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Sealed Air – 2Q Update
Downgrade to SELL

We are lowering our EQ rating on SEE to a 2- (Weak) and cutting the recommendation to a SELL after 2Q19 earnings. The company missed revenue by $10.4 million but beat Adjusted EPS forecasts by 16-cents. We see several items that account for that beat that may not repeat. More importantly, we continue to see little growth here at all beyond benefiting from hyperinflation on pricing in South America. We also question how much of new guidance is actually a stealth cut since the forecasts beat in both 1Q and 2Q and the company is adding another acquisition for five months. Yet, targets have not been boosted very much. The company's SEC investigation appears to be getting larger in scope too.

- **Without South America, is there any growth here at all?** We have talked about the short-comings of booking huge price hikes in adjusted constant currency growth but ignoring the very large FX losses. SEE lost on FX in every region. Without South America's inflation pricing, sales growth basically disappears at SEE. The company is also adding in acquired sales to boost the constant currency growth figure. That was another 2.5% of the total.

- **Forward revenues face more headwinds. Receivables and DSOs already appear very high** and the company has been securitizing more of them along with boosting its factoring activities. **That may have already pulled some sales forward. Brazilian volume growth in 2Q may have come against a very easy comp against the trucking strike in 2Q18.**

- **Sealed Air is attractive to investors as a way to play e-commerce growth. SEE is cutting forecasts for its product care unit from 1.5% to negative 3.0%.** This is due to major customers seeking to reduce the amount of packing materials in shipments. It does not sound like a short-term headwind.

- **Price Cost Spread came in much higher than forecast and helped sales and EBITDA. Essentially, SEE enjoyed lower prices for raw materials, but still pushed through stronger pricing.** This was called out as a big success of its Reinvent SEE program. However, going forward **even SEE admits that customer pricing will more closely track raw materials** and this windfall will shrink. **High inventories also point to pressure on selling prices and margins going forward.**

- **We question if SEE actually raised guidance at all**. It acquired a company with $290 million in sales, which should add $120 million in 2019, yet raised sales guidance only $50 million. EBITDA forecasts rose $15-$25 million, yet the acquisition will add $10-12 million and the price cost spread may have already added $20 million above plan. Adjusted EPS guidance rose 5-cents, but beats in 1Q and 2Q already are 18-cents and they expect another 2-cents from a lower share count now.

- **Free Cash Flow forecasts were reduced as SEE has additional one-time payments the 2H19. However, we think it may be worse than that because to reach targets it will need to see working capital become a sizeable source of cash flow in 2H19.** Also, the company does not include acquisitions in free cash flow but has already spent $473 million on more this year, which more than consumes the $180 million FCF target.

- **The company beat on EPS by 16-cents, but we can find several items that total that amount that should be one-time in nature or are a low-quality source of earnings.** These include reversing a Brazilian tax overpayment valuation, adding back professional fees paid to the 3rd parties not related to restructuring, a drop in stock compensation, the pricing from South America, the unexpected price cost income windfall…

- The **SEC investigations may be expanding after the company fired the CFO.** We put the new and prior language side by side. It's $1.49 billion tax dispute also continues.

Revenue Still Being Driven by South America Pricing

SEE reported 1% revenue growth in 2Q19 but 4% on its constant currency adjustment. We think both figures are overstated by rounding and acquisitions. Here is the basic report per Sealed Air:

SEE 2Q Sales	Px	Vol	Acq	FX	GAAP	Organic	SEE - CC
components	1.0%	0.5%	2.5%	-3.5%	0.5%	-1.0%	4.0%

Sealed Air reported 0.5% sales growth under GAAP due to a large FX negative. That is still with acquisitions adding 2.5% to growth. It defines Constant Currency growth as Price + Volume + Acquisitions to reach 4.0%. With over 40% of sales from overseas, including part of North America – FX is a constant issue for SEE. We do not believe the company should be viewed as though FX is not part of the equation here. It often dictates pricing too as it must compete on local currency terms just to make the sale before the FX translation of that sale is taken into account.

More importantly, we think hyperinflation in Argentina as part of South America is delivering over 100% of the pricing that SEE is posting as sales growth. South America is less than 5% of total sales, but look at the impact it is having:

SEE 2Q Sales	No. Am	EMEA	So. Am	APAC	Total
Price	-$2.7	$0.7	$13.7	$0.2	$11.9
Volume	$10.9	-$1.4	$2.9	-$7.1	$5.3
C-C Growth	$8.2	-$0.7	$16.6	-$6.9	$17.2
FX impact	-$1.1	-$15.2	-$15.7	-$8.8	-$40.8
Net	$7.1	-$15.9	$0.9	-$15.7	-$23.6

SEE lost money in FX at every unit. Look at the pricing gain taken in South America vs the size of the FX hit. South America does not look that strong when considering the full impact of what is happening there. Stripping out South America means Pricing becomes a negative figure at -$1.8 million and Volume is cut by more than half to $2.4 million. Net organic growth before FX falls to a mere $0.6 million, which is 0% y/y vs. 1.5%. So basically, all the constant currency growth at SEE was produced by South America. The company would have still had a -2.3% hit from FX and 2.5% positive from acquisitions. That means its only source of constant currency growth by its definition would be from acquired sales. Nothing internally generated would have helped.

More Problems for Revenues

Receivables are already very high too, which may be an indication that SEE cannot pull more demand forward as easily. We noted last quarter that DSOs were 38.1 and they were the same in 2Q19. However, the company securitized $78.5 million of receivables at the end 2Q19 vs. $75 million at the end of 1Q19 and $62.4 million in 2Q18. That is worth about 6.2 more in DSOs now vs. 4.9 days last year. Then, we already noted that SEE has been selling larger amounts of receivables via factoring deals. We do not know the amount of those receivables outstanding but they sold $84.5 million during 2Q19 and $72.9 million in 1Q19. This continues to grow vs. $181 million in all of 2017 and $250 million in all of 2018. They are now selling about $930,000 of receivables per day vs. $500,000 per day two years ago. Even with that, the on-balance sheet DSOs are starting to tick up from late 2018.

In summary, SEE only grew sales by $5.8 million y/y for 2Q19. That's with acquisitions too. A/R on the balance sheet is down $10.3 million, securitizations are up $14.1 million, and it appears factored receivables are up about $22 million as a rough estimate. Sales growth of 1% is about $11 million, and it appears they are growing receivables faster than that.

We focused above on South America producing more than 100% of the pricing power at SEE before giving it all back as FX losses. Under actual GAAP – this is a nice headwind for revenues. **During the call, SEE pointed out that South America also benefited from 15% volume growth in Brazil. We know from Mondelez that a trucking strike in Brazil helped drive results there in the y/y comp. We believe that would have helped SEE as well.** The strike lasted 10-days in 2Q18 and stopped the volume of traffic and shipping by shutting down highways. SEE also listed a stronger export market and equipment sales in Brazil y/y. To the extent Brazil was helped by the absence of a strike in 2019, we'd view that as a one-time event. Remember, total company volume growth was only $5.3 million before FX and $2.9 million came from South America.

Product Care is about 38% of total sales at SEE. This is where e-commerce would be primarily located. SEE just posted -2.5% volume growth for 2Q19 and -3.4% for 1H19 in this unit. Pricing was also not very strong. The company believes this will be hurt by product transition among customers, decelerating growth rates, and trade issues:

Jim Sullivan CFO

> ***"For product care organic sales growth, we have revised our forecast to be down approximately 3% compared to our previous expectation of up 1.5%.*** *This revision is largely due to the slowdown we've been experiencing in the industrial sector particularly in North America and China."*

Asked about Amazon's initiatives to optimize box size and is that a negative for product care and how long, Ted Doheny CEO responded:

> *"**As they go to package zones container, they're looking for less stuff in the package,** and also driving automation. So, the issue is can we drive an automated solution that's actually loading the package automatically. **So that transition will take over time, it will take time…So the transition is in place. It is showing up in our business and what we've lost in the product care business.** But we feel pretty confident that over time, and hopefully sooner rather than later, we'll get some of that business back and more."*

The company also noted that African Swine Fever would impact some of the fresh protein volumes it depends on. It should help South America and North America volumes – however, there are trade issues between the US and China of course. It also believes there will be volumes lost as the trade occurs with whole frozen carcasses rather than wrapped fresh protein. They have less to do with frozen and this could be a headwind too.

Price/Cost spread we will discuss below as the company breaks it down as a net figure that helps/hurts EBITDA not revenue. We know all the pricing came from South America in 2Q, but **the company benefited from lower raw material costs, which should have taken pricing down even further in other markets. Guidance would indicate that issue is still coming too.**

The stock popped after the earnings beat reported for 2Q19. Underneath that, revenue growth was very poor in our view driven almost entirely by hyperinflation pricing in South America. However, there are also signs of some mild channel stuffing given the rise in securitized and sold receivables; the growth in Brazilian volumes may be short-lived growth off an easy comp; SEE just reduced its forecast for product care revenue growth by 450bp and it is now a negative growth rate; the transition to less packaging materials sounds like it is more than a short-term issue; and there may be some negative impacts on fresh protein too.

How Real is the Guidance Raise?

After 2Q19 results, SEE raised guidance for revenue, adjusted EPS, adjusted EBITDA and cut Free Cash Flow:

SEE Guidance	Sales	Adj EBITDA	Adj EPS	FCF
Original	$4.80b	$925-$945	$2.65-$2.75	$250.0
Now	$4.85b	$950-$960	$2.70-$2.80	$180.0

On sales, the company still expects 5% constant currency growth and a -$130 million impact from FX in both sets of guidance. **It is forecasting sales up $50 million. Acquisitions have become a larger part of the deal with the APS purchase. APS was doing $290 million in sales and finishing the last five months should be worth about $120 million.** On the surface, they cut sales guidance by about $70 million in our view. We think that stems from the issues discussed above about Product Care. We also think the higher receivables could play a role here.

On EBITDA, SEE held its same -$25 million impact from FX. **The $15-$25 million forecasted improvement comes from two areas. APS is expected to add $10-$12 million.** That is hardly organic and it cost over $500 million to add it. What the company has really touted is its Reinvent SEE restructuring program for driving this as it produced $69 million in higher EBITDA in the first two quarters of 2019 and came in over projections. The bulk of this is actually coming from the price/cost spread. This is supposed to be the result of buying more cheaply and squeezing out higher profits:

SEE Restructuring	1H Food	1H Product
Restructuring	$17.0	$11.0
Price/Cost	$26.0	$15.0

The company picked up $41 million in EBITDA from lower raw material costs and pushing through better pricing. This came in better than expected. With the APS purchase and this windfall – that is basically the increase in EBITDA guidance. The company is only forecasting about $20 million from this area in the 2H19.

We believe this could actually be a headwind going forward for several reasons. First, the company doesn't think it is sustainable. They agreed with a caller about taking advantage of a benign raw material situation in the quarter. The CFO also pointed out "*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."* They also expected more volume over that time, and it does not sound like SEE is forecasting that to bounce back soon so that could further hurt EBITDA with lower volumes and less price cost spread.

Also, inventories continue to rise at SEE.

SEE Inv.	2Q19	2Q18	1Q19	1Q18
DSI	69.5	66.9	72.9	68.0

Their inventories are rising at the same time they may be unable to take pricing at the same rates. Also, SEE really didn't take much pricing anywhere except South America. If the channel has been stuffed a little, the company has too much inventory and is facing lower volumes – that points to lower pricing for the price cost spread. We think SEE could miss forecasts here as it is still forecasting a positive $20 million for the 2H19.

EPS has been raised by $0.05 per share and we would argue this is actually a stealth cut just like sales after reporting a beat of 16-cents in 2Q and 2-cents in 1Q. The company reduced the number of shares for its EPS forecast from 156 to 155 million – that alone adds 2-cents for the year. There was a Brazilian tax valuation that reversed in 2Q19 and added 3-cents in the quarter, the higher price cost spread so far in 2019 is double what the company is forecasting in the second half. Let's say 10-cents was a windfall. Against that, they see a 7-cent headwind from APS and its inventory step-up charge plus higher depreciation should be largely tied to APS too. Just on the surface, EPS forecasts should be higher by 13-cents (+2 in 1Q, + 16 in 2Q + 1 for half a year of lower share count – 7 for APS) instead of 5-cent raise in guidance. Either this is a way to simply try to beat forecasts handily or it looks like a stealth cut.

Free cash flow is where the bigger issues are. The company has boosted several places for spending outflow and has other cash spending that should increase in the second half. In addition, can they continue to pull money out of working capital?

SEE FCF Guide	2019e	1H19	2H19e
EBITDA	$950	$453	$497
Interest	$190	$86	$104
Restructuring	$115	$49	$66
Taxes	$115	$29	$86
CFO pre WC	$530	$289	$241
APS deferral	$20	$0	$20
Novipax	$59	$0	$59
CapX	$210	$94	$116
FCF pre WC	$241	$195	$46
Guidance	$180	$75	$105
W/C plug	-$61	-$120	$59

This is a long table but we know 2019 guidance and 1H19 results. So 2H is essentially the difference. The company expects $44 million in higher EBITDA for the 2H19, but its outflow should be $193 million higher too. The APS payment of $20 million represents a deferred pay liability it will make in the 2H and the Novipax settlement was announced already and will be paid in 2H. The working capital and changes in other assets/liabilities were headwinds of $120 million in the 1H19. That will need to become positive in the 2H19 to reach this guidance. They lowered expected tax payments by $15 million, and added $59 for Novipax, $20 for APS deferred pay and $10 to CapX for a net change of -$74 million. So again, after glowing results and a big windfall in EBITDA from price cost and accretive EBITDA from the APS deal – Sealed Air only boosted guidance by $6 million? Plus, that requires that inventories fall, receivables fall and perhaps even payables rising again.

We also question that SEE can hit the interest expense target given it has made $473 million in cash acquisitions this year that are not in the table above. We also question this method of disclosure as the company makes acquisitions frequently as a matter of course which should be pushing up operating cash flow. Yet, by ignoring the purchase cost in free cash flow, they are essentially saying that incremental cash flow required no investment. They can't have it both ways. The $473 million in cash costs for deals will make the $180 forecasted FCF already nearly a -$300 million figure for 2019 and higher borrowing for SEE.

Factors that Impacted EPS in the Quarter

The company beat on adjusted EPS by $0.16 in the quarter. We think the following items helped there quite a bit. We are going to use the forecasted tax rate for the year of 26% to adjust these items:

- Pricing in South America. This was $13.7 million and pricing should drop mostly to the bottom line. Perhaps some wages are inflated with it, we will give them 80% of the hike. That is 5.2 cents in EPS.

- SEE reversed a $4.8 million tax valuation allowance related to overpayment of taxes in Brazil in the quarter. It lists this as recorded on a net basis into other income. That added 3.1 cents to EPS.

- We know that SEE is forecasting $115 million of restructuring charges in 2019 and it only spent $49.2 million in the first half. However, the total restructuring charges being added back is $89.4 million in the first half. That also includes a third line for something called Special Charges – which are fees related to professional services but were not grouped with other restructuring charges. This was $7.3 million in the quarter and sounds like it may be related to ongoing operations. That added 3.5 cents to adjusted EPS.

- Stock-based compensation fell from $8.4 million in 1Q to $4.8 million in 2Q. That would be 1.7 cents to EPS.

- The company sees itself at least $5 million (and it may be $20 million) ahead of forecast from the price cost issue offsetting other weakness in the business. Just the $5 million would have added 2.4 cents to EPS.

- SEE also added back an FX loss for Argentina which is driving the pricing. This was $1.3 million and boosted adjusted EPS by 0.6 cents.

We would consider much of this to be unexpected sources of income that will not repeat like the Brazilian tax credit allowance or price cost windfall. The rest looks like low-quality sources of income such as raising prices in hyperinflation and or adding back charges that may not be one-time in nature.

The SEC and Tax Issues May Be Expanding

In the 10-K, the company noted the following language:

"On June 25, 2018, the Company received from the staff of the SEC a subpoena for documents, including requests concerning the Company's accounting for income taxes, its financial reporting and disclosures and other matters. We are fully cooperating with the SEC on this matter and cannot predict the outcome or the duration of the SEC investigation."

Six months later in the 10-Q, Sealed Air is saying this:

"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 independent audit firm beginning with fiscal year 2015, 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 independent audit firm beginning with fiscal year 2015.

The Company is fully cooperating with the SEC and the U.S. Attorney's Office and cannot predict the outcome or duration of either of those investigations."

Sealed Air continues to point to the IRS intending to disallow a $1.49 billion tax deduction from 2014. It still refers investors back to this text in the 10-K:

"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 payments made pursuant to the Settlement agreement. The IRS has indicated that it intends to disallow this deduction in full. We strongly disagree with the IRS position and are protesting this finding with the IRS. The resolution of the IRS's challenge could take several years and the outcome cannot be predicted. Nevertheless, we believe that we have meritorious defenses for the deduction of the payments made pursuant to the Settlement agreement. If the IRS's disallowance of the deduction were sustained, in whole or in part, we would have to remit all or a portion of the refund of taxes

previously received and such disallowance could have a material adverse effect on our consolidated financial condition and results of operations."

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 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.

Disclosure

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