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Sealed Air (SEE) Earnings Quality Update

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

We discontinue our SELL rating on SEE and continue earnings quality coverage with a rating of 2- (Weak) as part of our process of discontinuing our buy/sell ratings in favor of utilizing our quarterly Focus List to communicate top long ideas and sell recommendations. Note that SEE was featured as a sell recommendation in our Focus List issued in December and our outlook has not changed.

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

Summary

Sealed Air's adjusted 4Q20 EPS of 89-cents beat forecasts by 10-cents. To say we are not impressed is an understatement. Through three quarters of 2020, SEE had an adjusted tax rate of 25.3% and was guiding to a 26% rate for the full year. That would have required a 4Q tax rate of 27.8%, which instead came in at 22.3%! The lower tax rate was 6.3-cents of the beat.

Also, after the 3Q, the CFO guided to lower volume growth for the Protective unit too:

> *"We were up [4.4%] in the third quarter. The guidance would imply a little bit less than that on a volume basis. And I think the thing we are a little bit cautious of there, even though the trends around e-commerce remain very robust."*

SEE gained some business in this area for the vaccine rollout and ended up reporting 7.4% 4Q growth. That is not forecast to recur and the outlook again calls for lower total organic growth of

3%-5% for 2021 already. We view this as an unexpected one-time event. We believe this added about 2-cents to EPS as well.

SEE also added back more recurring cash charges for consultants. This was 2-cents in EPS. The price/cost finally became a minor headwind per guidance in 4Q. It was only a negative $7 million against 10-straight quarters of it being a positive. This is supposed to even out over time – coming into 4Q, SEE was + $179 million on price/cost since 1Q18. Every $1 million SEE didn't lose here added 0.5 cents to EPS. It is worth remembering that SEE guided to -$70 million in headwind from this area for 1H20 and instead it remained positive in 2020. This was a huge source of EPS last year $0.46 for 1Q20 and 2Q20 and why we think the $7 million figure in 4Q20 may not be the worst SEE will report in this area.

What is weak?

- Price/Cost is when customers allow price increases by SEE to recover higher commodity costs. This has been a huge source of recent EPS growth at SEE. It is supposed to net out to zero over time. A quarter where price hikes taken exceed commodity inflation should be followed by a future quarter where commodity inflation exceeds pricing. The issue we have is SEE had 10-straight quarters where Price/Cost was a positive impact on earnings. It guided to this becoming a drag on earnings for several of those periods as well and that helped fuel EPS beating forecasts when results were actually a tailwind. 4Q20 finally saw a -$7 million impact from this and is saying that the 1Q and 2Q of 2021 should expect the same, and then contracts should allow it to recover some of this drag in 2H21. We believe this will be a larger drag on earnings going forward than many are forecasting. The amount of excess pricing SEE has taken over recent years far exceeds 4Q's $7 million.

- One move we have seen repeatedly by companies reporting weak-to-no growth is to continually reorganize the same assets into different divisions. This tends to make reported results almost impossible to decipher for a year as everything becomes apples-to-oranges comps for the same assets. We noted in the past that as part of the Reinvent SEE program – SEE pulled Mexico and Central American operations out of Latin America and moved them to North America. The remaining operations became a new division – South America in 1Q19. Now, only two years later, South America will be rolled into a new unit called the Americas and put it in with the rest of Latin America again as well as with North America. This is designed to "realign the organizational structure," which again is part of Reinvent SEE.

- SEE's reported organic growth has been helped significantly by hyper-inflationary pricing gains in South America which is less than 5% of sales. The pricing gains have been unrealistic to us at 15%-25% because SEE defines organic growth before the FX hit which at negative 22%-33% completely wipes out that organic growth. That has not prevented SEE from reporting 0.4% organic growth in 2020, but without South America, the result would have been -0.4%. In 2019, SEE reported 0.0% organic growth, but without South America it would have been -1.4%. It is important to realize that in 2020, South America's $39 million organic growth figure powered by inflationary pricing carried the whole company's growth. Yet, this South American growth was completely wiped out by a -$66 million FX hit. Since South America at less than 5% of sales was moving the company's reported growth rate, watch for it suddenly supercharging results for the new Americas division in 2021. FX will be a key adjustment here.

- The last 10-Q reported that IRS completed its examination of the $1.49 billion deduction on SEE's 2014 taxes and the IRS proposed to disallow the deduction. SEE will now seek to appeal through the IRS administrative appeal process. SEE noted that it may be resolved before the end of 2021. Debt/EBITDA is 3.1x at this point. This $525 million potential cash payment would add 0.5x to the ratio.

Supporting Detail

Price/Cost Rubber Band Is Still Stretched and the Reversal Could Be Significant

The company deals with many customers in the food-related, industrial packaging, and e-commerce areas. It notes that its contracts with customers are set up to allow it to pass through commodity inflation and also give back deflation. There are lagging timeframes between when prices are adjusted vs. when the new costs are realized.

The two key points to understand are 1) SEE cannot just push through price increases – the customers have to accept them based on the commodity cost data too and 2) the price increases tied to cost increases are supposed to net out to basically zero over time. Think of the cost changes being linear and moving all the time while the price changes move in a stair-step. Sometimes, pricing is ahead of costs and other times costs move ahead of pricing.

Going back to 2016 and 2017, SEE saw what should be expected, periods of minor tailwinds and headwinds to earnings as a result of this price/cost dynamic. Then in 2018, SEE suddenly gained 3 years of positives from this process:

Price/Cost	4Q	3Q	2Q	1Q
2020	-$7	$9	$19	$7
2019	$18	$24	$19	$22
2018	$15	$17	$29	-$4
2017	$2	-$10	-$9	-$5
2016	$9	$22	$9	$1

Historically, there are positive and negative periods. In 2016, there was a positive $41 million and $24 million unwound for nine months in 2017. In our view, from 2Q18 to 3Q20, this equation moved in SEE's favor by $179 million and should be expected to correct.

During much of this time, SEE guided to this reversing – it just didn't happen:

- In 2Q19 management said it benefited from lower input costs and expected less earnings contribution from Price/Cost in 3Q19 and 4Q19

- After 4Q19, management said to expect Price/Cost to be impacted by lower resin prices running through the contract formulas and said to expect -$70 million in price/cost in early 2020.

- After 4Q20, SEE said that investors should expect negative Price/Cost for the first half of 2021 but then contract formulas will help correct that for 2H.

Also, SEE has touted that some of the Price/Cost gains have come from its restructuring programs allowing it to source commodities more effectively. Some has also come from changing the content of the products – using less resin or using other materials instead for example. In our view, SEE will likely get to keep some of this Price/Cost. Let's say resin is $1/pound and the cost formula in the contract uses that price. If SEE is a better buyer and can purchase resin for $0.95/pound, it will likely get to keep the incremental nickel. However, if the contract is expecting SEE to use 5 tons of resin, but it changed its content and only used 4 tons – we think the cost formula will take that 20% reduction in resin usage into account.

Thus, we don't expect the full $179 million to reverse on SEE, but the headwinds could be much larger than the $7 million seen in 4Q20. Looking at guidance for the first half of 2020 calling for -$70 million in price/cost and SEE posting +$26 million instead – that's a 46-cent swing in EPS for two quarters. And if the company has already benefited from $179 million, a negative swing of $50-$70 million may be realistic.

South America's Hyperinflation Has Driven SEE's Organic Growth

We have pointed this out several times in the past as SEE defines organic growth as the combination of only price change and volume change. By this definition, investors should have shunned the FANG stocks in recent years and focused on where the big growth was – South America. Even a turnip farm in Argentina may have been reporting faster growth than Facebook. Even in the pandemic and travel closed to much of South America, SEE said that segment of operations grew at 16.7%. The year before, South America reported 26.6% growth and more importantly was the only segment to report growth at SEE.

2020	N.AM	EMEA	APAC	S. Am	Total	W/O S.Am
Price	-1.3%	0.2%	-0.1%	15.0%	0.0%	-0.8%
Volume	0.8%	-1.5%	1.6%	1.7%	0.4%	0.4%
Organic	-0.5%	-1.3%	1.5%	16.7%	**0.4%**	**-0.4%**
FX	-0.7%	0.1%	0.2%	-28.0%	-1.7%	-0.4%
Net Growth	-1.2%	-1.2%	1.7%	-11.3%	-1.3%	-0.8%

2019	N.AM	EMEA	APAC	S. Am	Total	W/O S.Am
Price	-0.3%	0.1%	-0.1%	21.5%	0.9%	-0.2%
Volume	-1.5%	-0.4%	-0.9%	5.1%	-0.9%	-1.2%
Organic	-1.8%	-0.3%	-1.0%	26.6%	**0.0%**	**-1.4%**
FX	-0.2%	-4.8%	-3.7%	-24.8%	-2.9%	-1.8%
Net Growth	-2.0%	-5.1%	-4.7%	1.9%	-2.9%	-3.2%

This simply doesn't pass the smell test. One of the items we looked at in prior reports on Sealed Air was the company just doesn't grow much. For a company devoted to supplying e-commerce and fresh protein – it just never reported much topline growth at all. Backing out South America from the results would cut reported organic growth in a material way: from 0.4% to -0.4% in 2020 and from 0.0% to -1.4% in 2019.

The hyperinflation giving SEE the strong pricing gains in South America are crushed by the FX hits there. This is a big reason why we do not think South America should be reported without FX for organic growth. Going forward, SEE is combining North America with South America for its reporting. That will likely make finding figures like these nearly impossible, especially since South America is less than 5% of total sales and North America is 59%. But we do believe investors should remember that leaving FX out of South American organic growth was enough of a factor to drive all the growth SEE reported in the last two years. We expect to see growth suddenly explode upward on pricing for the new America's division in 2021. We believe that will be a mirage just as South America's hyperinflation was the last two years.

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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