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Ball Corporation (BLL) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
2-	3-

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

We are lowering our rating on Ball Corporation (BLL) to a 2- (Weak) from a 3- (Minor concern.

BLL reported EPS of $0.56 in the 9/18 quarter, 4 cps short of the Zack's estimate. We are lowering our rating on BLL based on the rapid increase in receivables factoring which we believe is giving cash flow growth an unsustainable boost.

- The amount of accounts receivable sold but outstanding at the end of the 9/18 quarter rose to over $940 million from approximately $650 million a year ago. We estimate that the increased use of factoring provided the bulk of reported operating cash flow growth in the period which was already benefitting from $150 million in lower cash pension contribution.

- Accounts receivable days (DSOs) rose by 2 days after adjustment for sold receivables.

- Accounts payable continue to rise year-over-year as days payable jumped by 18 days over last year's third quarter. However, the sequential increase is leveling out and the boost to cash flow growth from extending payment terms appears to have reversed.

Receivables Factoring Continues to Expand

BLL continues to sell off receivables at an accelerating pace. While the company does not disclose the exact amount of sold receivables that are still outstanding at the end of the period, it does tell us the current limit of the factoring facility and the amount available for sale at the end of the quarter. This is the company's latest disclosure on the matter from its 10-Q filing for the 9/18 quarter:

> *"We have entered into several regional committed and uncommitted accounts receivable factoring programs with various financial institutions for certain of our receivables. The programs are accounted for as true sales of the receivables, without recourse to Ball, and had combined limits of approximately $1.15 billion and $1.0 billion at September 30, 2018, and December 31, 2017, respectively. A total of $208 million and $439 million were available for sale under such programs as of September 30, 2018, and December 31, 2017, respectively."*

We arrive at an estimate of the amount of outstanding sold receivables by taking the difference between the facility limit and the amount still available for sale. The results are shown in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Limit of Factoring Facility	$1,150	$977	$800	$1,000
Available for Sale	$208	$139	$211	$439
Implied Amount Sold and Outstanding	$942	$838	$589	$561

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Limit of Factoring Facility	$1,000	$1,000	$865	$970
Available for Sale	$354	$342	$323	$374
Implied Amount Sold and Outstanding	$646	$658	$542	$596

We noted in our review of the 6/18 quarter that there was a noticeable jump in outstanding sold receivables. This increase accelerated in the 9/18 period as estimated outstanding sold receivables jumped by almost $300 million (>45%) over last year's third quarter. Reported operating cash flow would have received a tremendous boost from the acceleration of the collection of these receivables. We will discuss that more in the next section.

Adjusted DSOs Up Almost Two Days

As noted in the previous section, BLL appears to be rapidly expanding the use of its receivables factoring program. When the company sells receivables, they are treated as a sale with no recourse and the receivables are removed from the balance sheet altogether. This understates the reported receivable days of sales (DSO) calculation, so we must add back those outstanding sold amounts to the reported balance sheet amounts to get a clearer picture of trends in the company's revenue recognition. We show this exercise in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales Under Pre-606 Accounting Method	$2,985	$3,143	$2,752	$2,747
Receivables Under Pre-606 Accounting Method	$1,622	$1,722	$1,745	$1,634
Balance Sheet Receivables	$1,622	$1,800*	$1,745	$1,634
Pre-606 Balance Sheet DSOs	49.6	52.3	57.9	54.3
Receivables Sold and Outstanding	$942	$838	$589	$561
Adjusted Receivables	$2,564	$2,638	$2,334	$2,195
Adjusted DSOs	**78.4**	**76.6**	**77.4**	**72.9**

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales Under Pre-606 Accounting Method	$2,908	$2,855	$2,473	$2,523
Receivables Under Pre-606 Accounting Method	$1,793	$1,637	$1,695	$1,491
Balance Sheet Receivables	$1,793	$1,637	$1,695	$1,491
Pre-606 Balance Sheet DSOs	56.3	52.3	62.5	53.9
Receivables Sold and Outstanding	$646	$658	$542	$596
Adjusted Receivables	$2,439	$2,295	$2,237	$2,087
Adjusted DSOs	**76.5**	**73.4**	**82.5**	**75.5**

*includes $78 million of receivables that were held for sale

Note that the company adopted ASC 606 revenue recognition method at the beginning of the year. The above revenue and receivables for 2018 periods are restated to conform with the pre-606 method to be compatible with prior periods.

We see that DSOs calculated using the receivables reported on the balance sheet fell dramatically from 56.3 in the 9/17 quarter to 49.6 in the 9/18 quarter. However, this was a direct result of the company accelerating the sale of receivables as we discussed in the previous section. If we add back the estimated outstanding sold receivables, we get a much different picture. Adjusted DSOs rose to 78.4 from 76.5 a year ago. This is not an alarming increase by itself and we are not currently concerned that the company is boosting sales by aggressively offering more generous payment terms. However, let's look at how much the acceleration in receivables sales is boosting cash flow.

According to the above table, outstanding sold receivables increased by $381 million ($942m-$561m) during the first nine months of the year. This represents cash the company would not have collected during that period if it had not sold off the receivables. Also, consider that BLL reported $1.027 billion of operating cash flow and $411 million of free cash flow during the same period.

Further, let's compare the increase in cash generated by increased receivable sales to the year-ago period. During the first nine months of 2017, outstanding sold receivables increased by $50 million ($646m-$596m). This means that reported operating cash flow growth during the nine months ended 9/18 received a $331 million tailwind ($381m-$50m) from the increased rate of receivable sales. Consider that reported operating cash flow growth during the period was only $283 million, which implies that operating cash flow would have declined during in the first nine months of 2018 without the accelerated pace of receivables factoring. We understand that there are other factors impacting BLL's cash flow growth during the period including higher cash tax payments. However, cash flow also benefitted by a $148 million decline in cash pension contributions as well. It is clear that the receivables factoring program is having a major impact on the company's reported cash flow growth during the past year that may be giving investors a false picture of its true strength.

Days Payable (DSP) Continues to Climb YOY, But Are Leveling Off

We pointed out in our review of the 6/18 quarter that BLL's accounts payable balance has grown rapidly in the last several quarters. This trend continued into the 9/18 period as seen in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS Under Pre 606	$2,393	$2,522	$2,206	$2,134
Accounts Payable	$2,953	$2,937*	$2,822	$2,762
Adjusted Days Payable	112.6	106.3	116.7	118.1

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS Under Pre 606	$2,338	$2,270	$1,975	$2,009
Accounts Payable	$2,419	$2,146	$1,830	$2,033
Adjusted Days Payable	94.4	86.3	84.6	92.3

*Includes $198 million of payables classified as held for sale

While days payable (DSP) are still climbing on a year-over-year basis, the sequential growth has levelled out. Consider that payables at 9/18 increased by $191 million since the beginning of the year while they increased by $386 million in the comparable year-ago period. This is not a surprise given that the time the company was taking to pay suppliers had jumped to over 100 days. However, it highlights that a boost to cash flow growth is now turning the other direction.

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 recent 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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