BEHIND THE NUMBERS
Quality of Earnings Analysis

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Ball Corp. (BLL)
Earnings Quality Update- 6/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We downgrade our earnings quality rating on BLL to 2- (Weak) and maintain our On Deck Sell rating.

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

Summary

BLL reported non-GAAP EPS of $0.86 in the 6/21 quarter which was 3 cps ahead of the consensus. However, the effective tax rate fell to 16.6% from 18.8% in last year's second quarter adding 2.3 cps to growth. The company was projecting an 18% rate for the full year going into the second quarter, so we believe the bulk of the tax rate decline was unanticipated.

Our main concern surrounding BLL is the degree to which the company's reported cash flow figures are benefitting from unusual working capital items (discussed below) without which net debt/EBITDA would rise to roughly 4.4 compared to the reported 3.6. The most restrictive debt covenant requires the ratio to stay below 5.0x but this falls for 4.5x as of 12/22. The company recently expanded its dividend by 33% and promised to spend $800 million on buybacks in 2021 adding to its short-term cash flow needs.

- DSOs adjusted for factored receivables that were removed from the balance sheet but still outstanding rose to 94.1 in the 6/21 quarter from 81.9 in the year-ago quarter. This included factored but outstanding receivable days rising to 38.8 from 34.9. Adjusted DSOs are at historically high levels even when compared to 2019.

- BLL expanded the facility on its factoring facility in the 6/21 quarter to $1.8 billion from the previous $1.6 billion. Estimated factored but outstanding receivables rose from $1.37 billion at the end of the 12/21 quarter to $1.48 billion at the end of the 6/21 quarter, a $105 million increase. From the 12/20 quarter to the 6/20 quarter, estimated outstanding factored receivables fell to $1.07 billion from $1.17 billion, a $97 million decline. These factored receivables represent cash the company received which it would not have if it had waited until it collected the receivables. This implies that the increase in the rate of factoring in the six months ended 6/21 relative to the same period in 6/20 provided an approximate $200 million tailwind to operating cash flow growth which helped to offset some of the drain on cash flow from the increase in receivables left on the balance sheet.

- Despite a 7.5-day YOY drop in inventory DSIs, days payable outstanding rose to 130.6 from 110.1. The ratio of payables to inventory returning to normal over the next few quarters will prove to be a drain on cash flow growth. For reference, the trailing 12-month period ended 6/21 saw a $1.26 billion increase in payables versus a $102 million increase in inventory providing a $1.16 billion tailwind to cash flow growth in the period.

- Absent the accelerated receipt of cash flow from expanding payables and factored receivables, BLL would not have come close to covering the current buyback and dividend in the trailing 12-month period ending 6/21 without taking on additional debt. Net debt/EBITDA is currently 3.6x and the company hopes to keep it between 3.0x-3.5x by the end of the year. Its debt covenants allow it to go as high as 5.0 but that falls to 4.5 as of 12/22. If we count the increase in payables and factored receivables as debt, debt/EBITDA jumps to 4.4. During the second quarter, the company expanded the dividend by 33% which will take an additional $65 million in cash over the next 12 months and implied it will spend $800 million on buybacks in 2021 (it has spent $130 million so far.) We understand that if the company can get all the new production up and running and sell the cans at expected prices then cash from operations will expand, capex will come down, startup costs will subside, and there will be plenty of cash to reduce debt and return to shareholders. However, the short-run seems to depend very much on unorthodox short-term financing which does not show up in some investors' debt metrics. It does not seem to us that this risk factor has enjoyed much public discussion

Acceleration in Receivables Factoring- DSOs Rose

One of our biggest concerns regarding BLL is the degree to which it is utilizing its receivables factoring facility to increase cash flow growth. The following table shows trade and unbilled receivables plus the estimated outstanding factored receivables at the end of each period for the last twelve quarters. *(Note that we estimate factored but outstanding receivables as the difference between the facility limit and amounts still available for sale at the end of the quarter. The limit is rounded to the nearest hundred million in the disclosure so estimated factored receivables are not exact.)* Also included are DSOs for both components as well as a total adjusted receivables DSO.

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Sales	$3,459	$3,125	$3,102	$3,093
Net Trade + Unbilled	$2,102	$1,640	$1,344	$1,418
DSO	**55.3**	**47.2**	**39.9**	**42.2**
Outstanding Factored Receivables	$1,473	$1,252	$1,368	$1,316
Factored DSO	**38.8**	**36.1**	**40.6**	**39.1**
Adjusted Receivables	$3,575	$2,892	$2,712	$2,734
Adjusted DSO	94.1	83.3	80.4	81.3

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Sales	$2,801	$2,785	$2,719	$2,953
Net Trade + Unbilled	$1,447	$1,417	$1,186	$1,405
DSO	47.0	46.3	40.1	43.8
Outstanding Factored Receivables	$1,073	$1,098	$1,170	$1,145
Factored DSO	34.9	35.9	39.6	35.7
Adjusted Receivables	$2,520	$2,515	$2,356	$2,550
Adjusted DSO	81.9	82.2	79.7	79.4

	6/30/2019	3/31/2019	12/31/2018	9/30/2018
Sales	$3,017	$2,785	$2,803	$2,946
Net Trade + Unbilled	$1,511	$1,426	$1,280	$1,400
DSO	**45.6**	**46.1**	**42.0**	**43.7**
Outstanding Factored Receivables	$1,092	$1,008	$1,022	$942
Factored DSO	**32.9**	**32.6**	**33.5**	**29.4**
Adjusted Receivables	$2,603	$2,434	$2,302	$2,342
Adjusted DSO	78.5	78.7	75.6	73.1

We noted in our review of the 3/21 quarter that the YOY growth in balance sheet receivable DSOs and factored but outstanding receivable DSOs had stabilized. However, the disproportionate growth of receivables and factoring relative to sales resumed in the 6/21 quarter following the company raising the limits on its factoring facilities to $1.8 billion from the previous $1.6 billion. Receivables left on the balance sheet jumped to 55 days of sales from 47 in the year-ago quarter. Meanwhile, factored receivable days of sales jumped to almost 39 days from 34.9 days last year. Note that factored receivables rose from $1.37 billion at the end of the 12/21 quarter to $1.48 billion at the end of the 6/21 quarter, a $105 million increase. From the 12/20 quarter to the 6/20 quarter, outstanding factored receivables fell to $1.07 billion from $1.17 billion, a $97 million decline. These factored receivables represent cash the company received in the quarter which it would not have received had it waited until collecting the receivables itself. This implies that the increase in factoring in the six months ended 6/21 relative to the same period in 6/20 provided an approximate $200 million tailwind to operating cash flow growth which helped to offset some of the drain in cash flow from the increase in receivables left on the balance sheet. Operating cash flow in the six months ended 6/2021 was $168 million compared to a negative $232 million. The increase in receivables factoring appears to have provided about half that $400 million improvement.

The more than 12-day jump in total adjusted DSOs also appears out of line. On one hand, BLL did experience strong sales growth of 23% against a weak year-ago second quarter. However, we purposefully included three years of quarterly DSO data to demonstrate that DSOs were not depressed in the 2020 time frame and that the current DSO level in the mid-90s is very high by historical standards.

Days Payable Outstanding Jumped

BLL's accounts payable days outstanding jumped to almost 131 from 110 a year ago. This follows a near 14-day YOY jump in the 3/21 quarter.

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Trade Accounts Payable	$3,961	$3,355	$3,430	$2,832
Cost of Products Sold	$2,760	$2,493	$2,448	$2,430
DPOs	130.6	121.1	128.9	107.2

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Trade Accounts Payable	$2,699	$2,613	$3,136	$2,658
Cost of Products Sold	$2,230	$2,215	$2,159	$2,363
DPOs	110.1	107.4	133.6	103.5

	6/30/2019	3/31/2019	12/31/2018	9/30/2018
Trade Accounts Payable	$2,739	$2,739	$3,095	$2,953
Cost of Products Sold	$2,428	$2,253	$2,246	$2,362
DPOs	102.7	109.4	126.8	115.0

This is despite a decline in inventory DSIs resulting from raw materials sourcing delays which can be seen in the table below which shows the calculation of DSIs for the last twelve quarters:

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Total Inventory	$1,490	$1,399	$1,353	$1,309
Cost of Products Sold	$2,760	$2,493	$2,448	$2,430
DSI	49.1	50.5	50.8	49.6

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Total Inventory	$1,388	$1,354	$1,274	$1,180
Cost of Products Sold	$2,230	$2,215	$2,159	$2,363
DSI	56.6	55.6	54.3	45.9

	6/30/2019	3/31/2019	12/31/2018	9/30/2018
Total Inventory	$1,183	$1,275	$1,271	$1,243
Cost of Products Sold	$2,428	$2,253	$2,246	$2,362
DSI	44.3	50.9	52.1	48.4

We also think it is informative to look at the ratio of accounts payable to inventory over the last three years:

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Trade Accounts Payable	$3,961	$3,355	$3,430	$2,832
Total Inventory	$1,490	$1,399	$1,353	$1,309
Payables/Inventory	2.7	2.4	2.5	2.2

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Trade Accounts Payable	$2,699	$2,613	$3,136	$2,658
Total Inventory	$1,388	$1,354	$1,274	$1,180
Payables/Inventory	1.9	1.9	2.5	2.3

	6/30/2019	3/31/2019	12/31/2018	9/30/2018
Trade Accounts Payable	$2,739	$2,739	$3,095	$2,953
Total Inventory	$1,183	$1,275	$1,271	$1,243
Payables/Inventory	2.3	2.1	2.4	2.4

We see fairly consistent YOY trends when looking down the September and December columns but the ratio of payables to inventory definitely jumped in the 3/21 and 6/21 quarters. This ratio returning to normal over the next few quarters will prove to be a drain on cash flow growth. For reference, the trailing 12-month period ended 6/21 saw a $1.26 billion increase in payables versus a $102 million increase in inventory providing a $1.16 billion tailwind to cash flow growth in the period.

Market May Not Appreciate the Above Risk Factors

As we have discussed before, BLL started a major capacity expansion in 2020 which includes both greenfield expansion and adding new production lines at existing facilities. This is resulting in much higher capital spending and higher startup costs, but the hope is to double operating cash flow by 2025. BLL's net debt/EBITDA currently stands at 3.3x but its debt covenants allow it to go as high as 4.5x. We believe the market may not appreciate the degree to which the company is financing this expansion through non-traditional sources including the rapid expansion of payables and increasing use of receivables factoring and the risks those entail. Note that neither the payables increase nor the factoring increase would show up in traditional debt metrics used by many investors.

The below table shows adjusted cash flow figures for the last three trailing 12-month periods ended June 30:

	6/30/2021	6/30/2020	6/30/2019
T12 Operating Cash Flow	$1,832	$1,063	$1,385
Adjustments:			
Subtract YOY Rise in Outstanding Factored Receivables	*-$400*	*$19*	*-$254*
Subtract YOY Increase in Payables	*-$1,262*	*$40*	*$0*
Add Back Contributions to Pension Plans	*$259*	*$106*	*$73*
Adjusted T12 Operating Cash Flow	$429	$1,228	$1,204
T12 Capex	$1,423	$770	$647
Adjusted T12 FCF	-$994	$458	$557
T12 Dividends	$197	$199	$150
T12 Buyback	$121	$650	$951
Free Cash Flow after Dividend	-$1,312	-$391	-$544

We started with actual operating cash flow then subtracted the increase in outstanding factored receivables and the increase in accounts payable. We also added back pension contributions to not penalize for the higher-than-normal contribution in 2021.

Capital spending roughly doubled for the 12 months ended 6/21 and is expected to be $1.5 billion for all of 2021. It will likely remain well above the historical trend for the next couple of years. BLL also just increased the dividend by 33% which will drive the annual cash outflow up by about $65 million. In addition, BLL announced it will return $1 billion to shareholders in 2021 which implies an $800 million spend on buying back shares. However, the company would not have been able to support the current dividend and buyback without taking on additional debt had it not been for the expansion of payables and receivables factoring. If the $1.3 billion increase in payables and $400 million increase in factored receivables had been financed with traditional debt, it would have driven net debt/EBITDA up to 4.4. The company has told investors it is targeting a year-end leverage ratio between 3.0-3.5. The risk is that the company is no longer able to expand factoring or payables extension or worse, it is forced to unwind these positions earlier than it wants. As we can see in the following table, BLL has already increased the limit on its factoring facility by almost $700 million in the last two years and it currently has roughly the same amounts of uncollected trade receivables off the balance sheet as it does on.

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Limit of Factoring Facility	$1,800	$1,600	$1,600	$1,500

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Limit of Factoring Facility	$1,300	$1,300	$1,400	$1,300

	6/30/2019	3/31/2019	12/31/2018	9/30/2018
Limit of Factoring Facility	$1,280	$1,200	$1,200	$1,150

In summary, we understand that if the company can get all the new production up and running and sell the cans at expected prices, cash from operations will expand, capex will come down, startup costs will subside, and there will be plenty of cash to reduce debt and return to shareholders. We also understand that BLL's operations are relatively steady and can support higher amounts of leverage that would be uncomfortable under other business models. However, the short-run seems to depend very much on growth in unusual short-term financing methods and it seems unclear how far those can be stretched. It does not seem to us that this risk factor has enjoyed much public discussion. While we are not predicting that these unorthodox, short-term financing methods are going to blow up, investors should be closely monitoring these trends and discounting accordingly.

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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