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BTN Thursday Thoughts

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US Chemicals: Still in the Early Stages of Growth

"I just want to say one word to you, just one word-plastics… enough said."

-*The Graduate* (1967)

Every year, Byron Wien publishes his Ten Surprises for the coming year. His political predictions may not always hit, but he does well picking some trends for economic factors. We wanted to focus on his list this year because there is a very common theme among several predictions. Mr. Wien lays out his belief that the US growth rate will continue to increase with wage gains, which will cause world economic growth to rise. This means greater demand than forecast for commodities and higher prices there too. He also forecasts that all this inflation leads to higher interest rates and a stronger US dollar. This is a quick summary. A link to the full list and rationale is above to read at your leisure.

In our view, there are a few easy ways to look at playing this type of scenario. What jumps out to us are stocks with growing dividends to offset inflation and higher interest rates. We also think that companies with lots of fixed assets that are expensive and take a long time to build and duplicate are key. If inflation results from higher wages and materials prices, then the cost to build a new plant will go up as well, as will the value of the existing plant. Several things come to mind, like office buildings, casinos and toll-roads. However, something that may have some real zing in that type of environment are US chemical plants, which also offer a unique operating advantage.

It is not a secret that the US has pioneered and perfected drilling for oil and gas in shale. Nor is it a secret that the US has seen dozens of new pipeline projects built to move all this production to refineries and end markets. What still has not had much exposure is how much all this benefits US chemical companies in 3 major ways:

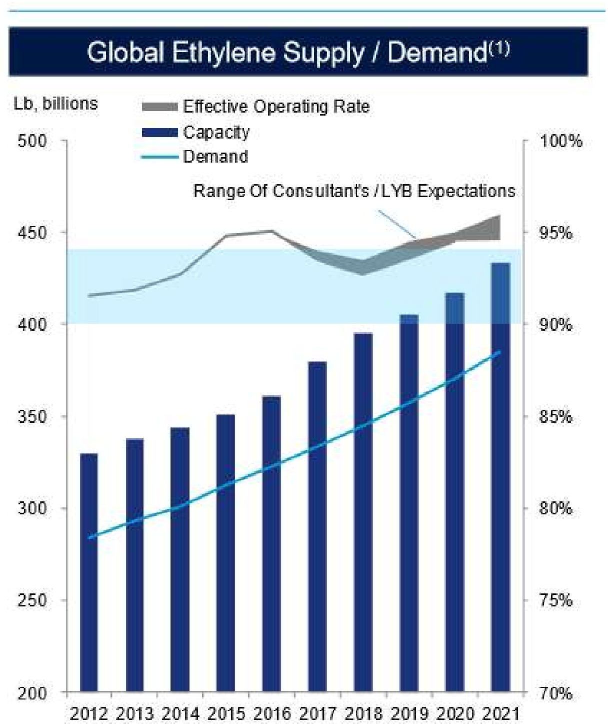
1. Most chemicals around the world are produced from oil derivatives. Drilling shale has also produced a huge supply of byproducts called NGLs (Natural Gas Liquids). These liquids are essentially ethane, propane and butane. They are cost competitive as a chemical feedstock when oil prices are at least 8x the cost of natural gas. Right now, it's running about 20x, and oil would need to fall under $25 to make NGLs uncompetitive.

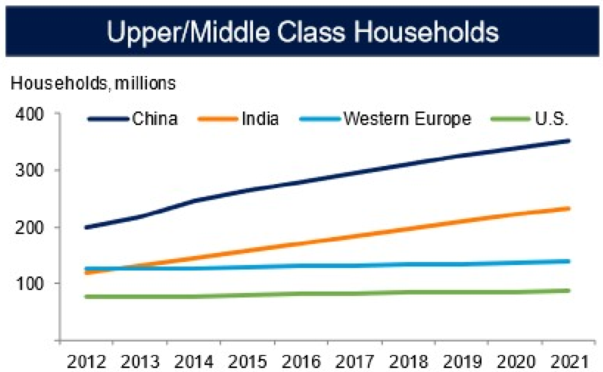
2. Chemical companies also consume a great deal of natural gas in running operations. Historically, gas trades about 1/6th the world oil price based on the ratio of energy content between the two fuels. The huge supply of gas in the US broke that link, and now US Industry enjoys the cheapest gas in the world. There are seasonal spikes in gas prices, but the US gas price is still about $3/mcf. Other areas of the world buy LNG (Liquefied Natural Gas) or gas from Russia and pay considerably more. Europe is paying close to $7, Japan about $8, and East Asia about $10.

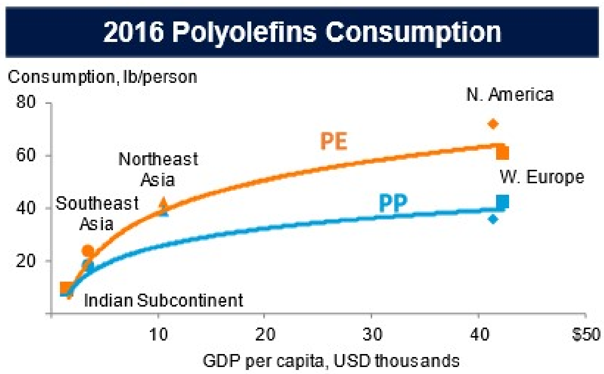
3. The pipelines were delivering NGLs faster than chemical plants could be built to use it all. Thus, simple supply and demand has kept prices low for US companies. Now, even more pipelines to carry NGLs and gas are coming online, so the supply will rise further even as export markets develop. High oil prices also help because it encourages more drilling which ends up producing more of all three products.

US chemical companies may thus end up with a great scenario. Higher commodity prices drive up building costs and operating costs for their competitors. But at the same time, the higher oil price should produce more of the key feedstocks they consume and keep their costs low. On top of that, the increases in world growth and incomes that Mr. Wien forecasts means more demand, and the high-cost competitors will set the market price. That's what gives these companies some extra zing.

Plastic use per capita increases with income. Many places in the world can still see not only more people using plastic, but higher amounts per person, and that's even in the developed world. That helps absorb new chemical capacity, which remains tight, and also the feedstock edge means that new US capacity continues to come online below the costs competitors can match







The above exhibits were prepared by Lyondellbasell (LYB) and industry sources, most notably IHS – a chemical industry research house. As is evident, long-term demand is positive for this industry due to favorable demographics for years to come. These growth forecasts do not reflect either the fact that US companies have a cost edge or accelerating growth projections by Mr. Wien. (BTW- PE means Polyethylene and PP means Polypropylene which are what the feedstocks become before being made into finished goods.)

Investors can buy chemical plants with these advantages by buying major oil companies like ExxonMobil (XOM), Chevron (CVX) and Royal Dutch Shell (RDS/B) who are all in this business too. If you want more pure-plays on chemicals, DowDuPont (DWDP), LyondellBasell Industries (LYB), and Westlake Chemical (WLK) make some sense. In terms of valuations, they simply are not that high relative to the growth rates already being realized in earnings and dividends.

DowDupont (DWDP) just completed a large merger, and 4Q results and projections for 2018 will not be available for about 10 days. On the surface, the merged company has reported pro-forma 16% EPS growth for the 9 months ended September 30, 2017 against a forward P/E ratio of 18.9. The yield on the current stock is 2.0%. The merger effectively cut the dividend to the current quarterly rate of 38-cents. Prior to this, Dow had been growing its dividend at a 10% rate until the merger was announced, and was paying 46-cents quarterly. DuPont's dividend on the conversion of the merger would have been a 49-cent dividend and had been flat as of late. There are too many pro forma adjustments to make on this one until we can see a 10-K report. There are also several company forecasts for considerable synergies from cost savings which the two companies were working on separately which will allow the dividend to grow again.

However, LyondellBasell (LYB) more cleanly illustrates what is happening here in terms of sustainable growth. The company yields 3% and is growing that at 6%. The dividend consumes about 40% of free cash flow. Historically, LYB has grown the dividend even faster and paid large special dividends as well. In recent years, the company has devoted more cash from operations to expansion and buying back its own stock. Our view is share repurchases are fine as long as two things are happening – the company is buying the stock cheap and the share count is actually falling rather than merely offsetting dilution from executives exercising stock options. As far as the stock being cheap, LYB is trading for about 12x forward earnings and 3Q y/y adjusted EPS growth rates (adjusted for an asset sale gain and the Houston Hurricane losses) was 26%. The company is selling for under 8x EBITDA and has debt of only 1.3x and is in fact is seeing its credit rating increased. We would argue that a P/E-to-growth ratio of under 0.5x is cheap. In addition, the share-count here is actually falling with the repurchases. They have set goals to buy back 10% of shares almost annually for several years and when they are done, the number of shares fall by 10%. It is far from the more typical situation of a company selling at 25x EPS buying back 10% of its shares only to see its share count rise 5% due to management cashing in stock options.

Earnings Quality Reviews

Below we examine the earnings quality of some higher profile companies that have reported earnings in the last week.

Procter and Gamble (PG)

Procter and Gamble (PG) reported earnings on Tuesday (1/23) of $1.19 after adjustment for acquisitions, divestitures and one-time items. This was almost 5% above consensus expectations. Nevertheless, the stock has been down over concerns that the company is still unable to realize any real pricing power and remains unable to offset increasing raw materials inflation. Despite 150 basis points of productivity improvements, rising costs and lower pricing still resulted in a currency-neutral core operating profit decline of 30 basis points. These pressures are well documented as name brand consumer packaged goods producers are all continuing to struggle with a cautious consumer and the ever more competitive consumer retail environment. This note does not attempt to weigh in on the near-to-medium term outlook for these factors, but suffice it to say that none of these company managements appear to be expecting a dramatic turnaround in the current environment in 2018.

Nevertheless, we do note some other items of concern in recent results:

Accounts payable growth is boosting cash flow

As noted above, slow growth and cost pressures have conspired to keep a lid on PG's cash flow growth in the last few years:

	12/31/2017	*12/31/2016*	*12/31/2015*
T12 Operating Cash Flow	$14,043	$13,442	$15,558
T12 Capex	$3,855	$3,520	$3,317
T12 Free Cash Flow	$10,188	$9,922	$12,241
T12 Div % of T12 FCF	**71.0%**	**74.0%**	**60.5%**

However, cash flow has been getting a boost from the company lengthening the time it takes to pay its suppliers. The following table shows accounts payable and the calculation of accounts payable days of sales:

Quarter ended:	*12/31/2017*	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*	*9/30/2016*
Sales	$17,395	$16,653	$16,079	$15,605	$16,856	$16,518
Accounts payable	$9,740	$9,458	$9,632	$8,076	$8,300	$9,024
Sales YOY growth	3.2%	0.8%	-0.1%	-1.0%	-0.3%	-0.1%
Accounts payable YOY growth	17.3%	4.8%	3.3%	3.6%	7.6%	16.3%
Sales Seq growth	4.5%	3.6%	3.0%	-7.4%	2.0%	2.6%
Accounts payable Seq growth	3.0%	-1.8%	19.3%	-2.7%	-8.0%	-3.2%
Accounts payable DSPs	**51.1**	**51.8**	**54.7**	**47.2**	**44.9**	**49.9**

The company stated in its 10-Q filing for the quarter that the increase in payables was "primarily driven by extended payments term with our suppliers…" Accounts receivable and inventories both increased during the period. Accounts receivable DSOs jumped by almost two days over the year-ago quarter, which the company blamed on the quarter ending on a weekend, resulting in lower collections. We are not overly alarmed by the increase in receivables but will monitor it going forward. Likewise, inventory DSIs jumped by 2 days, which we will discuss more in the next section. However, the increase in payables more than offset these two drains on cash flow. The following table shows the components of the company's cash flow conversion cycle, or number of days its takes the company to convert a dollar of sales into a dollar of profits:

Quarter ended:	*12/31/2017*	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*	*9/30/2016*
DSO	27.2	27.1	26.1	25.5	25.6	26.0
DSI	54.0	55.7	50.8	55.4	52.6	56.3
DSP	51.1	51.8	54.7	47.2	44.9	49.9
Days to convert	30.1	31.0	22.3	33.6	33.3	32.5

Days to convert fell from 33.3 to 30.1, yet it would have increased if not for the payables increase. This trend has been going on for some time. The following table shows the conversion cycle by year for the last five fiscal years.

Fiscal year ended:	**6/30/2017**	**6/30/2016**	**6/30/2015**	**6/30/2014**	**6/30/2013**
DSO	25.8	24.4	25.1	29.0	28.8
DSI	51.9	52.3	53.7	60.2	60.9
DSP	54.0	52.1	42.6	38.4	38.8
Days to convert	23.6	24.6	36.2	50.7	50.9

While all the working capital ratios have shown good long-term improvement, days payable has been the biggest contributor to improvement in the cash collection cycle. Also, this longer-term perspective shows that days payable stands at a definite historical low, calling into question how much more the company can lean on its suppliers to boost cash flow growth.

Inventories jumped in the quarter

As mentioned above, inventory DSI's jumped by 2.6 days over the year-ago quarter. The company attributed the increase to increased sales and new product initiatives. However, we think it is worth pointing out that most of the increase in DSIs came from an increase in finished goods, as seen in the following table which breaks out the increase in DSIs by inventory components:

Quarter ended:	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Materials and supplies days	15.5	14.9	14.4	15.4	15.4	15.5
In-Progress days	6.1	6.5	5.8	5.9	5.7	6.2
Finished Goods days	32.5	34.3	30.6	34.1	31.5	34.6
DSIs	54.0	55.7	50.8	55.4	52.6	56.3

It is possible that the increase in finished goods could be related to the company building up a supply of new products to be launched at the opening of the March quarter, so our concern level is not especially high. However, so much of the increase being centered in finished goods is always a concern, and we will be looking for a moderation of inventory levels in the March results.

Ongoing restructuring charges

Recurring restructuring charges are always an item of concern as they introduce the possibility that management is labeling expenses that should be considered operational as being "one-time," and then presenting an earnings figure with these charges adjusted out. This encourages investors to completely forget about them as if the expense never happened. In our mind, the larger and more frequent the charges, the more likely it is such manipulation is occurring.

PG has been undergoing restructuring activities for years. So much so, that even management began to cast some of these expenses as being "regular." Consider the following disclosure from PG's most recent 10-Q:

> "The Company has historically incurred an ongoing annual level of restructuring-type activities to maintain a competitive cost structure, including manufacturing and workforce optimization. Before-tax costs incurred under the ongoing program have generally ranged from $250 to $500 (million) annually."

The company presents adjusted earnings data with "incremental charges" added back in. These incremental amounts are deemed to be over and above the previously-referenced recurring charges. The incremental amounts have ranged from $400 million to over $620 million in the last three years alone. Investors must trust the company's judgement as to whether a restructuring expense is classified as ongoing, and therefore charged against current earnings, or incremental and added back in for analytical and valuation purposes. Considering that the $250 million to $500 million recurring charge range amounts to roughly 30-70 basis points as a percentage of sales, the potential definitely exists for adjusted results to be significantly impacted.

With this in mind, we think it is interesting to examine the company's earnings and revenue performance versus consensus, as shown in the following table:

	Adjusted EPS vs Consensus	Reported revenue vs. consensus
12/17	4.5%	0.0%
9/17	1.2%	-0.2%
6/17	8.7%	0.5%
3/17	2.1%	-0.8%
12/16	1.7%	0.2%
9/16	5.2%	0.2%
6/16	6.0%	1.7%
3/16	5.3%	-0.3%
12/15	5.8%	-0.3%
9/15	3.6%	-2.9%
6/15	5.7%	-0.8%
3/15	-0.2%	-1.5%

Note that in the last three years, PG has missed consensus revenue seven out of 12 quarters, yet it has missed earnings targets only once in the same time period. While this is not conclusive in itself, it certainly gives the impression that management has a greater degree of flexibility in what it reports as earnings versus sales. Restructuring charges have been 3-5% of adjusted net income during that period. While we are not alleging that all of the charges represent operational amounts, it does not take much in the way of executive pay being allocated to restructuring activities or asset writedowns leading to lower depreciation in order for these amounts to account for a material portion of the observed profit beats.

Kimberly-Clark (KMB)

Last week, we previewed KMB's 12/17 quarter earnings, noting some items of concern. This week, the company once again missed top-line revenue targets, but managed to report adjusted EPS of $1.57 which was 2.5 cents above consensus. The company also announced the largest restructuring program since it began its global initiative in 2003. We discuss the status of our concerns and the new program below.

Accounts receivable still elevated

Last week, we noted that after several quarters of trending down, KMB's receivables began to increase in the 9/17 quarter. This trend in the year-over-year DSO increase continued into the 12/17 quarter:

Quarter ended:	*12/31/2017*	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*	*9/30/2016*
Sales	$4,582	$4,640	$4,554	$4,483	$4,544	$4,594
Accounts Receivable	$2,315	$2,360	$2,221	$2,224	$2,176	$2,222
Sales YOY growth	0.8%	1.0%	-0.7%	0.2%	0.1%	-2.6%
Accounts Rec. YOY growth	6.4%	6.2%	-1.2%	-1.4%	-4.6%	-2.7%
Sales Seq growth	-1.3%	1.9%	1.6%	-1.3%	-1.1%	0.1%
Accounts Rec. Seq growth	-1.9%	6.3%	-0.1%	2.2%	-2.1%	-1.2%
Accounts Receivable DSOs	**46.1**	**46.4**	**44.5**	**45.3**	**43.7**	**44.1**

As we pointed out last week, the 9/17 jump in receivables could have pulled over $100 million into the third quarter at the expense of the fourth quarter. This very well could have contributed to the approximate $25 million revenue miss in the quarter. To be fair, KMB has missed 7 of its last 8 quarterly revenue targets, so that is nothing new. As far as the current status of the receivables, there was another 2.4 day year-over-year increase in

DSOs in the 12/17 quarter. However, the sequential decline in the accounts receivable balance was more in-line with what we would expect in a fourth quarter, indicating there was less of a noticeable buildup in receivables than in the previous quarter. We are therefore less concerned about the receivables balance going into the 3/17 quarter, but will remain watchful of the trend going forward.

Accounts payable still rising

We noted last week that KMB's cash flow was benefitting from the company putting pressure on its suppliers. This trend continued into the 12/17 quarter, as seen in the below table which shows the calculation of accounts payable days of sales:

Quarter ended:	*12/31/2017*	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*	*9/30/2016*
Sales	$4,582	$4,640	$4,554	$4,483	$4,544	$4,594
Accounts payable	$2,834	$2,729	$2,629	$2,571	$2,609	$2,454
Sales YOY growth	0.8%	1.0%	-0.7%	0.2%	0.1%	-2.6%
Accounts payable YOY growth	8.6%	11.2%	7.4%	5.3%	-0.1%	-2.5%
Sales Seq growth	-1.3%	1.9%	1.6%	-1.3%	-1.1%	0.1%
Accounts payable Seq growth	3.8%	3.8%	2.3%	-1.5%	6.3%	0.2%
Accounts payable DSPs	**56.4**	**53.7**	**52.7**	**52.3**	**52.4**	**48.7**

While sales rose by just under 1% in the quarter, accounts payable jumped by 8.6% over last year's fourth quarter. Keep in mind that accounts payable days of sales has risen consistently over the last six years from about 46 days to the current 56. As we noted last week, we are certainly not faulting management for efficient working capital management. Nevertheless, squeezing suppliers has been a meaningful boost to cash flow growth in recent years and the questions arises as to how much longer it can continue to be. This is an important question for a company struggling to grow its cash flow at all.

Next round of charges announced- and they are huge

KMB management announced in the quarterly conference call that it is starting its next round of restructuring activities. While KMB is not as bad as some companies about taking a material restructuring charge every quarter, regular restructurings are definitely a part of its history as seen in the below table:

	2016	2015	2014	2013	2012	2011
2014 restructuring	$35	$63	$133			
Pulp & tissue charges					$135	$415
European restructuring			$33	$81	$299	
Other	$23					$32
Total charges	$58	$63	$166	$81	$434	$447
Adjusted pretax income	$3,033	$2,932	$2,918	$2,758	$1,980	$1,844

The latest round of restructuring is the largest so far. The "2018 Global Restructuring Program" is expected to result in total restructuring charges of $1.7-$1.9 billion through 2020. Management predicts actual cash outlays of $900 million to $1 billion plus another $600-$700 million in incremental capital spending associated with the plan. The bulk of the charges are expected to be recognized in 2018 with $1.20-$1.35 billion expected in 2018. This will of course be added back to adjusted earnings. All of this spending is expected to result in annual cost savings of $500-$550 million by the end of 2021 and is in addition to its ongoing FORCE cost reduction program.

KMB management made an interesting comment on the conference call in regards to the 2018 Plan:

> "I will tell you I think I had an investor once tell me that he thought every CPG company restructured every five years. And I think your point would be, gosh, it would be great if we could avoid adding the cost in the first place so we didn't have to restructure it. But we've probably historically proven that we're not capable of that."

We tend to agree with the unnamed investor. While we understand global organizations are complex and it is impossible to expect one grand plan to align operations forever, at what point does one look at the regularity and magnitude of these charges over time and conclude that these are a regular cost of doing business that should be subtracted out of profits? Just a quick glance at the table above shows that from 2011-2016, these "one-time" charges amounted to over 8% of adjusted pretax income. That's pretty meaningful. One might argue that these programs resulted in ongoing annual cost savings, but do those cost savings cover the newest round of "incremental" spending on the next plan?

There is no doubt that the company's charge-adjusted operating margins have improved as a result of costs being removed from the model. The company's ongoing FORCE program has been attributed with $300-$450 million a year in cost savings over the last several years, and the company does not take one-time charges directly associated with that program. Since the 2014 restructuring program, the company has identified roughly $160 million in savings from the 2014 program and another $1.5 billion in FORCE program reductions. However, given that the latest program will spend almost all of that, it calls into question how much was actually saved over the whole time frame. One has to believe that this charge is the last charge, but as management confessed in the call, history doesn't seem to show they are capable of that. Meanwhile, the cash costs and incremental capex will weigh on what is available for future dividend growth.

Disclosure

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