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www.btnresearch.com

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Sealed Air (SEE)- 2Q20 Update
Maintain SELL

We maintain our SELL rating on SEE. We believe there is actual negative growth rather than the company's non-GAAP 3% growth that includes acquisitions and no FX impacts. **The company beat forecasts handily in 2Q20, but the forecast for a negative Price/Cost spread didn't happen.** The positive Price/Cost issue added 8-cents to EPS in 2Q20 and forecasts coming into 2020 were for $70 million in negative or 33-cents of drag in the first half. **On top of that, SEE guided to a -15% figure for 2Q for its protective unit, which came in down 8.6%. It guided to -5%/-6% for food in 2Q and that came in at -0.4%.** Those wildly lowballed forecasts also allowed SEE to beat expectations. A 6% change in protective sales is worth about 2-cents in EPS and a 4% change in food is worth about 4-cents in EPS.

Forecasts for the year of $2.85-$2.95 against $1.49 in the first half do not appear that strong for a company that beat recent forecasts already.

- **Sealed Air's 3% growth figure (rounded up from 2.8%) includes an acquisition and ignores FX headwinds**. We don't consider an acquisition to be organic growth and SEE's history shows that FX is almost always an expense – adjusting for these two items – the growth rate was -7.2% for 2Q20.

- **All of the pricing gain again came from South America which is due to hyperinflation, not market strength. Despite South America accounting for less than 5% of total sales – the price hike here added 0.9% to SEE's organic growth.**

- **Price/Cost is a contracted way for SEE to recover periods of cost inflation from customers. There are quarters where it benefits from this and quarters where it is a headwind – but over time it is expected to net out to zero. In 2019, Price/Cost was an $83 million positive causing the company to guide to -$70 million mostly in the first half of 2020.**

- **Price/Cost actually came in at positive $18 million in 2Q20 adding 8-cents to EPS. Compared to a forecast of headwind in the 9-20 cent range – this was a huge positive swing for 2Q EPS. The negative headwind may still occur in the 2nd half of 2020.**

- **COVID costs only amounted to $5 million as SEE netted it against the lower travel costs and other discretionary cost-cutting.** As COVID wanes, the other costs are expected to return and more than offset COVID savings.

- **Working capital has been helped by factoring receivables. The jump in inventory at the end of 2Q is worth monitoring.**

- **SEE's legal issues continue. It remains under investigation by the SEC regarding its tax accounting, financial reporting, and disclosure.** It has changed the text on its $1.49 billion deduction dispute with the IRS. It used to say this may take years to resolve to "it could have a material impact within the next 12 months." It also has resolved a clawback lawsuit related to its sale of Diversey. It is expected to lose some receivables which would cost as much as 6-cents to EPS. We could not find any discussion or place where there has been a write-off at this point.

Sealed Air's 3% Growth Remains Misleading Due to FX and Acquisitions

The press release touts that growth was 3% compared to GAAP revenue growth of -1%. Given that SEE should have been uniquely positioned to benefit in all areas from COVID with one division focused on food packaging and people ate at home more and huge grocery stores sales and the other division is focused on product packaging that is supposed to be enjoying the online e-commerce tailwind – they are debating 3% vs -1% growth?

The first problem is SEE is adding back the FX hit its adjusted growth rate. Then it has an acquisition that drove results from negative to positive:

Rev. Adjustments	2Q20
Price	0.6%
Volume	-4.2%
Organic Growth	-3.6%
Acquisitions	6.4%
SEE's figure	2.8%
FX	-3.6%
GAAP figure	-0.8%

As we have reported for some time, FX hits are a recurring cost of doing business for SEE. With the exception of 2017 when FX helped sales by 0.7%, the company routinely sees FX cut sales by about 3% from the years 2015-2020. That is a big reason why in past years, SEE has reported organic growth of 3%-5% and sales are still basically flat over that time. In fact, on the call, SEE raised its currency headwind outlook for 2020 from $8 million to $25 million.

Then 2020 has an acquisition that helped too along with 2019 and 2018 sales. We have noted in the past that management bonus targets are tied to figures that include sales growth from acquisitions and remove all acquisition costs such as interest expense on debt, amortization, and restructuring costs. However, they could buy a company with declining sales and it would still boost the growth rate for SEE. We consider that very low-quality growth. We would argue that the starting point for sales growth would be – price + volume + FX. On that formula, SEE's revenue growth has been abysmal for a company with two macro tailwinds (people eating more fresh protein and people buying more products via e-commerce).

Rev. Growth	1H20	2019	2018	2017	2016	2015
Price	0.1%	0.9%	3.0%	0.2%	0.6%	2.3%
Volume	-1.2%	-0.9%	1.5%	4.5%	0.6%	0.5%
Organic Growth	-1.1%	0.0%	4.5%	4.7%	1.2%	2.8%
FX	-3.1%	-2.9%	-1.0%	0.7%	-3.4%	-9.9%
Actual Growth	-4.2%	-2.9%	3.5%	5.4%	-2.2%	-7.1%

South America Is Also Inflating the Company's Growth Rate

In our view, SEE's actual growth in 2Q20 is more like -7.2% vs. the company's reported 2.8%. That's only adjusting for acquired sales and treating FX as a recurring item. However, South America still inflates its 2.8% figure even more.

At only 4.8% of sales, South America produced the entire company's price increase in the quarter.

2Q20 rev growth	North Am	EMEA	APAC	South Am	Total
Price in $	-$1.5	-$0.7	-$0.6	$10.6	$7.8
FX in $	-$9.3	-$8.1	-$5.8	-$18.7	-$41.9

This was essentially the case in 2019 also when South American pricing rose by $49.4 million and total pricing rose by $42.5 million. We know this is due to hyperinflation in Argentina. It is not a sign that SEE is able to take pricing which they are not getting anywhere else in the world. The FX hit that more than wipes out the South American price hikes also shows this.

If we eliminate the price hike and let SEE continue to ignore FX, its reported 2.8% figure for 2Q20 falls by 90bp to 1.9%. And that is still helped with 6.4% from acquisitions. On our calculation, removing South America's price increase, the acquisition, and adjusting for FX – the 2Q20 growth rate was -8.1%.

Price/Cost Spread Helped 2Q Earnings Too

One of the big windfalls that helped 2019 was the ability of SEE to push through pricing that exceeded the increase in raw material costs. This was adding about $20 million per quarter in 2019. However, as the company noted in the discussion and its guidance for 2020 – this process is designed to net out to zero over time. It was forecasting that the price/cost spread would turn negative in 2020 for a $70 million headwind mostly seen in the first half. COVID issues seem to have disrupted that forecast.

In 1Q20, Price/Cost was still a positive at $8 million. In 2Q20, it came in at a positive $18 million. For 2Q, this added 8-cents to EPS. However, considering expectations were for a $20-$40 million headwind – this is actually a 17-28 cent swing in results. This can explain

the EPS beat, and growth in EBITDA margins from 20.4% to 22.6% actually came in at 21.5% without the $18 million of price/cost benefit.

We think it is also worth noting that COVID was only a $5 million drag in 2Q. It netted the COVID costs with the benefits of lower travel costs and tighter expense control to reach the $5 million figure. The company also noted that as COVID costs decrease – it expects those other discretionary costs to return and offset the savings.

Factoring Receivables Is Helping Working Capital

The company has had securitization programs for receivables in the US and Europe for some time. Since the very end of 2018, it has had a factoring program too. The biggest difference is the securitizations move the receivables to prepaid expenses. Factoring removes them from the balance sheet.

Since this started, SEE has been factoring about $100 million in receivables per quarter:

Working Cap	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
US Securitz.	$0.0	$0.0	$0.0	$60.0	$0.0	$0.0
Eur. Securitz.	$49.5	$74.3	$0.0	$77.6	$78.5	$75.0
Factored A/R	$108.2	$113.8	$105.2	$88.7	$84.5	$72.9

Receivables on the balance sheet reflect these moves. Recent increases in inventory are more of the cause for working capital increasing in the last quarter.

Working Cap	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Trade Rec.	$515.8	$491.5	$556.5	$449.0	$485.2	$464.0
Inventory	$638.2	$568.2	$570.3	$618.3	$596.1	$597.4
Prepaid	$103.1	$133.9	$58.9	$201.4	$127.4	$127.8
less Payables	$724.1	$715.3	$738.5	$712.7	$753.0	$769.1
Working Cap	$533.0	$478.3	$447.2	$556.0	$455.7	$420.1

Sealed Air's Legal Issues are Changing

We have been pointing out that SEE has a potential $525 million tax issue with the IRS. **It is interesting to see that the company changed the language from the 10-K that it may take several years to resolve this to saying in the 10-Q that it could have a material impact for earnings and cash flow within 12 months:**

2019 10-K:

> "W*e are currently under examination by the IRS with respect to the deduction of the approximately $1.49 billion for the 2014 taxable year for the payments made pursuant to the Settlement agreement and the reduction of our U.S. federal tax liability by approximately $525 million. The IRS has proposed to disallow, as deductible expense, the entirety of the $1.49 billion settlement payments. Although we believe that we have meritorious defenses to the proposed disallowance and are protesting it with the IRS,* ***this matter could take several years to resolve and there can be no assurance that it will be resolved in the Company's favor.*** *An unfavorable resolution of this matter could have a material adverse effect on our consolidated financial condition and results of operations, including cash flows.*

2Q20 10-Q:

> *"We are currently under examination by the IRS with respect to the deduction of the approximately $1.49 billion for the 2014 taxable year for the settlement payments made pursuant to the Settlement agreement and the reduction of our U.S. federal tax liability by approximately $525 million. The IRS has proposed to disallow, as a deductible expense, the entirety of the $1.49 billion settlement payments. Although we believe that we have meritorious defenses to the proposed disallowance and are protesting it with the IRS,* ***this matter may not be resolved in 2020. It is possible that future developments in this matter could have a material impact on the uncertain tax position balances and results of operation, including cash flow, within the next 12 months.***

A dispute over a $49.2 million claw back from the sale of Diversey appears to be resolved. However, it cost SEE some receivables too:

2019 10-K:

"In the third quarter of 2019, ***<u>the Buyer (of Diversey) submitted a claim to us under the Clawback Agreement seeking such a refund in the amount of $49.2 million.</u>*** *In the fourth quarter, we delivered a dispute notice to the Buyer in respect to its claim. We are in discussions with the Buyer, in accordance with the provisions of the Clawback Agreement, in a good faith attempt to resolve this dispute.*

<u>Additionally, Sealed Air has a net receivable balance of $11.6 million included within Other Receivables on our Consolidated Balance Sheets as of December 31, 2019,</u> *representing amounts owed to Sealed Air from Diversey and/or the Buyer relating to the sale of Diversey or transition services we provided to Diversey after the closing under that certain Transition Service Agreement ("TSA"). This receivable balance includes: income tax receivables related to taxable periods prior to the sale of Diversey; cash held by Diversey in certain non-U.S. jurisdictions as of the sale closing date, which amounts the Buyer must cooperate to deliver to Sealed Air when and as permitted, subject to certain limitations; and receivables due from Diversey for services performed under the TSA."*

2Q20 10-Q:

"On April 29, 2020, Sealed Air and the Buyer entered into a Stipulation and Agreement of Settlement and Release (the "Diversey Settlement Agreement"), whereby, among other things, the Buyer released us from any and all claims under the Clawback Agreement, and the parties terminated the Clawback Agreement.

Pursuant to the Diversey Settlement Agreement, the parties settled their disputes relating to certain other Tax Receivables and other receivables arising out of the Diversey sale, including fees owed to Sealed Air from the Buyer pursuant to the Transition Service Agreement entered into in connection with the sale ("TSA") and cash held by Diversey in certain non-U.S. jurisdictions as of the sale closing date that Buyer was required to cooperate to deliver to Sealed Air when and as permitted, subject to certain limitations ("Trapped Cash"). ***<u>Under the Diversey Settlement Agreement, Sealed Air relinquished all of its rights to receive any of the Trapped Cash, and the parties further agreed to release each other from any and all claims arising under or with respect to the TSA, the Trapped Cash, and the Clawback Agreement</u>*** *and such other matters as expressly agreed upon in the Diversey Settlement Agreement (provided, that, except for those specific matters released, the*

terms of the Purchase Agreement otherwise remain in effect in accordance with their terms).”

We did not see the actual amount of trapped cash that SEE lost claim to in the 10-Q. We do know that Other Receivables have been declining by $6.0 million from 4Q to 1Q and down another $4.5 million from 1Q to 2Q. The trapped cash figure of $11.6 million in 4Q fell to $1.9 million in 1Q and there was no mention of it for 2Q. SEE adds back recurring legal costs, anytime they hire a consultant, and costs of acquisitions as one-time items. **However, we cannot find anywhere where they wrote off the trapped cash in 1Q or 2Q. Bad debt expense did not rise by an amount that indicates it went there and their adjustments do not note it went into something SEE added back as a one-time event. This could be as much as a 6-cent hit to EPS.**

On the positive side, the US Attorney investigating SEE over the termination of the former CFO and process of its auditor selection has closed its investigation. But the SEC is still investigating the company’s tax accounting and financial reporting:

2Q20 10-Q:

> *“The Company has received from the staff of the SEC subpoenas for documents and requests for information in connection with the SEC's previously disclosed investigation. Those subpoenas and requests seek documents and information* ***regarding the Company's accounting for income taxes, its financial reporting and disclosures, the process by which the Company selected its former independent audit firm which audited the fiscal years of 2015 through 2018, the independence of that audit firm, and other matters.***
>
> *Following the announcement on June 20, 2019 that the Company had terminated the employment of William G. Stiehl as Chief Financial Officer, the Company received a Grand Jury subpoena from the United States Attorney's Office for the Western District of North Carolina (the "U.S. Attorney's Office")* ***seeking documents relating to that termination and relating to the process by which the Company selected its former independent audit firm for the fiscal years of 2015 through 2018. The Company has been advised by the U.S. Attorney's Office that it has completed its investigation of these matters and will not be taking any action.”***

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.

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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