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Kicking the can

Hundreds of companies used to compete to sell canning jars to American families. In the days before cheap refrigeration, housewives put up fruit for wintertime consumption. Today, the giant corporate descendants of those glass-jar makers compete in a worldwide market to sell steel and aluminum cans to super-size beverage companies. It's not so clear that the 21st-century business model is any more lucrative than the legacy one.

Now under way is a bearish analysis of a one-time king of the glass-jar makers turned present-day beer- and soda-can colossus. Ball Corp. (BLL on the Big Board) is that storied and long-lived container creator (founded in 1880, it did not show its first net operating loss until 1949). Cans generate more than 80% of the corporation's $11 billion (pro forma) top line. Food packaging, aerosol cans and critical components for the new James Webb Space Telescope likewise figure into the revenue mix. It isn't every S&P 500 company that sells to Anheuser-Busch InBev SA, Campbell Soup Co., Heineken N.V., PepsiCo, Inc., The Coca-Cola Co., Unilever N.V., Monster Beverage Corp., Constellation Brands—*and* to NASA.

The seemingly incongruous aerospace activity is a marker of adaptability of the former pride of Muncie, Ind. (long since resettled in Broomfield, Colo.). Ball Corp. exited the home-canning business in 1993. Its 21st-century management speaks in the jargon of "economic value added," "visibilities," "cost-out efforts," "step-change," "value-capture initiatives" and non-GAAP "comparable" cash flows. Ball Corp. isn't afraid of leverage—the balance sheet proves it—and it champs at the bit to repurchase equity.

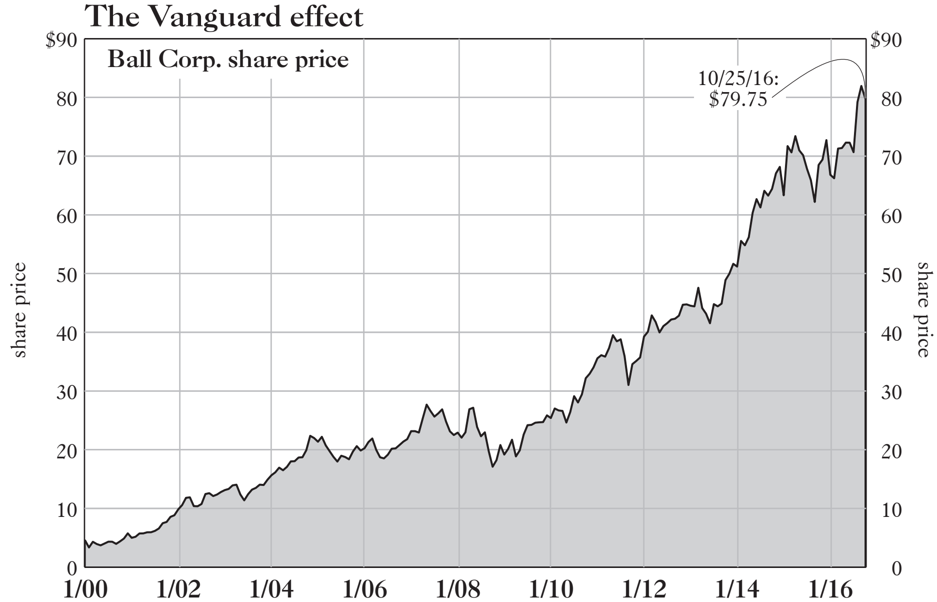
The stock, priced near its all-time high, trades at 36.3 times GAAP earnings per share in the year ended June 30, or, as management would rather phrase it, 13.8 times enterprise value to trailing, adjusted, pro forma earnings before interest, taxes, depreciation and amortization (EBITDA). The Ball Corp. 5¼s of July 1, 2025 change hands at 108.59, a price to yield 4.1%, 237 basis points over the comparably dated Treasury note. Rated Ba1/BB-plus, the company's $7 billion of net debt trades as if it were almost investment-grade.

In June, Ball Corp. closed on a purchase of the British can maker Rexam plc for $8.5 billion, a price representing 9.6 times the acquiree's 2015 adjusted earnings before interest, taxes, depreciation and amortization. Pro forma the landing of that London whale, the bulked-up Ball Corp. employs 18,700 people and produces 100 billion cans a year. It's the biggest can company in the world.

North and Central America account for 46% of Ball's beverage-can sales, Europe and Russia 27%, South America 16%, Asia Pacific 6% and Africa and the Middle East 5%. Of the aforementioned $11 billion in 2015 pro forma company-wide revenue, metal drinks containers delivered $8.9 billion.

The Rexam transaction was 17 months in the making, as it took some doing to convince antitrust authori-

The Vanguard effect



source: The Bloomberg

ties that a tie-up of the world's No. 1 (Rexam) and No. 2 (Ball Corp.) can makers would present no impediment to fair competition. (Then, again, Ball was once a defendant in an antitrust action that lasted for eight years, from 1939 to 1947.) To secure regulatory approval, Ball was obliged to sell 22 can-making plants to Ardagh Group, of Luxembourg, the world's No. 3 can business, for $3.1 billion. The facilities that Ardagh bought generated revenues of $3 billion, one-half of Rexam's sales in 2015.

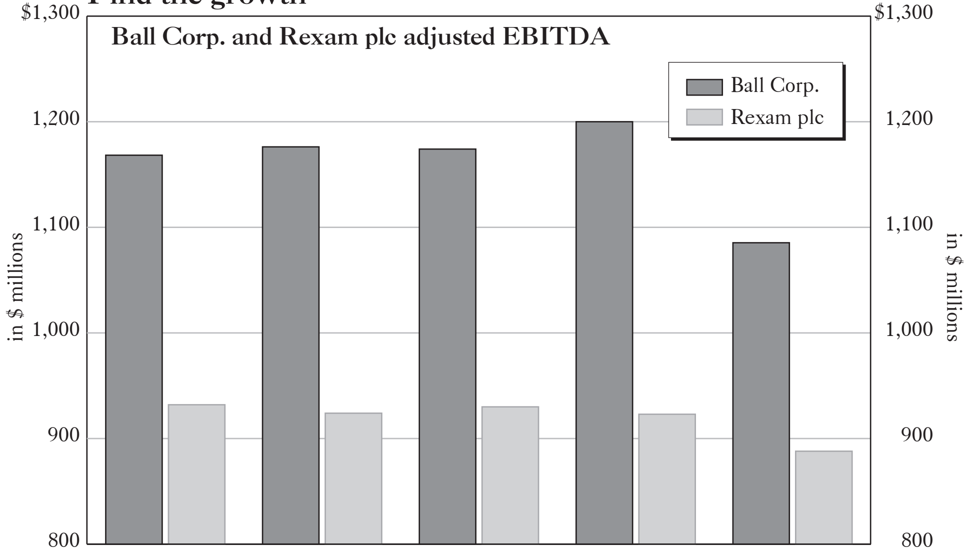
Ball's Rexam acquisition does analytical double duty. We view it as the crux of the bear case. For management and the Street, it's Ball at its best. John A. Hayes, CEO of Ball Corp., has laid out a $300 million synergy target to be achieved by 2019. It's a significant sum relative to the acquired Rexam sales (it is, in fact, 10% of acquired sales) as well as to the combined Ball-Rexam enterprise. As for that newly conjoined unit, it generated $1.1 billion in adjusted pro forma operating income in the year ended June 30. Ball and Rexam produced adjusted EBITDA margins of 13.6% and 14.2%, respectively, in 2015.

"Not that there aren't risks with acquiring and divesting assets, but Ball is very experienced with executing M&A transactions," Bill Densmore, who covers Ball at Fitch Ratings, tells colleague Evan Lorenz. "It is a very disciplined management team."

Mr. Market, too, thinks the world of the Ball front office. Adding the $7 billion of net debt to Ball's $14.1 billion market cap yields an enterprise value (EV) of $21.1 billion. Based on trailing, adjusted pro forma figures, Ball is quoted at the previously cited 13.8 times EV to EBITDA, which compares with an average of 8.5 times in the decade prior to the Rexam accession.

Management, thrilled to close the Rexam deal and be done with the drawn-out antitrust negotiations ("It feels really good to finally have the steering wheel firmly in our grip," says Hayes), anticipates a $270 million bump in EBITDA in 2017. Just over half of this improvement will stem from cost savings, it says, and the balance from growth. The grand plan is to resume share repurchases after reducing leverage. The goal, by 2019, according to Hayes, is to trim the ratio of net debt to EBITDA to 3 to 3.5 times, down from today's 4.6. Pre-Rexam, Ball was an industrial-scale share retirer: It shrank the share count by 25% in the five years ended 2014.

Find the growth



sources: The Bloomberg, company reports

Ball may be valued for growth, but it isn't growing, at least not by much. A big Ball shareholder with whom Lorenz spoke says that 5% to 6% per annum growth in EBIT—i.e., earnings before interest and taxes—in the mature markets in North America and Europe is both the form and the prospect: "This is kind of what you would expect from a consumer staple-like business," our source says. "Think of it as a combination of normal demand plus some transition from normal cans [with commodity-like pricing] to specialty cans [with better pricing]. On top of that you can build new plants. Right now they are not only in the process of integrating Rexam, but there have also been a few growth projects, especially the one in Mexico. That is how I would think about it. When it is all said and done—let's say it is 2019 and the integration is behind us—it should grow EBIT 5% to 6%. That translates into EPS growth of 10% to 12% [factoring in share repurchases]."

More easily said than done, perhaps. There can be no guarantee that Ball will find the targeted savings. Going in, circa February 2015, as Lorenz points out, "Ball knew it would have to divest some businesses to secure regulatory approval. Hayes did not share his estimate of how much revenue would be lost, but he did secure a right to cancel the takeover and pay a break fee equal to 7% of the transaction if regulators required divestitures with sales of $1.58 billion or greater. As noted, Ball sold factories with sales of $3 billion—almost twice the amount that would have let Ball cancel the deal—to Ardagh.

"In the conference call announcing the deal," Lorenz goes on, "Ball said it expected 22% of synergies to come from 'freight, logistics and warehousing.' Analysts asked about this after the transaction had closed.

"Here is what Hayes said on a July 1 conference call: 'I think some of the freight and logistics did go away because the footprint became a little bit smaller. I do think the other part of it is, as we got into the transaction and as we got into the integration, remember, our first estimate was at the time of signing, where we really didn't have much visibility, we still think there's at least $300 million there. I want to be clear about that, but the buckets have been changing a little bit. And so, as we go forward, I'm sure that freight-and-logistics number from April is probably not accurate as well. We think there's more opportunity in all the buckets, but we first need to validate those assumptions and those facts that we believe to be true, so we can get after some of these things.'"

While Hayes's words are open to interpretation, at least one easily accessible "bucket" is available for emptying; Ball could sell Rexam's London offices for a mooted savings of $75 million a year. The trouble is that Rexam—at least to judge by its 14.2% EBITDA margin—runs a slightly tighter ship than Ball Corp., which itself is capably managed. So $300 million a year is an aspiration, no more.

Nor is it obvious that even such a behemoth as the new Ball Corp. has much, or any, pricing power. "Anything is possible," an anonymity-seeking sell-side analyst tells Lorenz, "but there has not been a price increase for a very long time. What is different now? You might say that what is different is there has been some consolidation. To a degree, yes. In the U.S., Ball has around five to 10 points more market share than it did before. But is that a game-changer? I don't think so. In Europe, Ball took Rexam's position. Ball previously had 30% share and Rexam had 39%. Now Ball has 39% and Ardagh has 30%. They rearranged the deck chairs in Europe, but nothing fundamentally changed in terms of market structure."

"In fact," Lorenz observes, "Ball's and Rexam's financials show two businesses that struggled even to keep earnings flat. Between 2011 and 2015, Ball's adjusted EBITDA fell by 7.1%. Over the same period, Rexam's dropped by 4.7% in dollar terms. Earnings declined despite Ball's mix of specialty can sales—the ones with the supposedly higher margins, growing to 30% in 2015 from 15% in 2012—and despite Ball's spending $409.7 million on acquisitions and $595.5 million on capital expenditures in excess of depreciation and amortization between 2011 and 2015. All of which casts doubt on that guidance to an uptick in EBITDA next year of $270 million, of which $120 million is to stem from growth initiatives. It's not evident that past growth investments have generated any earnings increases, much less earnings increases on the magnitude of $120 million."

The recurring use of the word "adjusted," as in "adjusted EBITDA," may raise your eyebrows as it does ours. Management, for instance, adds back the costs associated with "business consolidation and other activities," though consolidating and de-consolidating business units would seem to define the Ball corporate strategy.

Costs designated "business consolidation and other" averaged $69.6 million in the five years ending in 2015, even excluding the charges related to the acquisition of Rexam. They represented 9.1% of reported GAAP operating earnings. It follows that Ball Corp. is even pricier than the "adjusted" non-GAAP metrics at which it trades.

"Dig through Ball's footnotes," says Lorenz, "and it's clear enough that the customers, not Ball, are the ones up in the commercial driver's seat. You can surmise as much by the can maker's growing recourse to factoring finance."

Factors buy, or lend against, receivables. For accounting purposes, Ball structures this financing as a true sale, so the factored receivables disappear from the balance sheet. Factoring has been on a growth spurt. It amounted to $137.5 million in 2013, $197.6 million in 2014 and $475.7 million in 2015. Adding these figures back to receivables would lift Ball's days-sales-outstanding to 62.1 days in 2015 from 43 in 2013. Which is to say that Ball's customers are taking their sweet time paying their bills. Longer payment terms boost the cash flow of Ball's customers but are a drag on Ball's cash generation. Ball reported free cash flow (i.e., cash flow from operations less capex) of $460.7 million, $734.2 million and $539.1 million in 2013, 2014 and 2015. If Ball retained, rather than factored, accounts receivable, free cash flow would have dropped to $398.2 million, $674.1 million and $261 million in the same three years.

In this light, the tie-up between Ball and Rexam appears to be a countermeasure undertaken in reaction to growing consolidation in the beverage business. Many companies invest for growth. We judge that Ball invests to not shrink. Graham Chipchase, the former Rexam CEO, writing to his shareholders last year, seems to suggest as much: "[C]onsolidation continues in the beverage industry, with customers taking a more coordinated, global approach to procurement to help them lower costs and innovate. They are also demanding a more complex product offering as they seek differentiation and shelf appeal." Reading Chipchase's letter and listening to his comments on Rexam conference calls, you understand the appeal of selling out to Ball Corp.

This is exactly what Crown Holdings, Inc. said on its Oct. 20 earnings call. Your return on capital has remained flat, an analyst observed, but you claim that new investments have returns well in excess of your cost of capital. What gives? "[W]hat I would argue," replied CEO Timothy J. Donahue, "is if we hadn't been so aggressive with what we thought were two very good acquisitions and a number of capital projects, we wouldn't be flat in return on capital. It would have continued to decline." The Crown share price promptly dropped by 3.5%. (It didn't help that management projected a reduction in fourth-quarter adjusted EPS to a value between $0.66 and $0.72 per share vs. Street expectations of $0.76. At the mid-point, guidance implies that adjusted EPS will decline by $0.01, or 1.4%, from the fourth-quarter 2015 figure.)

Ardagh constitutes another source of risk to Ball's big plans. A serial acquirer, the Luxembourg company shows net debt of 5.7 times EBITDA after its purchase of the spun-off Ball Corp. units. As leveraged as it is, Ardagh is motivated to produce and sell. If, as the adage has it, "debt drives production," Ardagh is likely to prove a highly motivated competitor.

It already is, as Ball can attest. In 2014, the European interloper aggressively courted ConAgra Foods, Inc. in the United States. Having built new American factories, Ardagh underbid Ball, ConAgra's incumbent can vendor, though Ball enjoyed the seemingly insuperable advantage of next-door-neighbor proximity to at least one of ConAgra's factories. In transporting food cans, beverage cans or empty aerosol canisters, the manufacturer mainly ships air. So it is that most can makers serve customers situated within 300 to 400 miles of their factories. That Ardagh could neutralize Ball's geographical advantages in this fashion ought to worry the Ball Corp. bulls more than it seems to. The ConAgra loss was a key reason why Ball's food- and aerosol-packaging division suffered a 14% drop in revenue and a 30% decline in adjusted operating earnings last year.

Anyway, the companies not named Ball have a less sanguine outlook for metal cans. "Looking into 2016, we expect a tough trading environment, but with continued volume growth," Chipchase said on Rexam's Feb. 18 earnings call, the last such call before the acquisition. "The premium benefit will be offset by pricing pressures in Europe, and the savings from the European restructuring will be partially offset by cost headwinds."

Vanguard Group, with an 8% position, is Ball Corp.'s largest shareholder.

We wonder how much Ball's disclosure would improve if the No. 1 owner were a more critical student of the companies in which it passively invests (BlackRock and State Street, also passive-investing giants, own 5.3% and 3.5% of Ball shares). The SEC, at least, reads the 10K reports and has weighed in on seven occasions since 2011 to protest against the paucity of detail given about geographic concentrations, the corporate tax rate (which plummeted to 14% in 2015 from 23% in 2014) and the bland language that seemed to allude to the devastating loss of the ConAgra account (the facts were, indeed, reported in no SEC filing; Lorenz picked up the information in conference-call transcripts).

Of the 11 analysts who cover Ball, six rate the company a buy and five a hold. Ordinarily, in sell-side code, "hold" means "sell," though in this case some of the non-bulls write more in sorrow than in anger. They have no case against management, or management's "economic value added" M.O. It's only the valuation that troubles them—if only the company were not so lovable.

We are far from being the sole skeptics, though the critical ranks appear to be thinning. Short interest amounts to 8.1% of the float, which is down from 13.2% on June 30 as the Rexam deal was closing.

Insiders did some buying in August—a net 22,530 shares for a consideration of $1.8 million. Then, again, they got advantageous terms through a company-sponsored "Deposit Share Program" that grants insiders one restricted share unit for each share purchased in the open market. Absent that not quite spontaneous expression of checkbook faith, officers and directors unloaded a net 4,300 shares in the past 12 months.

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