3Q19	2Q19	1Q19
Price/Cost	$24	$19	$22
Restructuring	$21	$17	$13
Oper. Costs	-$14	-$12	-$10
Sales	$1,219	$1,161	$1,113
EBITDA Margin Gain	130bp	160bp	130bp

This is becoming a tailwind even larger than the saving from the restructuring plans. The problem we see is EBITDA margins are rising about 130bp y/y. The excess pricing SEE is taking is basically 200bp of the improvement ($24/$1219).

Again, in the 3Q19, adjusted EPS was $0.64 per share with $0.05 coming from hyperinflation in South America. This excess pricing amounted to $0.12. Some of South America's impact is part of that $0.12 so we won't add them together. But that is a sizeable part of EPS that may be tough to maintain let alone expand further.

Remember – here is what the CFO said in the 2Q19 on price/cost spread, "*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."*

So pricing is expected to follow more closely the changes in costs, and they were forecasting Price Cost spread to decline. Yet it expanded further in 3Q. Taking SEE's guidance this source of profitability does not look sustainable at all.

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