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Sealed Air (SEE) 4Q Update
Downgrade to SELL

We are lowering our rating on SEE to a SELL again after 4Q results. The company beat by 3-cents on adjusted EPS. It had forecast that the benefits of higher price/cost spread would mitigate in 4Q and it still produced 8-cents in EPS for the 4Q. For the year, adjusted EPS rose by 32-cents and 39-cents came from price/cost spread benefits. SEE's contracts on pricing are tied to trailing commodity costs and there are periods where pricing exceeds cost inflation and periods when that reverses. The key is this trend evens out. Pricing taken above costs resulted in a windfall profit of $18 million pretax in 4Q and $83 million for 2019. That alone generated all the EPS and EBITDA growth for the year and SEE is forecasting a $70 million headwind in this area for 2020 – with a large part in the first half.

On top of that, SEE is not posting organic growth anywhere but South America, which we continue to rate as poor quality growth given the inflation-driven pricing and huge FX losses skew the results. Forecasts for 2020 call for SEE to outperform end markets in food – something the company rarely does – and for overall negative organic growth. The company picked up 4-cents in EPS in 2019 due to acquisitions too.

The company noted that customers are destocking inventory and China offers challenges. Share repurchases helped EPS growth in 2019 by 9-cents of the 32-cent gain – the forecast is for the share count to have a slight uptick in 2020. There was no mention of the status of the $1.49 billion tax dispute or the SEC investigation. We will need the 10-K to review those items.

- **SEE is seen as a way to play fast-growth markets such as e-commerce and fresh protein demand worldwide. Yet, except for North America in 2017 – volume growth trails end markets and is softening.**

- **Without acquisitions, SEE is forecasting negative growth in 2020. Forecasts also call for its food operations to grow at 2% in a flat market.**

- The only place SEE is growing is South America. Hyperinflation is driving organic growth via pricing, but FX losses offset all those price gains. **Organic growth for SEE goes from 0% to -1.4% in 2019 without South America and from -1.6% to -3.2% in 4Q19.**

- **Restructuring is not driving EPS growth – it is only offsetting higher operating costs and FX losses. In 2019, restructuring savings came in at $66 million – while higher costs and FX losses were $64 million.**

- **The Price/Cost spread of recovering commodity inflation added 173bp to EBITDA margins in 2019 and $83 million to earnings growth. That is how the company beat forecasts throughout 2019 and that is set to reverse in 2020.**

- Adjusted EBITDA and sales growth are key metrics at SEE as they determine management pay and incentives. **The price/cost spread is not something being adjusted for in these metrics nor is South America or acquisitions.**

- **Adjusted EBITDA does add back some FX losses for exposure to inflationary currencies – that was 2-cents in 2019. It also adds back 3rd party consulting fees and legal fees that were up considerably in 2019 – a 31-cent bump in EPS. By adding back interest, depreciation, restructuring, and amortization – is there any acquisition that doesn't make sense?**

- The company's working capital generated cash in 4Q, but we would need to review the 10-K for more detail. **SEE has a securitization facility that results in receivables moving to prepaid expenses and those two line items had large moves in the quarter.**

We Continue to Be Amazed at the Lack of Growth at SEE

People own this stock because it is a way to play: 1) the growing demand for more protein, 2) the growing demand for fresh/not frozen food, 3) growth in e-commerce packaging, 4) growth in cost-saving methods for e-shippers, and 5) eco-friendly/recycled packing methods. Despite those tailwinds – SEE does not see volume growth at the same rates as its end markets.

From 2015, there has been one year when SEE posted strong volume figures – that was in 2017.

	2020e	2019	2018	2017	2016	2015
Food Volume	2.0%	1.0%	2.2%	3.8%	0.9%	1.3%
Prod. Care Vol.	neg	-3.9%	0.3%	5.7%	1.4%	-1.9%

In 2017, North America drove the boat with 7.2% volume growth due to higher economic growth, an increase in e-commerce, and an increase in protein packaging. That was also off easy comps. After two more years of easy comps, forecasts do not call for a recovery in 2020.

In 2019, the company blamed weakness on China buying frozen protein instead of fresh. Starting this year, China growth is slowing with Coronavirus. Plus, if they boost demand again after the virus pause – will they boost heavily or will they be picky? Does that also mean they continue to buy frozen beef which offsets fresh beef and does not benefit SEE? Or do they buy any protein available – chicken, pork, fish, beef – frozen or fresh? We'd think the Chinese will not be driving SEE's market in 2020. On product care, SEE is blaming customers destocking inventory and weak industrial manufacturing. The company is not forecasting a turnaround in early 2020.

Despite not exceeding the growth of end markets, SEE is expecting 2% growth for the Food unit against what it forecasts as a flat market for 2020. That could be an area of disappointment this year. The first question on the conference call pointed this out as well. The company expects its forecast to be very choppy quarter to quarter. The US dollar is still strong and that hurts too on competitiveness. Without that forecast, organic growth will likely be negative overall.

Acquisitions are a larger part of growth too. The guidance for 2020 is that Product Care will be driven by 7-months of apples-to-oranges comps from 2019's acquisition. Organic growth is expected to be -2%.

Total Growth	2019	2018	2017	2016	2015
Volume	-0.9%	1.5%	4.5%	0.6%	0.5%
Price	0.9%	3.0%	0.2%	0.6%	2.3%
Acquisitions	4.1%	2.6%	0.6%	-1.4%	-2.2%
FX	-2.9%	-1.0%	0.7%	-3.4%	-9.9%

Without acquisitions, there was no growth in 2019. It also added $14 million to EBITDA for the year. SEE does not adjust that out of EPS or EBITDA as a special item. Given that depreciation is about 3% of sales ($6 million against acquired sales of $195 million) and the tax rate was 26.4% - ($2.1 million on EBIT of $8 million), we estimate that acquisitions added 4-cents to EPS in 2019. It sounds that in 2020, with 7-months of apples-to-oranges comps – the impact could be slightly higher.

To Make It Worse, South America (5% of sales) Is Materially Driving Results before FX of Course

We have written about this several times in the past, but it is incredible to us that South America is actually making volume change only -0.9% instead of -1.2% in 2019 and -1.7% vs -2.4% for 4Q19.

	2019	South Am	Adj 2019	4Q19	South Am	Adj 4Q19
2018 total	$4,732.7	$229.5	$4,503.2	$1,260.3	$59.4	$1,200.9
Price	$42.5	$49.4	-$6.9	$1.0	$10.9	-$9.9
Volume	-$41.9	$11.6	-$53.5	-$21.6	$7.3	-$28.9
Price Growth	0.9%	21.5%	-0.2%	0.1%	18.4%	-0.8%
Vol. Growth	-0.9%	5.1%	-1.2%	-1.7%	12.3%	-2.4%

The recent surge in volumes from South America is coming from higher packing of beef rather than not packaging. We believe it was also helped by China buying more from South America than the US last year and we see some of that reversing.

The standard issue we have with companies touting South America is definitely in place too – the FX losses crush the pricing gains that are boosting organic growth. Organic growth is defined as changes in volume and pricing without FX. In 4Q19, every other geographic unit at SEE was negative on pricing and volume. For 2019, every other geographic unit was negative on pricing and volume except a mere $1.0 million gain on EMEA pricing. How realistic is the organic growth? You can see this above, organic growth goes from 0% to -1.4% without South America for 2019. For 4Q19, -1.6% reported growth goes to -3.2%.

Did we mention that South America is only 5% of sales? Adjusting for FX blows up the growth story for South America. Organic growth from 2019 sinks from 26.6% shown above to 1.8% in with FX impacts.

2019 Growth	N. Am	EMEA	S. Am	APAC	Total	Adj w/o S. Am
Price	-$7.3	$1.0	$49.4	-$0.6	$42.5	-$6.9
Volume	-$42.8	-$3.8	$11.6	-$6.9	-$41.9	-$53.5
FX	-$4.2	-$49.4	-$56.9	-$26.7	-$137.2	-$80.3
Total Growth	-$54.3	-$52.2	$4.1	-$34.2	-$136.6	-$140.7
Y/Y growth	-2.0%	-5.0%	1.8%	-4.7%	-2.9%	-3.1%

4Q19 Growth	N. Am	EMEA	S. Am	APAC	Total	Adj w/o S. Am
Price	-$7.5	-$1.2	$10.9	-$1.2	$1.0	-$9.9
Volume	-$27.2	-$1.6	$7.3	-$0.1	-$21.6	-$28.9
FX	$1.2	-$4.0	-$13.2	-$2.8	-$18.8	-$5.6
Total Growth	-$33.5	-$6.8	$5.0	-$4.1	-$39.4	-$44.4
Y/Y growth	-4.6%	-2.5%	8.4%	-2.1%	-3.1%	-3.7%

The Price/Cost Spread Helped 2019 Earnings– It Is Not Expected to Help 2020

We have been talking in prior reports about how SEE has benefited of late by taking higher price increases than its commodity inflation justifies. The company notes that its deals with customers are linked to commodity prices for raw materials such as resin and that in the long-run, cost-driven commodity price-hikes tend to even out and match the actual changes in costs.

For 2020, SEE is forecasting negative price/cost spread squeezing its EBITDA forecast. Jim Sullivan, the CFO put it this way:

> *"And then we talked about negative price/cost spread in Food Care in particular, driven by the formulas. So keep in mind,* ***the formulas are driven off of the resin profile that the company experienced in 2019. And those will be passed – some of those gains in 2019 will be passed through these formulas as we talked about, mostly in the first half of 2020.*** *So together between inflation and, call it, net price/cost spread, that's about, let's call it, $70-ish million."*

A $70 million EBITDA squeeze in 2020 in this area would be about 33-cents in EPS. How much did SEE pick-up from price/cost spread in 2019? The answer is $83 million and it was fairly even through the year:

	4Q19	3Q19	2Q19	1Q19
P/C Spread	$18	$24	$19	$22

This has no depreciation or interest expense; the tax rate was 26.4% so this was 39-cents of EPS in 2019. For all the reports of growth and gaining traction in South America and cost savings – adjusted EPS for SEE was $2.82 in 2019. That adds back all the restructuring and one-time items. Compared to 2018, EPS was up 32-cents. Here's 39-cents of that growth from nothing the company did – and it's about to fully reverse in 2020. Forecasts are for adjusted EPS to rise to only $2.85-$2.95.

Adjusted EBITDA rose in 2019 from $889.5 million to $964.8 million or 8.5%. Without the P/C windfall, Adjusted EBITDA would have declined by 0.9%. During the year, the company touted its prowess in cutting costs and the headline is that the Reinvent SEE program drove 2019 results. SEE reported EBITDA margins rose by 130bp due to cost-cutting. In reality, Price/Cost added 173bp and the restructuring savings of $66 million basically offset higher operating costs and FX losses of $64 million.

We Think Investors Should Look at How Management Gets Paid

In addition to salaries, management gets a 50% bonus based on hitting targets for adjusted EBITDA and a 30% bonus for improving Adjusted EBITDA margins. On

long-term incentives, 33% is tied to Adjusted EBITDA margins and 33% is tied to hitting 3-year CAGR targets on sales growth.

We don't have the 2020 proxy yet, but we see several areas where these items can be boosted:

- Adjusted EBITDA does not back out Price/Cost spread swings.

- Total Sales benefitted by $43 million last year due to price increases and may have been largely tied to the Price/Cost spread issues.

- Neither measure backs out acquisitions – as noted above, this added $195 million to sales and $14 million to EBITDA.

- Is there much disincentive to making any acquisition? There is no penalty for interest on debt, no penalty for increased amortization, no penalty for restructuring costs and anything purchased with sales, and EBITDA will add to those target figures.

- The Adjustments include adding back some of the FX losses due to highly inflationary economies. In 2019, this was $4.6 million. That is 2-cents in higher EPS as well.

- Restructuring charges for severance, consolidation, writing off assets – are of course added back. However, SEE is also adding back fees paid to third-party consultants and third-party legal fees relating to the restructuring. These charges increased significantly in 2019 – from $23.3 million in 2018 to $89.4 million. The actual restructuring charges went down and were less than half that figure at $41.9 million. We are skeptical that all of that $89.4 million in consultants is related to one-time restructuring actions. If that total isn't added back – growth in EBITDA slows to 1.0%. Adding back the bump of $66.1 million y/y for consultants also boosted EPS by 31-cents.

- South America was also the only area of the company that reported any growth at all.

Working Capital Looks Better, but That Is Debatable

Management also has a 20% bonus incentive tied to improving the working capital/sales ratio. The company talks about looking for ways to pull working capital down. On the surface, this looks like it is happening:

	4Q19	3Q19	4Q18
Accts Rec	$556.5	$449.0	$473.4
Inventory	$570.3	$618.3	$544.9
Prepaid Exp.	$61.7	$201.4	$125.1
Accts Pay	$738.5	$712.7	$765.0
Other Curr. Liab.	$514.8	$482.4	$428.9

Liabilities increasing added $58.2 million in cash from September. Asset accounts declined and added $80.2 million in cash since September too. We would need the 10-K to review this more closely, but our concerns are:

1. Is inventory down because raw material costs have fallen and SEE has customers destocking? We don't consider raw material declines to be something SEE controls.

2. The company has a securitization facility for Accounts Receivable. It effectively moves receivables out of the A/R line on the balance sheet to puts them into prepaid expenses. When both those line-items show big movement, that is likely the cause, but we don't know what the current numbers are from the press release.

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