BEHIND THE NUMBERS
Quality of Earnings Analysis

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Ball Corp. (BLL) Earnings Quality Update 12/20 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 3- (Minor Concern)

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

Summary

Our review of the 10-K did not turn up any new earnings quality concerns. Our concern remains focused on the quality and sustainability of cash flow growth.

What deteriorated?

- Outstanding factored receivables rose by $52 million from the 9/20 quarter to the 12/20 quarter versus a $25 million increase in the comparable year-ago period. This implies a roughly $27 million incremental boost to cash flow growth in the quarter from increased factoring. The sequential increase in factoring is slowing and we remain concerned that the sizeable tailwind to cash flow growth it has provided will fade or even reverse. We are skeptical the company can reignite it given the balance of outstanding factored receivables exceeds receivables left on the balance sheet.

What to watch

- Depreciation expense rebounded from the 9/20 level to more in-line with recent trends. However, depreciation as a percentage of gross PPE has declined as the rising Construction in Progress component has yet to be depreciated. If we apply a historical deprecation percentage to the current gross PPE balance, depreciation expense would have been more than 5 cps higher than reported. Investors should remember this cost will hit the income statement as the new capacity is brought online.

Supporting Detail

Receivables Factoring Slows Sequentially

We have been tracking the rise in the company's use of its receivables factoring program for the last few quarters. In our review of the third quarter, we noted a sharp sequential YOY and sequential jump in factored but outstanding balances. In the fourth quarter, the sequential increase decelerated but outstanding factored balances are significantly higher than a year ago. The following table shows the calculation of balance sheet DSOs, factored DSOs, and total adjusted DSOs for the last eight quarters:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Sales	$3,102	$3,093	$2,801	$2,785
Net Trade + Unbilled	$1,344	$1,418	$1,447	$1,417
DSO	**39.9**	**42.2**	**47.0**	**46.3**
Outstanding Factored Receivables	$1,368	$1,316	$1,073	$1,098
Factored DSO	**40.6**	**39.1**	**34.9**	**35.9**
Adjusted Receivables	$2,712	$2,734	$2,520	$2,515
Adjusted DSO	80.4	81.3	81.9	82.2

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Sales	$2,719	$2,953	$3,017	$2,785
Net Trade + Unbilled	$1,186	$1,405	$1,511	$1,426
DSO	40.1	43.8	45.6	46.1
Outstanding Sold Receivables	$1,170	$1,145	$1,092	$1,008
Factored DSO	39.6	35.7	32.9	32.6
Adjusted Receivables	$2,356	$2,550	$2,603	$2,434
Adjusted DSO	79.7	79.4	78.5	78.7

We can see that total adjusted DSOs rose from 79.7 in the 12/20 quarter to 80.4 in the 12/20 quarter, so the company has not become much more aggressive in extending payment terms. Factored receivable days rose by 1 YOY and were up almost 1 sequentially. Factored receivables rose by $52 million from the 9/20 quarter to the 12/20 quarter compared to a $25 million increase in the comparable year-ago period. This implies that growth in cash from operations could have boosted by roughly the difference of $27 million. The artificial benefit to cash flow growth from accelerated factoring is waning and we are skeptical that it can be reignited given that outstanding factored receivables now exceed the total of trade receivables ($825 million at 12/20) and unbilled receivables ($528 million at 12/20) that are left on the balance sheet. This could lead to disappointing cash flow growth which could be a problem as the company looks to continue its aggressive capex plan over the next couple of years.

Depreciation Down Despite Rising PPE- But This Will Reverse

We noted an unusual decline in depreciation expense in our review of the 9/20 quarter. While depreciation expense rebounded in the 12/20 quarter, it remains even with the year-ago level despite a noticeable increase in PPE from the company's capital spending program. The company offers excellent disclosure on PPE, providing the gross components on a quarterly basis. This information is shown in the following table along with a calculation of depreciation expense as a percentage of average gross PPE for the last six quarters:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Land	$163	$160	$153	$151	$153	$148
Buildings	$1,653	$1,533	$1,466	$1,425	$1,433	$1,352
Machinery and Equipment	$6,214	$5,869	$5,696	$5,467	$5,513	$5,203
Construction in Progress	$883	$734	$626	$591	$434	$508
Gross PPE	$8,913	$8,296	$7,941	$7,634	$7,533	$7,211
Accumulated Dep.	$3,562	$3,401	$3,279	$3,135	$3,063	$2,891
Net PPE	$5,351	$4,895	$4,662	$4,499	$4,470	$4,320
Quarterly Depreciation Expense	$123	$115	$126	$124	$123	$123
Depreciation % of Gross PPE	1.4%	1.4%	1.6%	1.6%	1.6%	1.7%

We are still unsure why depreciation dipped in the 9/30 quarter. Nevertheless, we see that despite the material increase in gross PPE, depreciation has remained flat with historical levels. This would ordinarily be a red flag signaling an aggressive increase in average deprecation periods. However, the following table which shows the PPE components as a percentage of gross PPE gives us more insight into the cause:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Land	1.8%	1.9%	1.9%	2.0%
Buildings	18.5%	18.5%	18.5%	18.7%
Machinery and Equipment	69.7%	70.7%	71.7%	71.6%
Construction in Progress	9.9%	8.8%	7.9%	7.7%
Gross PPE	100.0%	100.0%	100.0%	100.0%

Despite the significant increase in Machinery and Equipment, which is depreciated over 2-20 years versus 5-40 for building and improvements, Construction in Progress, which is not depreciated until placed in service, has increased more as a percentage of gross PPE. However, when this capacity is brought online, it will begin being depreciated and we will see the depreciation percentage as a total of gross PPE begin to return to normal. For reference, if we apply the more normal 1.7% depreciation percentage to the current gross PPE, depreciation expense would be more than 5 cps higher than reported in the 12/20 quarter. We reiterate that we see no indications management is playing with depreciable lives, but this should remind investors that a sizeable cost related to the new capacity is already on deck.

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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