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BEHIND THE NUMBERS
Quality of Earnings Analysis

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Sealed Air Corporation (SEE)
Earnings Quality Update- 6/21 Qtr.

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

We are maintaining our earnings quality rating of SEE at 2+ (Weak) and maintain our Top Sell rating.

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

Summary

Sealed Air reported non-GAAP EPS of 79-cents, which beat by only 1-cent. It was also up only 3 cents from 2Q20 with the full force of Covid issues impacting meatpacking plants and restaurants in particular. On the 1-cent beat this quarter, SEE picked up 3-cents from a lower tax rate. This was due to combinations of more income in lower tax locations and settlement of prior audit matters. None of that sounds like it is due to SEE's business. It also added back 2-cents for third-party consultants in what is now late in year four of the reinvention plan.

The price/cost headwind that we have been warning about was a -$36 million item in 2Q21 vs. -$18 million in 1Q21. The $36 million cost SEE 18-cents in EPS. We still expect this to be a problem going forward as SEE's pricing is coming on a lagged basis vs. the higher commodity prices. Also, as we have noted, SEE was taking pricing in excess of inflation for years prior to 2021 and the deals it has with customers are for pricing and cost inflation to net to zero over time. SEE guided to a negative headwind for 3Q20 in this area too. Already, the company is at negative $55 million for 2021 with negative coming in 3Q, and it is guiding to only negative $25-$30 million for the full year.

What is strong?

- SEE raised guidance by 5-cents on 2021 non-GAAP EPS and $150 million on sales. It appears that the bulk of the sales gain will come from positive FX and price increases. With the EBITDA forecast staying flat, it seems SEE still expects inflation to consume most of the price hikes. With EBITDA flat, higher EPS is likely coming from a combination of a lower share count and tax/interest expense issues.

- SEE has two more quarters of easy comps for food to help the top line:

	4Q20	3Q20	2Q21	2Q20	1Q21	1Q20
Food Vol y/y	0.3%	-1.8%	4.2%	-1.9%	-0.4%	4.6%

What is weak?

- It appears SEE took pricing in South America anticipating more FX hits, but FX was actually a positive for the region after a -33% y/y figure in 2Q20. That is where a large degree of the higher sales came from in the quarter. Remember, SEE rolled the South American division in the Americas unit at the start of the year. It was typically from South America where SEE picked up the bulk if not all of its pricing gains:

Pricing Gains	North Am	Latin/South Am	Total SEE	FX Hit
2019	-$7.3	$49.4	$42.5	-$137.2
2020	-$36.5	$35.0	-$0.8	-$81.8
2Q21	$24.7	n/a	$30.4	$45.9

SEE has always included the pricing it takes ahead of depreciating currencies as its organic growth, which we do not consider actual growth. It is benefitting from the disaster that hit in 2Q20 when the FX hit was about twice the normal rate. In early 2021, SEE took its expected inflationary pricing but it also enjoyed positive FX income. After this, the company boosted its revenue guidance. It also helped EPS by adding back 0.6 cents from hyperflationary currency factors and only beat by 1-cent.

- The company points that Reinvent SEE is working. It touts that restructuring helped 2Q21 by $14 million. It helped the Price/Cost spread by $1 million – yet Price/Cost was a $36 million headwind. It said operating costs fell by $13 million – yet net higher operating costs were still a $13 million headwind. Margins declined 280bp for 2Q21 and 160bp for the YTD. If price hikes coming in September are not enough, this could continue to outweigh the restructuring. The higher operating costs are the loss of Covid related savings and higher labor costs. It is important to note that over and above Price/Cost – the normal operating costs were 100bp of headwind y/y. SEE's 3Q20 margin was 21.0% with over 100bp of operating cost tailwind. That looks like an area where SEE will again have pressure in the current quarter.

- Reinvent SEE started in 2017. In 2021, they still added back 2.1-cents paid to third-party consultants as part of this plan. We're wondering late into year four, just what advice third-party people are still giving? Also, we recall SEE talking about how the plan would help its procurement process improve, yet it only helped by $1 million in 2Q21 in a net $36 million headwind.

- SEE is out of easy comps for the protective business. We have been skeptical of the sustainability of the surge in volume growth the last two quarters as it came from an unexpected source – Covid vaccine rollouts. SEE picked up 2-cents in 4Q20 from this and we estimate 4-cents in 1Q21. In 2Q20, SEE did not quantify but said, "we play a key role in Covid-19 vaccination distribution." Other markets have recovered too, but SEE has been helped already by very easy comps:

	3Q20	2Q21	2Q20	1Q21	1Q20	4Q20	4Q19
Protect Vol y/y	4.4%	15.2%	-8.0%	13.0%	-2.3%	7.4%	-3.8%

What to Watch?

- From the earnings call, almost everything at SEE for the rest of this year and into 2022 revolves on 1) being able to take pricing and 2) have commodity inflation weaken and let SEE keep the excess pricing they lost the first half of 2021. The increased revenue guidance given after 2Q21 was repeatedly attributed almost solely to higher pricing the company expects to achieve. We have noted that price/cost differentials for commodity prices have worked in SEE's favor in almost every quarter for over three years. These are supposed to net to zero over time. That does not bode well for SEE simply getting all the pricing it needs to recover the last two quarters.

- Lyondellbasell is reporting many reasons why the commodity cost surge for the various plastics that SEE uses will not get much of a reprieve in the 2H of 2021 on its call. These include, they are seeing such strong demand across all industries that they are still on allocation for orders. In fact, they saw order demand hit a record for August for polyethylene and polypropylene because all customers need more product. In their words, that indicates the inventories are still very low at customers and even LYB is still trying to fill orders "hand to mouth" as they cannot get inventory levels back where they prefer. Added to this, there is still a heavy maintenance cycle for US plants for 3Q and 4Q this year plus holiday downtime in Europe, and the hurricane season hasn't started yet. While SEE is cheering its 5%-10% price increase for September 15 – LYB has raised prices every month this year so far and the prices are still rising. On top of that, the transportation costs with higher fuel costs make it unlikely that imports can help the supply situation.

- We believe SEE's price increases will occur but may prove inadequate to handle the increase in commodity costs. It is also important to note that while SEE expects a negative headwind from price/cost spread in 3Q, it will only have 15 days of higher prices in place for 3Q. That could be an area where they miss guidance for 3Q and if the price hikes do not cover the commodity inflation that could be in place going into 4Q, SEE may need to reduce forecasts.

- While SEE is expecting a 2% positive impact to sales from FX this year and are already at 3% for the 1H21, we think investors should remember that this is a rare tailwind for SEE:

	1H21	**2020**	**2019**	**2018**	**2017**	**2016**	**2015**	**2014**
FX Impact	3.0%	-1.7%	-2.9%	-1.0%	2.2%	-2.3%	-9.9%	-2.4%

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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