BEHIND THE NUMBERS
Quality of Earnings Analysis

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Ball (BALL)

Update on 3/22 results and 10-Q review

We are maintaining our earnings quality rating of 3- (Minor Concern).

Summary

BALL's non-GAAP EPS for the 3/22 quarter fell 6 cps short of consensus targets while revenue topped estimates by more than 5%. Key areas of disappointment in the quarter included a 21% volume decline in revenues in South America which the company blamed on weak performance from Brazil stemming from a sharp fall in the purchasing power of the consumer.

North America saw volumes rise by only 3% which the company admitted was below its expectations. It blamed the shortfall on consumer products companies taking price in the first quarter which dampened their sales volumes as well as customers pre-buying in 4Q21 ahead of BALL's contracted price increases. Management still believes forecasts for the year for North America are doable.

There also seemed to be concern on the call regarding aluminum availability impacting both the demand for and ability to produce aluminum cans. This seems overdone to us given the secular shift away from plastic due to ESG pressures not to mention the fact that aluminum spot prices have been plummeting since the end of March. Also, oil is over $100 with many supply questions of its own which hardly makes plastic a more attractive alternative for CPG companies.

In the area of earnings quality we note the following items:

- While the company raised the limit of its receivables factoring facility, its factored but outstanding receivables balance continued to fall for the third straight quarter. However, total receivables adjusted for factored but outstanding balances were up with lower factoring and swings in aluminum prices likely playing roles. This helped drive overall outstanding receivables DSOs higher which was a drain on cash flow.

- All inventory components rose in the quarter as the company successfully rebuilt its inventory levels. We had previously warned that the company's use of average cost inventory accounting for some of its inventories could result in higher costs in the quarter in an environment of skyrocketing aluminum prices as the cost of sales would reflect the higher costs regardless of whether the inventory was sold. We wonder if this could have contributed to some of the profit disappointment in the quarter. However, aluminum prices have fallen precipitously since the end of the quarter which could put the company in more of a bind in negotiating pass-through provisions for the rest of the year.

- The reserve for obsolete and slow-moving inventory has fallen sharply as a percentage of gross inventory for the last two quarters. We estimate it would take a charge of about 7 cps to restore the reserve to a historically normal level.

While we are maintaining our 3- (Minor Concern) earnings quality rating on BALL, we note that the decline in the stock price appears excessive to us. BALL's massive capital spending program gives the company a "pipeline" quality in our minds. The company opened 12 billion units of additional capacity in 2021 and anticipates a like increase in 2022. All of this new capacity is reportedly already spoken for and the secular shift to aluminum from plastic containers seems to be intact. Our concern with BALL all along has been the degree to which it is relying on receivables factoring and increasing payables to fund this expansion and the resulting risk of short-term hiccups. However, unlike most of the low-quality names being sold off in the market today, BALL is a real company that will generate substantial free cash when the $1 billion of excess capex begins to roll off.

Receivables Factoring Declined Accelerating the Drain on Cash Flow

BALL is undergoing a massive capital spending program to build out its production capacity and one of the ways it was financing this program was through the aggressive expansion of its receivables factoring program. The company sells receivables off its balance sheet to third-party financing companies who then receive customer payments as they come in. This acts as a form of short-term financing as the company gets its cash now instead of having to wait 4-6 weeks as it would for the receivables left on the balance sheet. However, we have pointed out in the last couple of quarters that the company is factoring fewer receivables which is resulting in a drain on cash flow growth. The following table shows a breakdown of receivables between those left on the balance sheet and what has been factored but is still outstanding. Note that we estimate the amount factored by taking the difference between the limit of the factoring facility and what is still available under the facility.

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Sales	$3,716	$3,674	$3,553	$3,459
Net Trade + Unbilled	$2,495	$2,022	$1,976	$2,102
DSO	**60.4**	**50.6**	**51.2**	**55.3**
Outstanding Factored Receivables	$1,108	$1,392	$1,270	$1,473
Factored DSO	**26.8**	**34.9**	**32.9**	**38.8**
Adjusted Receivables	$3,603	$3,414	$3,246	$3,575
Adjusted DSO	87.3	85.5	84.1	94.1

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Sales	$3,125	$3,102	$3,093	$2,801
Net Trade + Unbilled	$1,640	$1,344	$1,418	$1,447
DSO	**47.2**	**39.9**	**42.2**	**47.0**
Outstanding Factored Receivables	$1,252	$1,368	$1,316	$1,073
Factored DSO	**36.1**	**40.6**	**39.1**	**34.9**
Adjusted Receivables	$2,892	$2,712	$2,734	$2,520
Adjusted DSO	83.3	80.4	81.3	81.9

Despite the company expanding the limit of the facility from $1.7 billion in the 12/21 quarter to $2 billion at the end of the 3/22 quarter, the amount of receivables factored but outstanding fell noticeably both sequentially and year-over-year. The decline in factoring mutes cash flow growth as less cash is received upfront. These receivables that are not factored wind up staying on the balance sheet where they are collected more slowly. This is resulting in a steady rise in adjusted DSO based on receivables still on the balance sheet plus receivables that are factored but outstanding. This not only is suppressing cash flow growth but also the rate of generation of new receivables relative to sales does call into question if the company may be offering more generous credit terms to customers.

Raw Materials Are Back Up

We expressed concern last quarter about the fact that BALL's raw materials inventory in the 12/21 quarter was flat sequentially with the 9/21 quarter despite a significant increase in aluminum prices. The company utilizes both FIFO and Average Cost accounting for its inventories. Under average cost accounting, the cost of sales is immediately impacted when higher-cost inventory is acquired regardless of whether the inventory is sold that quarter or not. We were concerned that BALL's gross margins could have benefitted in the 12/21 quarter by the delay in acquiring higher-cost raw materials. The company was able to rebuild its inventory in the 3/22 quarter as raw materials, work in process, and finished goods inventories all rose sequentially and year-over-year in the 3/22 quarter as seen in the table below:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Raw Materials & Supplies DSI	35.8	32.8	32.7	31.2
Work in process and finished goods DSI	36.2	25.3	23.1	21.1
Inventory Reserve DSI	-2.7	-2.8	-2.9	-3.1
DSI	69.3	55.4	52.9	49.1

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Raw Materials & Supplies DSI	31.3	33.4	32.3	36.0
Work in process and finished goods DSI	22.5	20.9	20.9	24.6
Inventory Reserve DSI	-3.4	-3.5	-3.6	-4.0
DSI	50.5	50.8	49.6	56.6

Aluminum prices soared during the first quarter and we wonder if some of the profit disappointment stemmed from acquiring raw materials at this higher cost which drove up the average cost. However, aluminum prices fell off sharply at the end of the quarter which may put the company in a difficult position in negotiating higher pass-throughs under its contracts if prices remain suppressed for the rest of the year.

Note that while aluminum is the key raw material, energy is also a key component of the company's cost structure and that is becoming a significant source of pressure, particularly in its European operations. Consider the following commentary from management on the conference call regarding its pass-through negotiations with customers:

> *"One of the things is we did not experience a lot of inflation in Q1. It accelerated towards the tail end of the quarter. So it's a little bit more of what's yet to come versus what we've experienced. I will say how that plays into the cost recovery discussions that we initiated kind of November-December time frame with our customers is those conversations have been going well.* ***But we haven't secured 100% short-term pricing pass-through****. As you can imagine, these conversations are ongoing. We're trying to make those as equitable as we can moving forward in the event that we're moving into a more of a high inflation environment. So there's more work to do.* ***And I think it would be safe to say that I don't think we anticipated the level of inflation that we're now seeing in Europe.*** *There's more work to do, but our contracts are sound. We will get this back. Europe may look a little bit more like North America did last year and then transitioning into this year relative to the pass-through."*

Inventory Reserve Declining

One item of concern to keep an eye on is the company's declining reserve for obsolete and slow-moving inventory. Inventory reserves are typically created with a charge to cost of sales at the time the inventory is acquired. If the company has underestimated the amount of inventory that will go bad, it may result in a charge to earnings when this becomes obvious and the inventory is written off. If the inventory is later found to be viable, the company will reduce the reserve with a debit while crediting the value of the inventory.

The following table shows the reserve as a percentage of gross inventory for the last sixteen quarters:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Inventory Reserve	$91	$90	$90	$94
Gross Inventory	$2,414	$1,885	$1,728	$1,584
Reserve %	3.8%	4.8%	5.2%	5.9%

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Inventory Reserve	$93	$93	$94	$97
Gross Inventory	$1,492	$1,446	$1,403	$1,485
Reserve %	6.2%	6.4%	6.7%	6.5%

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Inventory Reserve	$86	$82	$81	$79
Gross Inventory	$1,440	$1,356	$1,261	$1,262
Reserve %	6.0%	6.0%	6.4%	6.3%

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Inventory Reserve	$71	$70	$68	$57
Gross Inventory	$1,346	$1,341	$1,311	$1,314
Reserve %	5.3%	5.2%	5.2%	4.3%

Looking back over the last four years, we see that the inventory reserve as a percentage of gross inventory has run in the 5-6% range fairly consistently. However, the reserve percentage has gone sharply down in the last two quarters. As we noted above, this could be either a sign that the company has reduced its rate of reserving for new inventory purchases, or it has suddenly been seeing less inventory go bad. The first case would provide an artificial but temporary benefit to earnings. The second one wouldn't. Given the fact that the decline has spanned two quarters and appears to have accelerated makes it look to us like the company changed its rate of reserving for new inventory which would have provided a tailwind to EPS. To get an idea of the potential benefit to earnings, we estimate that to get the reserve percentage back to 5% would require a charge of about 7 cps.

Weakness in Latin America

Latin America was a key weak spot in the quarter with management placing most of the blame on Brazil which experienced significant volume declines. Management gave good color on the topic in the conference call:

> *“Yes. Thanks for that. One thing that you did indicate, just to be clear on this, volume -- liquid volume was down 15%. And so plus or minus that number is kind of where we ended up in terms of volume decline, and a lot of that has to do with discretionary spending power in Brazil because all of the other countries surrounding in South America performed really much better than Brazil, Southeast Brazil, in particular. So I think rough math, what our colleagues in South America and Brazil specifically were telling us is your spending power was cut by 1/3 basically over the last three to four months. And on top of that, because these products are U.S.-denominated in terms of the aluminum profile of them, our customers were passing through price on top of that, so you could see a 30% to 40% impact on an end consumers' buying power relative to a package in Brazil. The things that are going to be transitory relative to allowing recovery in the second half of the year and why we're a bit bullish on the back half of the year, in particular, a couple of things. Number one, it's an election year. It's an election year in Brazil. So what that means is there's a stimulus package coming. That will certainly help. You referenced in your question timing in and around Carnival. As we sit here today, we believe that there will be a carnival reflective of what you've seen in years past, a street carnival. Somewhere in July is what's being contemplated. And the last thing is there's a World Cup, and the World Cup sits in a different time slot than typically does. So a November World Cup, we should see the benefits of that. And that's what our customers are certainly building and discussing with us. So I think you'll see a second half performance lift kind of versus where we anticipated. I don't know if that's all going to be able to make up for what we experienced in the first quarter. But I think there are plenty of things to point to that we'll see continued strong performance, not only in the extending surrounding South American countries, but in Brazil, in particular, where the decline was in the quarter.”*

This will be a key area to watch during the rest of the year.

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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