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Ball Corp. (BLL) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are lowering our earnings quality rating to 3- (Minor Concern)

BLL's 9/20 non-GAAP earnings of $0.89 beat the consensus estimates by 12 cps. We identified about 4 cps in one-time benefits in the quarter, so the earnings beat remains well intact. Our reduction in rating reflects the continuing increase in factored receivables.

What deteriorated?

- The growth in factored receivables continues. Factored receivables balances rose sequentially in the quarter by approximately $240 million versus about $53 million growth in the year-ago quarter. This could have added almost $200 million to cash flow growth in the first nine months of 2020. Outstanding factored receivables balances are larger than trade receivables left on the balance sheet. Factored receivables days of sales stood at 39 days at the end of the quarter compared to the mid-20 range two years ago. How much longer can this disproportionate growth continue to drive cash flow growth?

(Concern level: MEDIUM)

- Depreciation expense fell to $115 million in the quarter from a recent trend in the $125 million range seen over the last several quarters. This was despite an increase in net property, plant, and equipment from the August acquisition of Tubex. The absolute decline in depreciation from the 6/20 quarter added about 2 cps to EPS in the 9/20 quarter. This should reverse soon as new production facilities are brought online and capex remains elevated over the next two years.
(Concern level: LOW)

- We estimate that the adjusted effective tax rate used in the calculation of adjusted EPS fell by 200 bps to 17.7%. This would have added about 2 cps to EPS in the period.
(Concern level: LOW)

What to watch

- BLL plans to add 25 billion units of capacity by the end of 2023 with as much as 45 billion units by 2025. This is expected to keep capex spending above $1 billion in the next two years. Also, investment in working capital is expected to remain a drain on cash flow growth. Over the long-term, however, management declared that it has a "path to doubling cash from operations by 2025." In the meantime, free cash flow growth may be limited.

- Debt to adjusted EBITDA was 3.6 at the end of the 9/20 quarter. Management noted in the call that it is in "growth mode" in terms of capital allocation. It does not plan to deleverage over the next year and it will limit the buyback in 2021. In the last few quarters, the lower share count from previous buyback activity has been adding about 2.5-3.0% to EPS growth so that source or earnings growth could fade in the next year.

- BLL's contracts contain pass-through provisions where pricing moves to compensate for the rise and fall of aluminum prices to protect it from rising costs of aluminum While this helps protect BLL's bottom line, changes in the rate of pass-throughs can materially impact reported revenue growth. Currently, declining aluminum prices are a drain on reported revenue growth.

- In the short-run, BLL has seen volume growth boosted by COVID driving an increase in packaged beverages for at-home consumption. Longer-term the bull story centers around an expected switch from plastic cups and beverage containers to new lightweight, recyclable aluminum cups and bottles. In the last conference call, the company forecast 6% volume growth in North America over the next 3-5 years with "mid-single-digit" growth in EMEA. An evaluation of this forecast is beyond the scope of this report and aluminum packaging will certainly help with the buildup of plastic waste which is a current source of public concern. However, we note some onlookers worry that aluminum production gives off substantially more greenhouse gases than paper or plastic and increases the problem of pollution from bauxite mining.

Factoring Continues to Climb

(Concern level: Medium)

The accounts receivables number on BLL's balance sheet includes trade receivables, unbilled receivables, and other receivables. Other receivables contains items such as tax receivables and other items not related to revenue. Therefore, we define base balance sheet receivables as trade receivables plus unbilled receivables net of allowances for bad debts.

Also, the company maintains a receivables factoring program whereby it sells receivables to third parties to accelerate the receipt of cash which results in these receivables being removed from BLL's balance sheet. BLL discloses the limit of the factoring facility and the amount currently available. We estimate the amount of receivables sold but still outstanding at the end of the period by taking the difference between the limit and the amount still available under the facility. Note that the limit is disclosed rounded to the nearest $100 million so our factored receivables number is not exact. We estimate rounding could potentially impact the days sales calculation around 1-1.5 days of sales.

The following table shows the calculation of DSOs based on base receivables, factored receivables, and the total of both:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Sales	$3,093	$2,801	$2,785	$2,719
Net Trade + Unbilled	$1,418	$1,447	$1,417	$1,186
Base DSO	42.2	47.0	46.3	40.1
Outstanding Sold Receivables	$1,316	$1,073	$1,098	$1,170
Factored DSO	39.1	34.9	35.9	39.6
Adjusted Receivables	$2,734	$2,520	$2,515	$2,356
Adjusted DSO	81.3	81.9	82.2	79.7

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Sales	$2,953	$3,017	$2,785	$2,803
Net Trade + Unbilled	$1,405	$1,511	$1,426	$1,280
Base DSO	43.8	45.6	46.1	42.0
Outstanding Sold Receivables	$1,145	$1,092	$1,008	$1,022
Factored DSO	35.7	32.9	32.6	33.5
Adjusted Receivables	$2,550	$2,603	$2,434	$2,302
Adjusted DSO	79.4	78.5	78.7	75.6

As we have observed in previous reviews, factored receivable DSOs have been steadily rising YOY for the last several quarters. A large sequential and YOY jump in factored balances again drove a 3.4-day increase in factored DSOs. Base receivables on the balance sheet were essentially flat YOY with DSOs down 1.6 days. Adjusted DSOs which take into account the factored balances, rose by 1.9 days, continuing a trend in YOY increases seen for several quarters.

Our most immediate concern regarding receivables is the impact that rising factoring has on cash flow growth. We see in the table above that factored receivables rose to $1.316 billion at the end of the 9/20 quarter versus $1.073 billion at the end of the 6/20 quarter- a $243 million increase. If the company had not factored those receivables, cash generated in the quarter would have been lower by roughly that amount. Looking at last year's third quarter, the increase in factored balances was only $53 million. If we take the impact of factoring out of both periods, it appears as if the increase in factoring in the quarter could have boosted cash flow growth in the first nine months of 2020 by around $190 million, a period in which reported cash from operations actually fell from $656 million last year to $345 million this year. This decline was driven partly by the timing of metal payments in the first quarter of this year along with inventory rebuilding. We have nothing against a company working to collect cash faster- that's good cash management. However, if the growth in receivables factored flattens or reverses, receivables will revert to being a headwind to cash flow growth. Trade receivables (excluding unbilled) on the balance sheet amounted to $925 million at the end of the quarter compared to the $1.3 billion that has been removed but still outstanding. With the balance of sold trade receivables already exceeding those left on the balance sheet, how much longer can the outpaced growth in factored balances continue?

Total DSOs Adjusted for Factoring Rose by 2 Days YOY

Another concern regarding receivables is the growth in adjusted DSOs. The company acquired Tubex Industries in August for $80 million which could have contributed to the increase in DSO although the impact was likely minimal. It is worth noting that the current level of adjusted DSOs in the low 80s compares to the mid-to-low 70s two years ago. We have been watchful of the increase in unbilled receivables which have been partly driven by the growth in Aerospace sales which are recognized under long-term contracts. The following table shows the increase in unbilled receivable DSOs compared to the increase in total adjusted receivable DSO which includes trade receivables, unbilled receivables, and factored receivables.

	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Increase in Unbilled DSOs	-0.4	2.4	2.8	3.1	4.1	3.7
Increase in Adjusted DSOs	1.9	3.4	3.5	4.2	6.3	5.8

We can see that the increase in unbilled receivables has accounted for some, but not all of the increase in adjusted DSOs over the last couple of years and they *declined* in the 9/20 quarter. Note that acquisitions and divestitures can impact all these periods, but over time there is a definite increase in rising DSOs.

While the increase in adjusted DSOs over time has not been especially dramatic, it deserves attention as it could be an indication of the company offering better terms to customers to drive sales growth.

Depreciation Expense Declined Sharply in the Quarter

We noticed that depreciation expense declined materially in the 9/20 quarter as seen in the following table:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Quarterly Depreciation Expense	$115	$126	$124	$123
Net PPE	$4,895	$4,662	$4,499	$4,470

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Quarterly Depreciation Expense	$123	$123	$122	$123
Net PPE	$4,320	$4,385	$4,360	$4,542

BLL acquired Tubex Industria in the 9/20 quarter for $80 million which resulted in net property, plant, and equipment (PPE) increasing. There were no other significant acquisitions or divestitures made in the last three quarters that would have resulted in the sudden decline in depreciation expense seen in the period. The absolute decline in depreciation expense from the 6/20 quarter added about 2 cps to EPS in the 9/20 quarter.

BLL has been investing heavily in new production facilities for several quarters and expects capex to remain elevated for the next couple of years. Depreciation expense can be expected to begin increasing as these new facilities come online.

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.

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