BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Ball Corp. (BLL) EQ Review-6/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

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

We are maintaining our earnings quality rating to 2- (Weak)

- DSOs calculated on trade receivables and unbilled receivables on the balance sheet fell by 1.7 days versus the year-ago quarter. However, when we add back the outstanding sold receivables, DSO increases by 7 days. The bulk of the increase in receivables on the balance sheet is coming from unbilled receivables which may be the result of rapid sales in the aerospace segment. However, even if we completely remove unbilled receivables from the DSO calculation, we still get a 3-day YOY increase in DSOs which is a red flag.

- Contract liabilities (deferred revenue) fell versus the year-ago period which could indicate slower bookings or more aggressive revenue recognition. Like unbilled receivables, we suspect contract liabilities are more related to the aerospace business than the base packaging business. Aerospace sales rose by more than 30% which makes the decline in contract liabilities look even more peculiar.

- Trailing 12-month cash from operations declined to $1.39 billion from $1.69 billion. While the company contributed about $60 million more to its pension plans in the six months ended 6/19 compared to the year-ago period, this would have been more than compensated for by the rapid increase in receivables sales.

- Free cash flow after the dividend and accelerated buyback was a deficit of more than $360 million. The 3.7% reduction in share count was a huge boost to the 10.3% growth in adjusted EPS.

- Pension cost declined by $8 million (1.8 cps) due to lower service cost and lower recognized actuarial loss.

Adjusted DSOs Continue to Climb

We have highlighted the company's accounts receivable factoring program under which the company sells its receivables to accelerate the receipt of cash. These receivables are removed from the company's balance sheet at the time of sale, so to get a true picture of how much the company is extending credit to its customers, we must add back the sold but still outstanding balances to the balance sheet receivables. The amounts and the calculation of days sales outstanding (DSO) are shown below for the last six quarters. The 6/19 and 3/19 quarters are adjusted for China beverage packaging receivables which had been designated as held for sale while the 6/18 quarter is adjusted for US food and steel aerosol receivables that were designated as held for sale.

	6/30/2019	3/31/2019	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Sales	$3,017	$2,785	$2,803	$2,946	$3,101	$2,785
Gross Trade Receivables	$1,017	$958	$812	$1,052	$1,259	$1,332
Gross Unbilled Receivables	$503	$477	$478	$359	$390	$429
Held for Sale	$107	$100	$0	$0	$78	$0
Allowance	$9	$9	$10	$11	$9	$10
Net Trade & Unbilled Receivables	$1,618	$1,526	$1,280	$1,400	$1,718	$1,751
Outstanding Sold Receivables	$1,092	$1,008	$1,022	$942	$838	$589
Trade and Unbilled Receivable DSOs	48.9	50.0	41.7	43.4	50.6	57.4
Outstanding Sold Receivable DSO	33.0	33.0	33.3	29.2	24.7	19.3
Adjusted DSOs	82.9	83.0	74.9	72.5	75.2	76.7

We can see that net trade & unbilled receivables DSOs have been declining on a year-over-year basis. However, we see that DSOs calculated on just outstanding sold receivables balances jumped by most than 8 days which drove the total adjusted receivable DSOs up from 75.2 to 82.0. We have noted in previous reviews that the company's receivable patterns could be impacted by the disproportionate growth in the company's aerospace business which could generate more in receivables. We note that the increase in unbilled receivables is likely related to the growth in revenue under long term contracts in the aerospace division. However, even if we take the unbilled receivables balances completely out of the

DSO calculation, we still get a 3-day increase in DSOs. The company does have some long-term contracts in its aluminum packaging business so it is possible that some of the increase in unbilled receivables could be coming from that area. Therefore, we believe it is reasonable to assume that at least half of the increase in adjusted DSO is coming from receivables generated by the base business.

Deferred Revenue Down

Another minor red flag in the area of revenue recognition is the decline in contract liabilities (deferred revenue.) Contract liabilities include cash received from customers that has not yet been recognized as revenue. Current and non-current contract liabilities are shown below along with the days of sales of total contract liabilities:

	6/30/2019	3/31/2019	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Current Contract Liabilities	$52	$57	$45	$67	$65	$52
Non-Current Contract Liabilities	$9	$10	$8	$8	$6	$6
	$61	$67	$53	$75	$71	$58
Days of Sales	1.8	2.2	1.7	2.3	2.1	1.9

A decline in contract liabilities is an indication that either the company is booking less revenue, or it has become more aggressive in recognizing its deferred revenue balances. Like unbilled receivables discussed above, the contract liabilities are likely disproportionately attributable to revenues from the aerospace business. The fact that aerospace sales are growing much faster than the base business makes the decline in contract liabilities look even more peculiar.

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.

Disclosure

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