BEHIND THE NUMBERS
Quality of Earnings Analysis
September 9, 2022

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

BTN Thursday Thoughts

Updates and New Developments on Active BTN Ideas

Reports in this issue:

Security Software Group
Update of Earnings Quality Comparison
(OKTA, NET, ZS, CRWD, PANW, FTNT)

Summary

We consider all the companies in this group to have similar business models and many of the same concerns. All make similar adjustments from GAAP to non-GAAP earnings, have some of their growth tied to acquisitions, and use their common stock as currency for employee pay and M&A deals.

We made our first comparison among the six companies on June 6, 2022 and are updating that work here with recent results from the group. Here is what we have seen from the last quarter that is positive and negative in terms of Earnings Quality and Sustainability for each. **Zscaler is scheduled to report after we publish this report. We have included ZS in the tables found in this report, but we will comment more on its Earnings Quality and guidance next week when we have the full information and likely its 10-K report to review.**

Cloudflare (NET) – reported $0.00-cents for non-GAAP EPS, which beat forecasts by 1 cent. We can account for the entire beat via gains in "other income", lower taxes, and non-GAAP interest expense becoming income. The company guided to higher revenue for 2022 from $955-$959 million to $968-$972 million, but also guided to $3 million in lower non-GAAP earnings and held EPS flat at 3-4 cents.

- NET's GAAP to non-GAAP EPS spread continues to be high at -$0.20 to $0.00 in 2Q22, up from -$0.12 to -0.02 in 1Q22. The biggest reason for the sequential jump was adding back a growing amount of stock compensation (18 cents vs. 12 cents sequentially and vs. 8cents y/y).

- It did see Deferred Revenue growth exceed Revenue gains last quarter, which we see as a positive. Deferred Revenue DSOs reached a new high of 63 days vs. 58 in 1Q22 and 50 in 2Q21.

- NET touted positive operating cash flow of $38 million for 2Q. However, we noted that it also stretched payables and accrued expenses from 147 days in 1Q22 and 4Q21 to 203 days in 2Q22. Free Cash Flow remained negative despite adding back a much higher stock compensation and with the help from higher payables.

- NET remains very reliant on paying more expenses with stock compensation, which is added back to non-GAAP EPS. However, on a trailing 12-months basis, its free cash flow was negative $99 million despite adding back $169 million of stock compensation. **(See Below)**

- The company looks to have a long way to go to reach its target of a 20% non-GAAP operating margin from the current -0.4% which already adds back stock compensation equal to 24.5% of sales in 2Q22.

OKTA (OKTA) reported -$0.10 cents in non-GAAP EPS beating forecasts by 20 cents for 2Q22. This follows 1Q22 results of -$0.34 cents beating by 7 cents. About 9 cents of the 20-cent beat came from non-GAAP R&D falling to 19% from 22% y/y and sequentially. Its fiscal 2023 revenue guidance was raised only about $50,000 but it did boost non-GAAP EPS forecasts by 41 cents.

- Deferred revenue has stalled as revenue growth has continued. Deferred revenue of $996 million at the end of 4Q22 is now only $1,011 million at the end of 2Q23 with quarterly revenue up $69 million.

- Lack of deferred revenue growth is impacting cash flow. Cash from operations was -$0.2 million vs. $53.5 million on a -$143 million swing in deferred revenue growth. Plus, cash flow is being helped by receivables being paid down. DSOs are down from 95 days to 65 days from 4Q.
- The company's free cash flow margin is the lowest in 10-quarters at -5.3%. It is normally a positive figure. Stock compensation falling y/y by $16.5 million accounts for some of that, but it would have still been negative. **(See Below)**

- OKTA also appears to be the company most reliant on buying its R&D via acquisitions and adding back the amortization and not expensing the goodwill. We estimate that this non-GAAP accounting added back 35 cents in 2Q23 in a period when OKTA still posted a -$0.10 in adjusted EPS. **(See Below)**

CrowdStrike (CRWD) posted $0.36 in non-GAAP EPS for 2Q23 beating by 9 cents which followed 1Q23 of $0.31 beating by 8 cents. We note that CRWD picked up 3.6 cents in other income driven by higher interest income on its cash, positive marks on investments, and FX gains. We also see that capitalized software jumped to $8.0 million in 2Q vs. $4.8 million y/y and $5.2 million sequentially. That added another penny to adjusted EPS. Revenue guidance for fiscal 2023 was boosted slightly by about $30,000 and non-GAAP EPS by 11 cents.

- CRWD would be free cash flow positive even if it paid its stock compensation in cash. Stock compensation is the primary spread of 57 cents and 45 cents between GAAP and non-GAAP EPS in 2Q23 and 1Q23. All but 4 cents of the $1.02 in adjustments was stock compensation. **(See Below)**

- Days of backlog is declining – falling in the last four quarters from 159 days, to 157 days, to 121 days, and now 114 days.

- Deferred revenue in days has flattened out at just over 300 days: 312, 326, 309, and 317 for the last four quarters. The high level continues to drive cash flow.

- Free cash flow conversion dropped from 8.2% in 1Q to 6.3% in 2Q. Higher capital spending can explain part of that, but the real change was $60 million in lower cash flow from deferred revenues and receivables. It appears 1Q was out of the ordinary on the positive side, but this is worth watching.

Palo Alto Networks (PANW) beat non-GAAP forecasts by 11 cents in each of the last two quarters (fiscal 4Q22 and 3Q22). Non-GAAP R&D declined as a percentage of sales by 60bp and added 7 cents in 4Q. A large restructuring charge occurred in 4Q for 19 cents that was added back to 4Q22 EPS. There was very little discussion of what this was beyond manufacturing charges. This type of charge has not been seen in the last two years. PANW gave strong guidance of 20% revenue growth and 25% non-GAAP EPS growth for fiscal 2023. There was also a 6-cent increase in other income – that was primarily due to higher interest rates on the cash balances.

- PANW is posting positive free cash flow and would be even if it was paying all stock compensation in cash. Plus, stock compensation is falling as a percentage of free cash flow from almost 70% a few quarters ago to just under 60% in 4Q. That is not being helped by cutting capital spending. And 4Q22 saw an additional $425 million cash headwind from falling receivables that offset much of the $600 million cash flow increase from more deferred revenues. **(See Below)**

- Deferred revenue growth and billings growth are both exceeding revenue growth rates.

- The huge goodwill balance that is not being expensed is a sign of PANW buying some of its R&D. This along with adding back amortization of intangibles added 18 cents to 4Q non-GAAP EPS. **(See Below)**

Fortinet (FTNT) posted 2Q22 non-GAAP EPS of 24 cents last quarter, beating by 2 cents. Its 1Q22 non-GAAP EPS of 19 cents beat by 3 cents. It is worth pointing out that the difference between GAAP and non-GAAP EPS is only 3 cents. It boosted guidance slightly with forecasted margins rising from 24%-26% to 25%-26% and non-GAAP EPS from $1.00-$1.03 to $1.01-$1.06.

- FTNT's stock compensation growth has slowed and is now consistently $53-$55 million per quarter, while sales are rising at more than 25%. Thus, the earnings quality is improving as stock compensation added back is falling from over 7% of sales to 5.4% last quarter.

- FTNT is showing Deferred revenue growth, billings growth, and deal count all exceeding revenue growth rates.

- Free cash flow saw a negative headwind on receivables last quarter. That doesn't look alarming. FTNT has been boosting capital spending in 4Q21 and 1Q22. Free cash flow is still positive and that is with a small contribution from adding back stock compensation.

- FTNT is buying back shares and the share count is falling – thus, the company isn't only trying to avoid dilution from stock awards. This is helping EPS growth.

Some of These Companies Rely More Heavily on Paying with Stock

All these companies add back stock compensation in calculating non-GAAP earnings. The problem we see is the companies that rely the most on using their stock as a currency to pay employees and pay for acquisitions (NET and OKTA) have the weakest stock performance. Also, the market expects the most margin improvement for those companies. That likely requires revenue growth leveraging cash costs while boosting the non-cash percentage of total expenses such as stock compensation. The non-cash part of expenses will be added back to non-GAAP results.

Stock Performance	FTNT	PANW	CRWD	ZS	OKTA	NET
High to Sept 7	-32%	-17%	-42%	-61%	-78%	-72%
YTD thru Sept 7	-24%	-1%	-13%	-51%	-73%	-52%
Month of Aug. 2022	-18%	12%	0%	4%	-7%	22%

This is free cash flow as normally defined: Cash Flow from Operations – Capital Spending and Software Investments. The initial point to focus on is whether the company would generate free cash flow if it was not adding back stock compensation.

The companies seeing some issues with slowing deferred revenue growth (OKTA and CRWD) are being helped by adding back larger stock compensation levels. Also, as we noted above, NET's free cash flow continues to worsen even with higher stock compensation and stretching payables. ZS still could not post positive free cash flow without enormous stock pay being added back. FTNT appears the best positioned in this area with stock compensation flattening while cash flow continues to grow:

	Q2 2022	Q1 22	Q4 21	Q3 21	Q2 21	Q1 21	Q4 20	Q3 20
NET								
T12 Free Cash Flow	-$99.9	-$105.3	-$43.1	-$75.2	-$53.3	-$63.7	-$92.1	-$92.2
T12 Stock Compensation	$169.4	$136.1	$117.3	$93.6	$81.5	$72.0	$63.5	$56.8
Stock Comp % of Free Cash Flow	-169.5%	-129.3%	-272.3%	-124.4%	-152.9%	-113.0%	-69.0%	-61.6%
OKTA								
T12 Free Cash Flow	$25.3	$45.7	$87.5	$114.9	$123.1	$133.8	$110.7	$96.4
T12 Stock Compensation	$654.4	$670.9	$565.5	$464.0	$361.9	$222.6	$196.2	$176.7
Stock Comp % of Free Cash Flow	2585.3%	1468.6%	646.5%	403.7%	293.9%	166.4%	177.2%	183.4%
ZS								
T12 Free Cash Flow	$172.8	$155.4	$144.4	$103.2	$66.9	$40.7	$20.7	-$12.1
T12 Stock Compensation	$397.6	$351.3	$314.3	$278.6	$248.6	$212.5	$170.7	$129.6
Stock Comp % of Free Cash Flow	230.2%	226.1%	217.7%	269.9%	371.9%	522.4%	824.2%	-1072.0%
CRWD								
T12 Free Cash Flow	$544.1	$482.0	$441.8	$411.8	$364.4	$323.2	$292.9	$246.2
T12 Stock Compensation	$413.3	$358.1	$310.0	$265.0	$219.0	$180.4	$149.7	$126.3
Stock Comp % of Free Cash Flow	76.0%	74.3%	70.2%	64.4%	60.1%	55.8%	51.1%	51.3%
PANW								
T12 Free Cash Flow	$1,791.9	$1,605.8	$1,505.5	$1,436.0	$1,387.0	$1,390.5	$1,223.2	$1,148.6
T12 Stock Compensation	$1,072.0	$1,059.9	$1,039.9	$995.2	$936.5	$878.6	$804.9	$743.3
Stock Comp % of Free Cash Flow	59.8%	66.0%	69.1%	69.3%	67.5%	63.2%	65.8%	64.7%
FTNT								
T12 Free Cash Flow	$1,249	$1,125	$1,072	$1,002	$946	$915	$869	$813
T12 Stock Compensation	$218	$216	$212	$207	$202	$199	$194	$189
Stock Comp % of Free Cash Flow	17.4%	19.2%	19.8%	20.6%	21.4%	21.7%	22.3%	23.2%

R&D Components Point to Issues for Some Companies

FTNT	-0Q	-1Q	-2Q	-3Q	-4Q	-5Q	-6Q
Sales	$1030.1	$954.8	$963.6	$869.2	$801.1	$710.3	$748.0
R&D	$124.3	$124.9	$112.6	$107.8	$106.6	$97.2	$89.0
R&D %	12.1%	13.1%	11.7%	12.4%	13.3%	13.7%	11.9%
R&D Stock Comp	$16.1	$15.1	$14.7	$14.5	$14.5	$13.0	$12.0
Cash R&D	$108.2	$109.8	$97.9	$93.3	$92.1	$84.2	$77.0
Cash R&D %	10.5%	11.5%	10.2%	10.7%	11.5%	11.9%	10.3%

- R&D spending in total dollars and in cash-only appears to have stalled.
- FTNT is gaining operating leverage as the non-GAAP figure declines as a percentage of sales.
- If FTNT needed to grow R&D by 100bp as a percentage of sales, it would only cost quarterly EPS about 1 cent.

PANW	-0Q	-1Q	-2Q	-3Q	-4Q	-5Q	-6Q
Sales	$1550.5	$1,386.7	$1,316.9	$1,247.4	$1,219.3	$1,073.9	$1,016.9
R&D	$363.8	$355.4	$359.0	$339.5	$325.3	$311.0	$266.7
R&D %	23.5%	25.6%	27.3%	27.2%	26.7%	29.0%	26.2%
R&D Stock Comp	$111.5	$119.0	$130.3	$128.3	$113.7	$122.0	$107.2
Cash R&D	$252.3	$236.4	$228.7	$211.2	$211.6	$189.0	$159.5
Cash R&D %	16.3%	17.0%	17.4%	16.9%	17.4%	17.6%	15.7%

- As noted above, the 60bp drop in cash R&D last quarter helped EPS by 7 cents.
- Total dollars spent and cash-only R&D continue to rise in dollar terms.
- Strong revenue guidance on growth and even faster growth in deferred revenues should help PANW continue to leverage in this area.

CRWD	-0Q	-1Q	-2Q	-3Q	-4Q	-5Q	-6Q
Sales	$535.2	$487.8	$431.0	$380.1	$337.7	$302.8	$264.9
R&D	$137.9	$123.4	$105.0	$97.6	$90.5	$78.2	$66.1
R&D %	25.8%	25.3%	24.4%	25.7%	26.8%	25.8%	24.9%
R&D Stock Comp	$40.0	$34.0	$31.1	$27.3	$25.8	$17.8	$14.6
Cash R&D	$97.8	$89.4	$73.9	$70.3	$64.7	$60.4	$51.5
Cash R&D %	18.3%	18.3%	17.2%	18.5%	19.1%	19.9%	19.4%

- CRWD's deferred revenue and backlog point to some potential margin leveraging for R&D.
- It is likely a positive that the company continues to grow spending in this area, but it could become a larger headwind.

ZS	-1Q	-2Q	-3Q	-4Q	-5Q	-6Q
Sales	$286.8	$255.6	$230.5	$197.1	$176.4	$157.0
R&D	$76.6	$69.2	$65.2	$56.2	$41.0	$41.8
R&D %	26.7%	27.1%	28.3%	28.5%	23.2%	26.6%
R&D Stock Comp	$31.4	$30.0	$28.6	$25.6	$15.0	$17.8
Cash R&D	$45.2	$39.2	$36.7	$30.6	$25.9	$24.0
Cash R&D %	15.8%	15.3%	15.9%	15.5%	14.7%	15.3%

ZS has not reported since our last review. We will comment after the next quarter and the 10-K are released.

OKTA	-0Q	-1Q	-2Q	-3Q	-4Q	-5Q	-6Q
Sales	$451.8	$397.9	$383.0	$350.7	$315.5	$251.0	$234.7
R&D	$155.8	$161.7	$147.5	$130.5	$122.4	$68.9	$62.3
R&D %	34.5%	40.6%	38.5%	37.2%	38.8%	27.4%	26.5%
R&D Stock Comp	$70.1	$69.0	$62.7	$56.6	$53.3	$20.1	$18.8
Cash R&D	$85.8	$92.6	$84.7	$74.0	$69.1	$48.8	$43.5
Cash R&D %	19.0%	24.8%	22.1%	21.1%	21.9%	19.4%	18.5%

- Economies of scale with the recent large acquisition have helped boost non-GAAP margins.
- Both total R&D and cash-only R&D appear to have flattened out in the last three quarters.

- Adding 100bp as a percentage of sales to R&D would cost OKTA just under 3 cents in non-GAAP EPS per quarter.

NET	-0Q	-1Q	-2Q	-3Q	-4Q	-5Q	-6Q
Sales	$234.5	$212.2	$193.6	$172.3	$152.4	$138.1	$125.9
R&D	$75.1	$67.1	$61.8	$46.8	$41.4	$39.5	$34.8
R&D %	32.0%	31.6%	31.9%	27.1%	27.1%	28.6%	27.6%
R&D Stock Comp	$27.9	$24.1	$24.8	$14.0	$11.3	$11.1	$9.1
Cash R&D	$47.2	$43.0	$37.0	$32.8	$30.1	$28.5	$25.7
Cash R&D %	20.1%	20.3%	19.1%	19.0%	19.7%	20.6%	20.4%

- The cash spending on R&D has stayed very close to 20% of total sales

- Total R&D spending has grown as NET has added more stock compensation – that is 1200bp of its spending.

Who Is Buying Their R&D?

A key point to make as well is all these companies make some acquisitions. This is often to add new products or technology rather than develop it in-house. In many cases, these companies do not point to sizeable proforma sales coming from these deals. In terms of earnings quality, all these companies are guilty of three main issues in making deals:

- They assign the bulk of the purchase price to Goodwill, which is not expensed at all from GAAP or non-GAAP earnings. Had they duplicated much of the work to match the technology and development, most of that cost would have been expensed as incurred. As Goodwill, none of it is.

- They assign other parts of the purchase price to intangible assets. These are normally expensed over a short period for GAAP earnings. However, these companies add-back this amortization in computing non-GAAP earnings. Again, the costs of developing new products and systems in-house would be expensed under both GAAP and non-GAAP. With an acquisition, the non-GAAP earnings ignore the cost completely.

- Many of the acquired companies have stock award obligations to current employees. During the acquisition, the acquirer frequently converts those stock awards into its own common stock for the workers coming onboard. That creates future dilution for existing shareholders unless the stock is repurchased.

The following table shows an estimate of what goodwill amortization would be over 40 years and amortization expense relative to EPS for each company.

	FTNT	PANW	CRWD	ZS	OKTA	NET
Goodwill	$121.3	$2,747.7	$416.1	$59.8	$5,400.3	$149.1
Goodwill over 40 years	$3.030	$68.693	$10.402	$1.496	$135.007	$3.728
Goodwill EPS/Quarter	$0.001	$0.161	$0.011	$0.003	$0.214	$0.003
Intangible Assets	$45.5	$89.8	$89.8	$27.0	$287.5	$42.3
Amortiz/Integration EPS/Quarter	$0.006	$0.020	$0.020	$0.020	$0.135	$0.020
Non-GAAP EPS	$0.240	$2.390	$0.360	$0.168	-$0.102	$0.001
Purchased Adjustments	$0.007	$0.181	$0.031	$0.023	$0.349	$0.023

- If we look at just the sheer size of goodwill and intangibles – PANW and OKTA appear to be the companies benefiting most from acquisition accounting.

- OKTA posted a non-GAAP loss of 10 cents per share but gained 35 cents from ignoring expensing goodwill assets and adding back amortization.

- PANW saw 18 cents in non-GAAP items in these areas. At least it has non-GAAP EPS of $2.39 before looking at acquisitions, so this is 8% of the reported EPS.

- Don't ignore ZS is getting over 2 cents of its reported 17 cents (14% of non-GAAP) EPS here.

- And NET reported 0 cents for its non-GAAP EPS but added 2.3 cents from adding back acquisition costs. If NET had to expense that 2.3 cents as R&D, it would be reporting about $8 million more in R&D per quarter.

In terms of settling stock obligations of the acquired companies, we will refer to the stock option discussions in this report and the first report from June. All of the new stock awards would not be expensed through R&D. Some will be charged to Sales and Marketing, General &

Administrative, or Cost of Goods. The result should be rising stock compensation, which all these companies add back. We can quantify what is coming from recent deals that are significant:

- OKTA has over $800 million of stock compensation expense coming to replace the awards held by Auth0 employees. That is more than a full year of stock compensation.

- PANW has $260 million of stock compensation going forward to replace awards held by multiple deals. That is roughly a 25% increase in annual stock compensation.

- NET has over $330 million of future stock compensation going to employees of acquired companies - $300 million to the Area 1 deal. This is more than double the annual stock compensation before the deal.

Ball Corp (BALL)
Earnings Quality Update

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

BALL missed earnings expectations in the 6/22 quarter by 8 cps as higher costs took their toll on profits. The company does not give specific forward guidance but is sticking with its medium-to-long term growth forecast of 4-6% for worldwide demand for aluminum cans. However, North American beverage demand fell below company expectations as beverage companies saw their volumes plummet in the wake of their aggressive pricing strategies. This led the company to announce it was permanently ceasing production at its Phoenix and St. Paul plants and delaying the construction of its new plant in Las Vegas to match supply with near-term demand. This was enough to prompt the market to drive the stock down nearly 20% on the day of the announcement.

- Depreciation showed an unusual decline in the quarter despite an increase in depreciable assets. Just the sequential decline added about 2.7 cps to EPS in the quarter. However, a decline in depreciation expense as a percentage of assets in service seems to indicate that the company is depreciating new assets over a longer time frame than its older assets. If depreciation expense increased to the same percentage rate as it was in 2019, it would result in EPS being about 6% lower than reported.

- Operating cash flow was a $398 million outflow YTD versus a $168 million inflow in the year-ago period. This was primarily due to the company's rising inventory. However, we have warned in the past that the company has been boosting cash flow growth by ramping up its payables balances. While payables did increase, the pace slowed significantly and the boost to cash flow growth from rising payables appears to be over.

- While total DSOs adjusted for factoring fell in the quarter, factored receivables increased both YOY and sequentially which we estimate added about $115 million to cash flow growth. With rising rates, it must be getting more expensive for the company to borrow against its receivables and we doubt this source of cash flow growth has much staying power from here.

- The news of the shuttering of two plants was disappointing as the narrative has quickly turned from the company not being able to produce enough to satisfy demand to it having to throttle back on production. Management does not give specific guidance but did indicate it did not expect 2022 EPS to match 2021. Nevertheless, its forecast for 4-6% long-term worldwide aluminum can volume remained intact even though it was not clear if this involves international markets accelerating longer-term to offset a lower outlook for North America.

- The company is scaling back its capital spending plans in the short run which will help free cash flow. Nevertheless, it expects to return only $1 billion to shareholders in 2022. The dividend will account for about $260 million of this and it has already spent $566 million on buybacks, implying the buyback pace will fall off the next couple of quarters.

Depreciation Expense Declined Despite Rising PPE

An unusual item we noticed was another decline in depreciation expense. The following table shows BALL's depreciable assets along with depreciation expense for the last twelve quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Buildings	$2,209	$2,134	$2,081	$1,944	$1,867	$1,708
Machinery and Equipment	$7,177	$7,016	$6,876	$6,736	$6,607	$6,338
Gross Depreciable PP&E	$9,386	$9,150	$8,957	$8,680	$8,474	$8,046
Average During Quarter	$9,268	$9,054	$8,819	$8,577	$8,260	$7,957
Quarterly Depreciation Expense	$129	$140	$140	$130	$127	$123
Percentage of Average Depreciable PPE	1.39%	1.55%	1.59%	1.52%	1.54%	1.55%

	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
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
Gross Depreciable PP&E	$7,867	$7,402	$7,162	$6,892	$6,946	$6,555
Average During Quarter	$7,635	$7,282	$7,027	$6,919	$6,751	$6,524
Quarterly Depreciation Expense	$123	$115	$126	$124	$123	$123
Percentage of Average Depreciable PPE	1.61%	1.58%	1.79%	1.79%	1.82%	1.89%

The company's plant expansion can clearly be seen in the steady increase in depreciable assets over time. Depreciation is not recorded when assets are under construction and recorded in the "construction in progress" account. However, when they are brought online and moved to the "machinery and equipment" and "buildings" accounts, depreciation begins. Therefore, we would expect to see a steady increase in depreciation expense over time. While the trend has been slightly upward, there have been unusual timing shifts in certain periods such as the 9/20 quarter which saw depreciation fall to $115 million after an unusually high 6/20 quarter. The 6/22 quarter also experienced an unusual decline, falling to $129 million versus $140 million in the previous two quarters. Just this sequential fall would have added about 2.7 cps to earnings in the quarter.

Also worth noting is the steady decline in depreciation expense as a percentage of average depreciable assets. This has fallen from approximately 1.9% in 2019 to 1.4% in the latest quarter. As old assets become fully depreciated but remain in gross PPE, it will push the depreciation percentage down. However, we would expect this to be more than offset by bringing new assets online. To get a better look at how depreciation expense is trending against assets that are still being depreciated, we will compare it to Net PPE less Construction in Progress:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Net PPE	$6,629	$6,683	$6,502	$6,170	$5,915	$5,570
Construction in Progress	$1,341	$1,245	$1,179	$1,130	$1,017	$990
Net PPE less CIP	$5,288	$5,438	$5,323	$5,040	$4,898	$4,580
Average Balance	$5,363	$5,381	$5,182	$4,969	$4,739	$4,524
Quarterly Depreciation Expense	$129	$140	$140	$130	$127	$123
Depreciation % of Average Balance	2.4%	2.6%	2.7%	2.6%	2.7%	2.7%

	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Net PPE	$5,351	$4,895	$4,662	$4,499	$4,470	$4,320
Construction in Progress	$883	$734	$626	$591	$434	$508
Net PPE less CIP	$4,468	$4,161	$4,036	$3,908	$4,036	$3,812
Average Balance	$4,315	$4,099	$3,972	$3,972	$3,924	$3,825
Quarterly Depreciation Expense	$123	$115	$126	$124	$123	$123
Depreciation % of Average Balance	2.9%	2.8%	3.2%	3.1%	3.1%	3.2%

Interestingly, Net PPE less Construction in Progress did decline in the 6/22 quarter, an indication that more assets were either retired or became fully depreciated in the quarter than new ones than the new ones being brought online. Regardless, depreciation expense still has been trending down against assets that are still being depreciated. This seems to indicate the company is using longer depreciation periods for new assets. The company depreciates buildings and improvements over 5-40 years and machinery and equipment of 2-20 years. This policy has not changed in the last three years, but these are broad ranges which does not rule out the possibility that effective depreciation periods are longer than in the past which weakens earnings quality somewhat.

To put this in perspective, if depreciation expense had been 3% of Net PPE less Construction in Progress over the last four quarters, depreciation would have been over 20 cps higher than reported which is about 6% of $3.50 in non-GAAP EPS the company reported over the same time frame.

Factoring Update

We have noted for some time that BALL factors a large portion of its accounts receivable balances which has been adding to cash flow growth and masking a marked rise in its DSOs. The following table shows the company's receivables on the balance sheet along with an estimate of receivables that have been factored but are still outstanding:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Sales	$4,134	$3,716	$3,674	$3,553
Net Trade + Unbilled	$2,546	$2,495	$2,022	$1,976
DSO	**56.0**	**60.4**	**50.6**	**51.2**
Outstanding Factored Receivables	$1,589	$1,108	$1,392	$1,270
Factored DSO	**35.0**	**26.8**	**34.9**	**32.9**
Adjusted Receivables	$4,135	$3,603	$3,414	$3,246
Adjusted DSO	91.0	87.3	85.5	84.1

	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

We see that DSOs based on receivables left on the balance sheet increased slightly YOY. While factored receivables did jump YOY and sequentially, on a DSO basis it fell by almost 4 days which led to the first YOY decline in total adjusted DSOs in years. However, factored receivables did increase again both YOY and sequentially which would have helped boost cash flow growth. The following table shows the approximate YOY net impact of the outflow from rising receivables on the balance sheet versus the inflow in the increase in factoring:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
YOY Increase in Factored Receivables	$116	-$144	$24	-$46
YOY Increase in Receivables on Balance Sheet	$444	$855	$678	$558
Net Impact	-$328	-$999	-$654	-$604

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
YOY Increase in Factored Receivables	$400	$154	$198	$171
YOY Increase in Receivables on Balance Sheet	$655	$223	$158	$13
Net Impact	-$255	-$69	$40	$158

We noted in past reviews that the cash flow growth from factoring had faded after the 9/21 quarter. However, it returned in the 6/22 quarter and helped offset outflow from growth of receivables on the balance sheet.

BALL increased the limit of its factoring facility to $2.1 billion in the 6/22 quarter from $2 billion in the previous quarter:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Limit of Factoring Facility	$2,100	$2,000	$1,700	$1,700

	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

While we are not predicting the immediate reversal of the factoring program, we note that given the increase in interest rates, it must be getting more expensive for the company to borrow against receivables to get a short-term boost to cash flow as it did in the latest quarter.

Payables Growth Is Slowing

We have also pointed out in past reviews that the company has been rapidly expanding its accounts payables to help fund its expansion program. Accounts payables are still increasing, just not as rapidly as before:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Trade Accounts Payable	$4,991	$5,026	$4,759	$4,210
Cost of Products Sold	$3,445	$3,016	$2,981	$2,851
DPOs	131.8	150.0	146.9	135.9

	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

The YOY change in payables indicates the boost to cash flow growth from rising payables began to fall in the 6/22 quarter:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
YOY Increase Payables	$1,030	$1,671	$1,329	$1,378

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
YOY Increase Payables	$1,262	$742	$294	$174

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
YOY Increase Payables	-$40	-$126	$41	-$295

Rising payables resulted in a cash inflow of over $1 billion in the 6/22 quarter, but that was over $200 million less than the year-ago period which resulted in a net drain to cash flow growth. Some of the recent increases in payables was driven by higher aluminum prices and now rising inventories. However, it appears that the pace of extending payment times has slowed which we would expect given the increase in interest rates. Looking at the comparisons starting in the 9/22 quarter, it does not look likely that rising payables can continue to propel cash flow growth as it has in the past.

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.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.