GRANITE CONSTRUCTION: BLUEPRINT FOR DISASTER

NYSE:GVA

GLASSHOUSE RESEARCH

GRANITE CONSTRUCTION INC.

NYSE: GVA

SUMMARY

Initiation of Granite Construction Inc. (GVA) with a Strong Sell Opinion

Granite Construction Inc., a company marked with recent accounting failures, faces substaintial revenue and earnings headwinds, accompanied by an elevated risk of potential restatements.

Granite's shaky balance sheet portends recent premature revenue recognition by management. This is coupled with cost overruns, delays, and missed milestones on many of its major projects.

REPORT DATE
09/27/23

SHARE PRICE
$36.70

AVG DAILY VOLUME
267,000

MARKET CAP
$1.61 BILLION

SHORT INTEREST %
9.32%

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Granite's Structural Weakness Exposed

Our short report centers around Granite Construction Incorporated (GVA), a construction company that faces countless accounting red flags on top of recent SEC and legal complaints about its percentage of completion accounting. We would have expected Granite's Board of Directors to clean house after its prior calamities, but it appears to be more of the same. The family-style run company appears to have grown too large since its humble beginnings with a clear lack of accounting expertise in key areas.

In an industry abundant with underbidding, delays, cost-overruns and suspect dealings, we believe that Granite is one of the worst offenders. While the company settled with the SEC for $12 million in August 2022 related to accounting malfeasance, we believe current issues are even worse.

Previously, the SEC accused Granite of:

- Orchestrating a scheme to conceal deteriorating performance of its Heavy Civil Group by improperly deferring the recording of additional costs that arose on significant projects.[1]
- Manipulating financials by directing employees to use specific, higher than justified profit margin numbers.
- Recording certain increases to the total expected costs, which had the effect of overstating revenues and profit margins.
- Materially overstating revenue by approximately $62 million over several quarters of 2017 and 2018.

Exacerbating Granite's legal woes, investors sued the firm in 2020 for fraudulent statements made by the company regarding accounting treatment of several of Granite's largest construction projects.

The February 2020 complaint, alleged the following primary concerns:

- Granite knowingly inflated the company's revenue, income, and margins, among other metrics.[2]
- Granite intentionally excluded known costs from the calculation to inflate revenues and profits by hundreds of millions of dollars.

[1] https://www.sec.gov/news/press-release/2022-150
[2] https://casetext.com/case/police-ret-sys-of-st-louis-v-granite-constr-inc

- CEO Kyle Roberts sought to game Granite's financial disclosure requirements by concealing and delaying projects' negative financial results until Granite filled its portfolio with newer, less risky, more profitable projects that would blunt the necessary write-downs and losses.

- Granite repeatedly reported vastly better results from its joint ventures (JVs) for the first five quarters (starting in 2018).

Management has assured analysts and investors that this time it is different – they have moved away from risky projects that have hampered them in the past. However, our research illustrates otherwise.

We believe:

1. GVA is significantly behind on many construction projects, well beyond what they detail on recent call.
2. GVA has prematurely recognized revenue on material projects without reaching the necessary milestones.
3. The recent CAP (Committed and Awarded Projects) increase is mostly due to low-quality revenue projects contradicting management's recent statements.

After going through countless filings, earnings calls, presentations, and conducting interviews with past employees, we believe that Granite management used similar accounting gimmicks to appear to turn around a company that previously reported depressed margins and earnings. Based on our extensive experience researching accounting frauds, especially within the construction industry, we take issue with both the quantity and scope of financial engineering used by management over recent years.

When we analyze Granite's unsavory past, contract assets/liabilities diagnostics, and lackluster cash flow, we find a company that we believe has been manipulating its accounting for significant gains to the income statement. However, in our experience, the manipulation of all these balance sheet accounts points to share price degradation in upcoming periods as these issues tend to violently reverse while future restatement risk remains extremely high.

Key Similarities Between Granite Construction and Tutor Perini

GlassHouse juxtaposes both Granite Construction and the past transgressions of similar construction company Tutor Perini (TPC), which we initially wrote in March of 2016. GVA has eerily similar PoC accounting red flags as TPC. **The end result for Tutor Perini was not a pretty one. Litigations, claims, and unapproved change orders have decimated the company, causing the stock price to drop over 80% at its lowest point.**

Key Characteristic	Tutor Perini (TPC)	Granite Construction (GVA)
Business Strategy	Underbid on large scale projects to win awards. Increase bookings/backlog at the cost of future profits.	Granite's prior CEO, James Roberts, implemented a strategy to win every award at all costs that nearly bankrupted the company according to past employees.
Violations of PoC Accounting	Unbilled AR, unapproved change orders, and claims all rose by double digits for years as the firm fell behind on milestones, but continued to recognize revenue. Now the company is in constant litigation with its clients.	Granite portrays extremely similar spikes in unbilled AR/contract assets in the last two fiscal years. Delays on major projects corroborate our premature recognition of revenue/PoC accounting thesis.
Deferred Revenues Plummet	Tutor Perini's deferred revenues consistently declined as the firm received less upfront payments for its projects, signaling a low quality of future revenues.	Granite's contract liabilities relative to CAP neared a recent low of 3.1% in the last two periods. This suggests that GVA's recent CAP increases have been replenished with low quality revenue.
Free-cash-flow Non-existent	TPC reported a cumulative FCF loss of $352.5 million in the five years preceding FY2016, as the company did not receive payment for its shoddy work.	GVA's TTM FCF figures have tumbled into negative territory for six consecutive periods as decreased profits and working capital concerns afflict the company.
Past Incidents of Restatements	Tutor Perini surprisingly has disclosed no past incidents of restatements.	GVA has recently settled with the SEC and faced lawsuits regarding its revenue recognition and inflating performance figures. The company restated past financials, faced adverse auditor opinions, and continued late filings among a plethora of other internal control red flags.
End Result	**Our thesis came to fruition: TPC's stock plummeted to under $5.00, dropping over 80% at its lowest point.**	**???????**

Management Concealing Scale of Project Delays

When analyzing long-term contract companies, a crucial harbinger in determining their future lies within its percentage-of-completion (PoC) accounting. When contract assets surge and inversely contract liabilities decline relative to historical norms, we can predict: 1) future shortfalls in sales and earnings, 2) delays and missed milestones are encumbering certain projects, and/or 3) management may be recognizing revenue prematurely.

Thus, Granite's contract assets and contract liabilities trends all suggest that the company has not been forthcoming regarding its future. Coupled with recent restatements and prior litigations at GVA due to the same accounting errors, we believe that the company is now facing major headwinds.

While a new CEO, Kyle Larkin, was announced since its last announcement of restatements, we believe Mr. Larkin, a long-standing employee of the company, is cut from the same cloth as the prior CEO. Thus, we believe management is up to its same old financial engineering, as its poor earnings quality appears to have intensified.

When dealing with PoC accounting, there is a large emphasis on management subjectivity, estimates, and assumptions when compiling reported results. Focusing on these factors within Granite's 2023 10K, we highlight the following which pertains to our thesis:

The accuracy of our revenue and profit recognition in a given period depends on the accuracy of our estimates of the forecasted revenue and cost to complete each project. Cost estimates for all of our significant projects use a detailed "bottom up" approach. There are a number of factors that can contribute to revisions in estimates of contract cost and profitability. According to GVA's 2022 10-K, the most significant of these include:

- changes in costs of labor and/or materials
- subcontractor costs, availability and/or performance issues
- extended overhead and other costs due to owner, weather and other delays
- changes in productivity expectations
- changes from original design on design-build projects
- ability to fully and promptly recover on affirmative claims and back charges for additional contract costs
- a change in the availability and proximity of equipment and materials,
- complexity in original design
- length of time to complete the project
- the availability and skill level of workers in the geographic location of the project

- site conditions that differ from those assumed in the original bid;
- costs associated with scope changes
- and the customer's ability to properly administer the contract.

We understand that the above 10-K excerpt is fairly boilerplate for companies with long-term contracts. However, eerily similar to Tutor Perini (TPC), we believe that Granite is exhibiting significant adverse trends regarding its percentage-of-completion accounting. This deviates from management's recent statements of a more conservative, leaner Granite Construction.

Granite's managers, rather than outside auditors, determine the company's revenues and profits for each period. Similar to what happened before at Granite, we believe managers are highly motivated to game the system for their benefit. We believe the C-Suite at Granite has been overly optimistic in recognizing recent revenues and profits, all at the expense of future earnings and potential restatements.

Recently the stock has been buoyed by an increasing CAP/backlog and comments from management about a shift to less risky projects. However, many of the same large project concerns remain at Granite based on reported metrics.

> *They [Granite management] were trying to work themselves out of some really bad deals that they got into. My understanding is that it almost bankrupted the company.*
>
> -Former High-Ranking Executive at Granite

Outsized Growth in Unbilled Receivables, Contract Assets, and Claims Suggest Project Delays and Cost Overruns

With revenue being recognized in accordance with ASC Topic 606, the accuracy of Granite's revenue recognition depends heavily on estimates of forecasted revenue and project costs. This opens the door to inaccuracies caused by delays in project completion, rising costs of materials, unfavorable weather conditions and several other factors. We tracked unbilled receivables, contract assets, and claim recovery amounts over the past five years to find an inauspicious trend, which suggests missed milestones and delays that management has not fully disclosed.

Though management has been open about the delays to an Interstate 64 bridge project, which is already two years past its target completion of July 2021, we believe that this project isn't a one off for Granite. This issue pertains to scope and pricing, rather than collections. Thus, our focus is mainly on unbilled receivables and contract assets. The revenue recognition concern bodes much worse for Granite and its investors in the long run.

Our enthusiast readers know just how much our analysts loathe unbilled AR growing on the balance sheet of a company. When unbilleds/costs in excess of billings continue to grow and customer advances/billings in excess of costs continue to decline, this creates a cash flow problem. It also could mean that:

1. The company is spending faster than they are billing on their projects
2. The project managers are behind in getting their bills out, and/or
3. The company has costs on the balance sheet that are actually losses such as job overruns or change orders that are not or will not be approved.

In layman's terms, unbilled AR/contract assets represent revenue recognized by management on the income statement which has not yet been invoiced or agreed upon by the client.

Granite's total accounts receivables (including all billed and unbilled receivables, contract assets and claims), display an unfavorable trend where total accounts receivables (AR) increased 28.9% YOY to $925.1 million in Q2 2023. This contrasts with the recent 3M (12M) sales decline of 6.1% (6.4%) in the same period.

- As a result of this trend, total AR-to-3M sales increased 2,796 bps YOY to 102.9% in Q2 2023, representing a seasonal five-year high for the company and greatly deviating from the 87.3% five-year seasonal average (see Table 1, below).

- Relative to 12M sales, total AR increased 779 bps YOY to 28.4% YOY, representing a five-year high in any period for Granite.

- Three-month days-sales-outstanding (DSO)[3] metrics jumped to a concerning 34.2% YOY increase to 82 days, again reaching a seasonal five-year high for any Q2 period.

- Longer-term trends predict a similar pattern with 12M DSO rising 15.0% YOY to 87 days, a five-year maximum in any period (see Chart 1, Page 10).

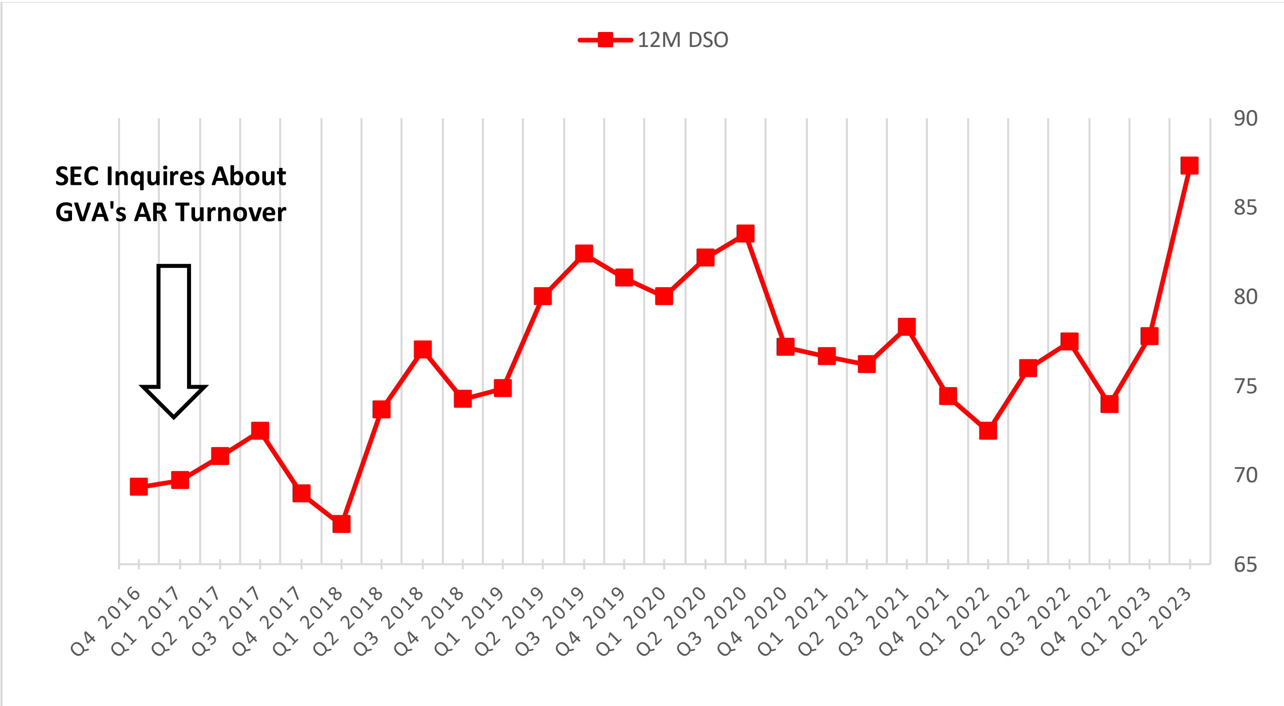
- Previously on 02/17/17, Granite received a letter from the SEC pertaining to its accounts receivable turnover metric. At the time, we calculate that GVA presented a 12M DSO value of only 69 days with the SEC inquiry (compared to 87 days listed now).

Table 1: Granite Receivables and DSO Metrics
($ in millions)

Period Ended:	Q2 2023	Q1 2023	Q4 2022	Q3 2022	Q2 2022
Total Accounts Receivable (AR)	$925.1	$685.4	$705.9	$859.4	$717.5
AR-to-3M sales	102.9%	122.4%	89.7%	85.1%	75.0%
AR-to-12M sales	28.4%	20.7%	20.7%	25.1%	20.6%
3M DSO	82	113	91	71	61
12M DSO	87	78	74	77	76
YOY					
Total Accounts Receivable	28.9%	22.3%	15.7%	–3.3%	–14.7%
AR-to-3M sales (bps)	2,796	3,665	1,397	142	–382
AR-to-12M sales (bps)	779	507	330	–12	–321
3M DSO	34.2%	38.8%	6.9%	–4.1%	–5.0%
12M DSO	15.0%	7.3%	–0.6%	–1.0%	–0.3%

[3] Three-month days sales outstanding (3M DSO) = Average receivables QOQ / 3M Sales * 91.25.

Chart 1: Days-Sales-Outstanding 12M Trends



Receivables Sub-Accounts Reveal an Even Worse Scenario for Granite

Within total receivables the company breaks out the following sub-receivables-accounts, listed in order of least to most risky type of receivable:

- **Billed receivables** (client has been invoiced, but not paid): Increased 26.2% YOY to $279.0 million as of 06/30/23.
- **Unbilled receivables** (client has not been invoiced, milestones have not been achieved): Increased 25.0% YOY to $200.4 million, the highest figure recorded in company history.
- **Contract assets** (costs in excess of billings and estimated earnings and contract retention): Surged 51.6% YOY to $288.3 million, representing the highest value in company history.
- **Claim recovery estimates** (pricing and scope are in litigation with the client, included in contract assets): Increased 19.0% YOY to $70.3 million. This represents the worst type of receivable on the balance sheet.

While all these accounts have increased substantially relative to sales over the past two years, we take issue with the riskiest forms of receivable (i.e. unbilleds, contract assets, and claims). For simplicity, we will refer to these three risky types of receivables in aggregate as “total contract assets” or “total CA”.

In the latest Q2 period, total contract assets spiked 39.4% YOY to $488.8 million, the highest amount in company history. Again, this varies greatly from the recent mid-single-digit sales decline, leading us to believe that GVA is both prematurely recognizing revenue and is behind on many large projects.

- As a result of this trend, total CA-to-3M sales increased 1,776 bps YOY to 54.4% in Q2 2023. This represents a seasonal five-year high for the company (see Table 2, Page 12).

- Relative to 12M sales, total CA increased 494 bps YOY to 15.0% YOY, representing a five-year high in any period and deviating from the 10.2% five-year average.

- Three-month total CA DSO metrics surged to a 47.0% YOY increase to 45 days, again reaching a seasonal five-year high for any Q2 period. An increase of this magnitude is extremely high for a long-standing construction company.

- When GVA was accused of accounting manipulation, the firm's total CA DSO value stood at only 31 days in Q4 2018. The CA DSO value has now increased to 45 days, a 46.7% rise since the SEC's inquiry.

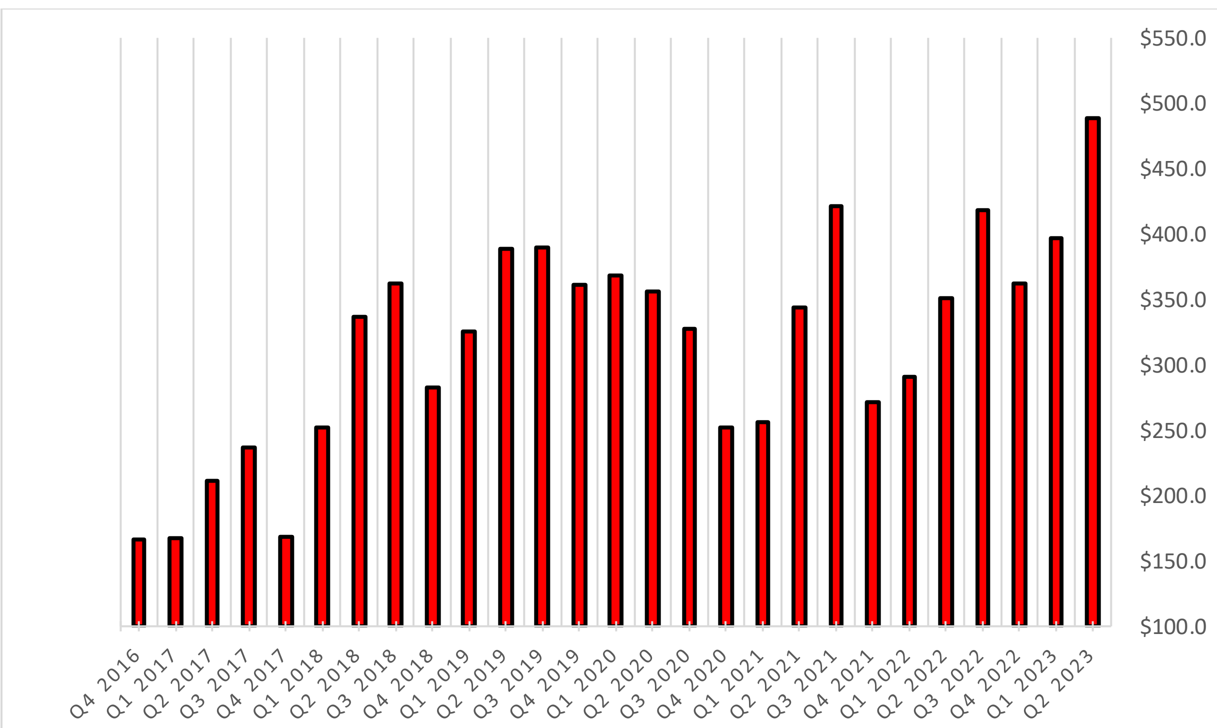
- Finally, the two riskiest forms of receivables, contract assets and claims have spiked. For instance, contract assets have increased by 18.2%, 66.3%, 60.1% and 51.6% YOY in periods Q3 2022, Q4 2022, Q1 2023 and Q2 2023, respectively. Matching that trend, claim recovery estimates have spiked 72.3%, 113.5%, 91.7% and 19.0% YOY during the same timeframe.

This type of deviation suggests management is involved in prematurely recognizing revenue, even though they are behind on project milestones. Thus, we believe that Granite is headed for a rocky fall whether that be with massive earnings shortfalls in future periods as well as a high likelihood of financial restatements.

Table 2: Unbilled Receivables/Contract Assets Metrics
($ in millions)

Period Ended:	Q2 2023	Q1 2023	Q4 2022	Q3 2022	Q2 2022
Contract Assets & Unbilled (Total CA)	$488.8	$397.1	$362.3	$418.5	$350.5
Total CA-to-Total AR	63.7%	67.6%	62.1%	59.9%	61.3%
Total CA-to-3M Sales	54.4%	70.9%	46.0%	41.4%	36.6%
Total CA-to-12M Sales	15.0%	12.0%	10.6%	12.2%	10.1%
YOY					
Contract Assets & Unbilled	39.4%	36.4%	33.3%	–0.7%	1.9%
Total CA-to-Total AR	233	286	861	–31	–343
Total CA-to-3M Sales (bps)	1,776	2,638	1,229	176	443
Total CA-to-12M Sales (bps)	494	387	287	26	33

Chart 2: Long-Term Total Contract Asset Trends
($ in millions)



Contrary to Granite's Contract Assets Spike, Contract Liabilities Stagnate

We believe much of the recent stock price run up is a result of the double-digit growth in Granite's Committed and Awarded Projects (CAP) over the past year. Granite's CAP consists of unearned revenue and other awards (which contain GVA's construction management/general contractor contracts). However, we believe much of the increase is still coming from low quality projects with minimal margins.

When analyzing companies with a surging unbilled receivables/contract assets balance, we also review the firm's contract liabilities on the balance sheet. If the firm is pulling in more cash in the form of customer advances, this usually alleviates most of our concern about the contract asset increase. This is not the case for Granite.

We detail GVA's recent adverse contract liabilities (CL) trends:

- Total CL decreased by 3.4% YOY to $173.3 million at the end of Q2 2023. We find this balance to be on a consistent downtrend from the 2021 high. From a quality of revenue standpoint, GVA managers and outside analysts should hope for this number to increase, as it represents future revenues on the income statement.

- Relative to 3M sales, Granite's CL has increased by 54 bps YOY to only 19.3% of sales (see Table 3, Page 15). Longer-term metrics report similar trends with CL increasing modestly by 17 bps YOY to only 5.3% of 12M sales. While this is within historical averages for Granite, this ratio has fallen from its 2021 high.

- When viewed relative to total CAP, contract liabilities have decreased 107 bps YOY to only 3.2% of total CAP. Besides the recent low of 3.1% achieved with this ratio in the Q1 2023 period, this represented the second lowest ratio dating back to Q4 2019 (see Chart 5, Page 15). While the company has won more bids in recent periods, this metric leads us to believe these awards are of lower quality as the customer is not obliged to put a higher down payment for the bid.

- Exacerbating our efficiency concerns at Granite, the company is converting less and less revenue from CAP every period. So, while the overall CAP number has been on the climb, the amount of work completed continues to dwindle relative to total CAP.

- For example, in the latest period where total CAP increased by 29.0% YOY to $5.44 billion, the amount expected to be recognized into revenue declined by 4.2% to only $2.30 billion. This results in a recognized-to-CAP ratio of 42.3%, coming dangerously close to the recent low of 40.1% in Q4 2022. In fact, if we go back to Q4 2019 when GVA first started reporting this figure in the filings, this percentage stood at a healthy 66.9%. Since then, it has been on a consistent decline becoming less efficient as time passes.

While management has been mostly mute about the decline of its contract liabilities, Granite's 2022 Annual Report offers some insight into the situation:

The components of the contract liability balances as of the respective dates were as follows (in thousands):

December 31,	**2022**	**2021 (1)**
Billings in excess of costs and estimated earnings, net of retention	$ 152,294	$ 169,542
Provisions for losses	20,992	30,499
Total contract liabilities	$ 173,286	$ 200,041

(1) These balances do not include amounts held for sale (see Note 2).

The decrease in contract liabilities is primarily due to revenue recognized in excess of billings as well as reductions in provisions for losses as certain loss projects progress towards completion.

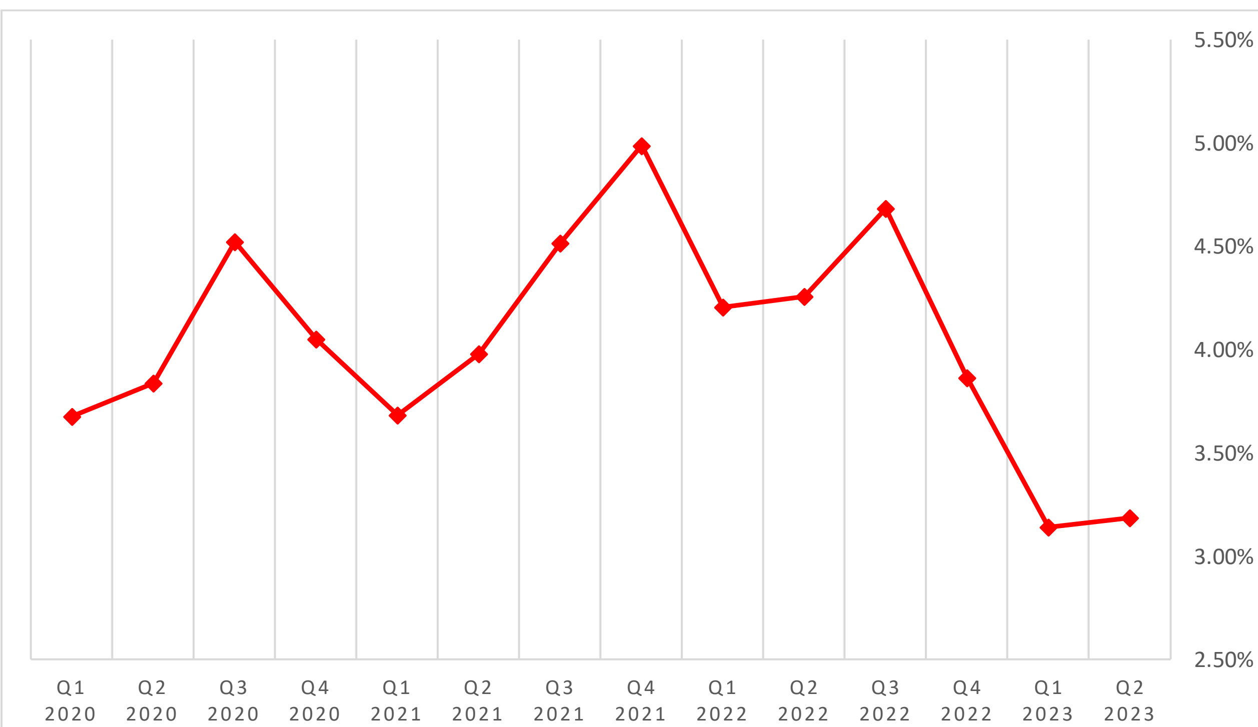
Thus, the company has been unable to replenish its contract liabilities at the same rate that it is recognizing revenue on the income statement, an unfavorable trend.

Expounding on the reduction in provisions, this reserve declined by 31.2% to $21.0 million for no apparent reason at the end of 2022. Using the prior period's, provision-to-contact liabilities ratio, GVA benefitted approximately $5.6 million in pre-tax income from lowering this reserve. In other words, GVA benefitted from an accounting gimmick that added $5.6 million to operating income, or 6.7% of operating income in fiscal year 2022.

Table 3: Contract Liabilities Metrics
($ in millions)

Period Ended:	Q2 2023	Q1 2023	Q4 2022	Q3 2022	Q2 2022
Contract Liabilities (CL)	$173.3	$160.2	$173.3	$191.0	$179.3
CL-to-3M sales	19.3%	28.6%	22.0%	18.9%	18.7%
CL-to-12M sales	5.3%	4.8%	5.1%	5.6%	5.2%
3M DDR	17	27	21	17	16
12M DDR	20	19	19	20	19
YOY					
Contract Liabilities	–3.4%	–3.1%	–13.4%	–2.2%	7.8%
CL-to-3M sales	54	332	–281	53	316
CL-to-12M sales	17	23	–63	4	44
3M DDR	3.0%	6.6%	–5.7%	7.7%	20.2%
12M DDR	3.4%	6.9%	6.4%	10.4%	10.5%

Chart 5: Contract Liabilities / Total CAP



Net Contract Assets Spike 84.3% YOY in Latest Period

We analyze contract assets (including unbilleds) and liabilities trends to get a full picture of a firm's quality of revenues. In most cases, we expect to see companies with a net balance near $0 or negative, meaning the firm's contract liabilities are above its contract assets. But this is not the case for Granite.

- We calculate Granite's net contract assets (NCA) as total contract assets net of total contract liabilities. In GVA's case, NCA reached its highest absolute value in company history surging by 84.3% YOY to $315.5 million as of Q2 2023.

- As a result, relative to quarterly sales, NCA jumped by 1,721 bps YOY to 35.1%, representing the highest ratio reached in any Q2. Net CA-to-12M sales reported its highest value in the last five years, reaching 9.7%.

- The continued increase of unbilled AR and contract assets, coupled with the deterioration of its contract liabilities metrics, lead us to believe that the quality of Granite's recent revenues is extremely low. Although this type of financial engineering can provide short-term boosts to revenues and earnings, these types of accounting tactics generally reverse in future periods. We expect to see a material drop-off in revenues in future periods as a result.

- To quantify the impact that recognizing this revenue earlier relative to historical standards has had on performance, we can reverse engineer GVA's net current asset balance using the firm's NCA-to-12M revenue value reported in Q2 2022 (4.9%). As a result, we calculate that GVA recognized an astonishing $155.3 million in additional revenue (also pure margin gains) over the TTM (see Table 4, Page 17).[4]

[4] With a net contract asset-to-12M sales ratio of 4.9% in Q2 2022 ($171.2 million of NCA / $3,478.5 million in 12M sales), this assumes that NCA should equate to a normalized balance of $160.2 million versus the reported $315.5 million balance in Q2 2023.

Chart 4: Long-Term Net Contract Asset Trends
($ in millions)

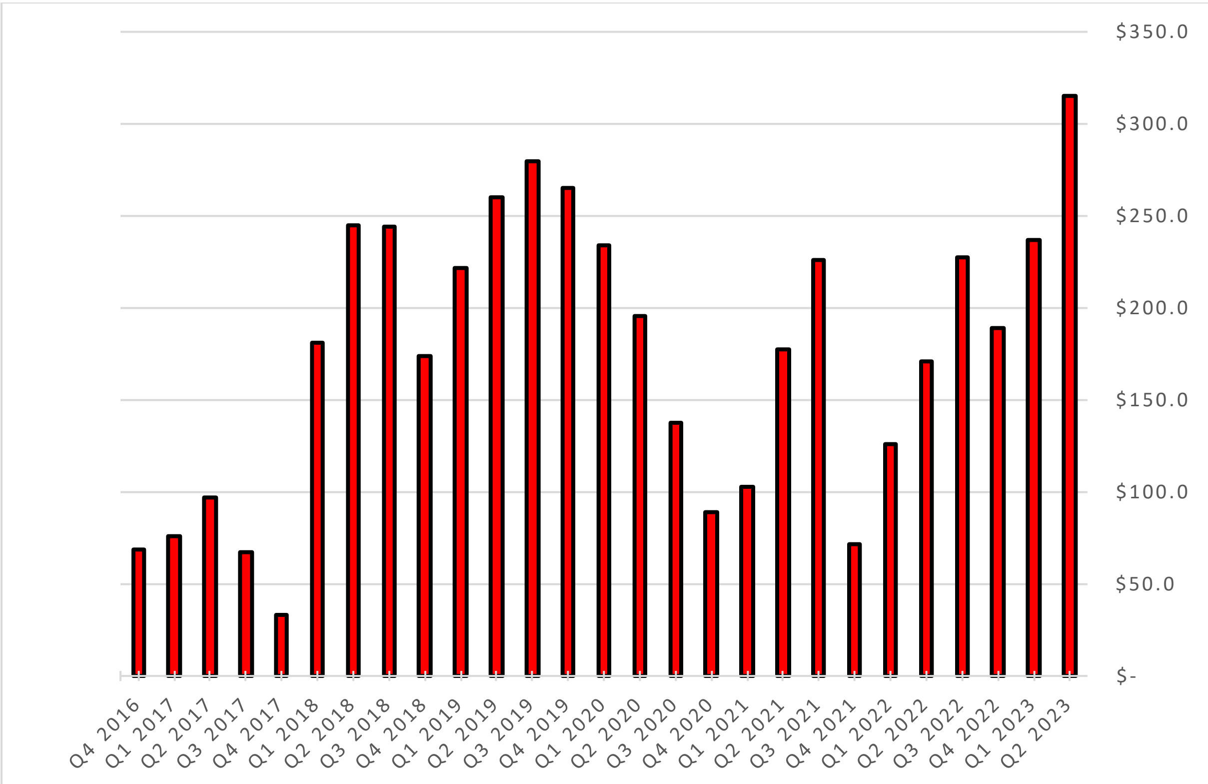


Table 4: Adjusted Revenue Metrics Vs. Estimates

Period Ended:	Q2 2023	Q1 2023	Q4 2022	Q3 2022
Reported Revenue	$898.6	$560.1	$787.1	$1,009.8
Consensus Estimates	$924.1	$648.1	$732.2	$983.7
GlassHouse Adjusted Revenue	$859.8	$521.3	$748.2	$971.0
Difference from Actual (%)	–4.3%	–6.9%	–4.9%	–3.8%

Revisions in Estimates Result in Material Losses in Dating Back to 2017

There seems to be a long track record at Granite of downward revisions. It's a really tough business, super thin margins, so not a lot of wiggle room.

-Former High-Ranking Executive at Granite

It is normal for a construction company with long-term contracts to revise estimates and assumptions in the footnotes of its filings. However, according to GVA's 10K filings, the company has needed to revise its overall income significantly lower dating back seven fiscal years.

3. Revisions in Estimates

Our profit recognition related to construction contracts is based on estimates of transaction price and costs to complete each project. These estimates can vary significantly in the normal course of business as projects progress, circumstances develop and evolve, and uncertainties are resolved. Changes in estimates of transaction price and costs to complete may result in the reversal of previously recognized revenue if the current estimate adversely differs from the previous estimate. In addition, the estimated or actual recovery related to estimated costs associated with unresolved affirmative claims and back charges may be recorded in future periods or may be at values below the associated cost, which can cause fluctuations in the gross profit impact from revisions in estimates.

While a downward revision for a year or two is not worrisome, seven years in a row of material changes to the net downside is extremely rare for this industry. In fact, out of the 11 public companies GVA lists as peers in its proxy, only three (KBR, Primoris, and our old short target Tutor Perini) have disclosed a negative revision in the last year. No company in the peer group came close to 7.5 years of material downward revisions reported by Granite.

Hilariously, GVA reported positive revisions in 2015, 2016, and 2017, only to retract this in the 2018 10K filing, which then showed massive losses:

Years Ended December 31,	2018	2017	2016
Number of projects with downward estimate changes	5	6	4
Range of reduction in gross profit from each project, net	$ 5.3 - 32.0	$ 6.1 - 17.2	$ 6.0 - 13.6
Decrease to project profitability	$ 86.5	$ 67.2	$ 39.4

Continuing this trend into 2023, the company already disclosed downward revisions on two of their projects, resulting in a decrease of $13.0 million in net income in H1 2023 (see Table 5, below). On average, over the past seven fiscal years, GVA has reduced net income by an astonishing $67.7 million, or $1.49 in EPS.

According to GVA's annual report, the company's recent headwinds were attributable to "additional costs related to extended project duration, increased labor and materials costs, and disputed work being performed where there are ongoing legal claims. The decreases [in 2021] were primarily due to additional costs from acceleration of work coupled with lower productivity and higher costs than originally anticipated, unfavorable weather and extended project duration."

While Granite faces the same challenges today, we believe management has decided to recognize revenue prematurely on its long-term contracts, even though they are well behind schedule on many significant projects. Our analysts observe a very different narrative on page F-16 on the 10-K that discusses delays and higher costs.

The crux of our thesis revolves around GVA's lackluster accounting expertise compounded with failing internal controls. In a later section, we detail distinct times where GVA failed to protect their investors with proper accounting or correct personnel. As a result, the company's recent history is full of restatements, late filings, downward revisions, litigations, unapproved change orders, claims, adverse auditor opinions, and material misstatements.

Table 5: Granite Change in Estimates
($ in millions, except EPS)

Period Ended:	H1 2023	2022	2021	2020	2019	2018
Net Income Δ	–$13.0	–$52.4	–$48.6	–$82.9	–$140.5	–$77.7
EPS Δ	–$0.30	–$0.87	–$0.78	–$1.79	–$3.02	–$1.76

Management's Explanations for Spike in Contract Assets

Granite management has repeatedly promised more streamlined projects with less ambiguity and risk. However, management has very little visibility into its projects. The recent spike in unbilleds and contract assets lead us to believe that GVA is taking on risky long-term design projects while becoming less efficient and productive as time goes on. Management provides new updates on departing its "Old Risk Portfolio" or "ORP" each quarter, but it appears Granite is still hampered by these never-ending projects.

In early June of 2017 Granite received a SEC letter about its accounts receivable turnover. Granite responded later that month:

> We note for the Staff that our accounts receivable turnover decreased to 5.5 in 2016 from 6.6 in 2015 primarily due to an increase in accounts receivable from customers in the private sector, which are typically slower paying than customers in the public sector… We manage our combined accounts receivable, net, costs and estimated earnings in excess of billings and billings in excess of costs and estimated earnings balances, our primary working capital assets, using day's sales outstanding ("DSO")… DSO increased 8 days to 67 days as of December 31, 2016 from 59 days at December 31, 2015.

As noted in Chart 1 on Page 10, it appears that the SEC was concerned (and rightly so based on the ensuing litigation), about GVA's growing receivable balance when DSO was at only 67 days. As discussed earlier, we calculate the current balance at 87 days, over 20 days higher and representing the highest value reported in the last five years. As Granite's transgressions have stacked up over the past five years, we imagine the SEC might be interested in the company once again.

Again, we believe most of these issues stem not from a collectability issue, but rather a premature recognition of revenue on projects that are materially behind schedule. Based on GVA's persistently bad revisions of estimates coupled with the spike in contract assets and unbilleds, we believe Granite management is subjectively choosing to recognize revenue on projects they know are well behind on.

Q4 2022

GVA's receivable woes first began to accelerate in 2022. Though management was still cavalier about the increase of its CAP balance, they discussed the current contract assets and claims situation very sparsely throughout earnings calls. For example, in 2022 contract assets (claims) surged by 60.1% (91.7%) YOY, increases that should be explained by the C-suite. However, in the Q4 2022 earnings call, CFO Elizabeth Curtis only stated the following regarding possible reasons for the increases:

> So for the contributions that we made in 2022, those [working capital and claims] are higher than we had initially planned during – at the beginning of the year. And so they relate to the non-sponsored joint ventures and those continue to have some challenges throughout the year.
>
> So that contributed to what we're seeing at the cash flow for the full year. As it relates to operating cash flow for 2023, how we look at it, that is a component in our incentive compensation plan that we added last year to really have the company focus on the cash flow component because, as you know, we've – that's something that's been very volatile for us historically and is included in our strategic plan, and bringing the company together to make sure that, that's an area of focus.

We view this as a non-answer that just explains that Granite hopes to improve this in later periods [they have not]. When we research Granite's 2022 10K filing, we receive a little more detail with respect to the increases:

Cash provided by operating activities of $55.6 million during 2022 represents a $33.7 million increase when compared to 2021. The change was primarily due to a $105.1 million increase in cash provided by net income after adjusting for non-cash items and a $76.6 million decrease in cash provided by working capital. The decrease in cash provided by working capital was primarily due to an increase in contract assets, largely due to unresolved disputed work, as well as increased retention balances related to certain ongoing projects. This was partially offset by a decrease in receivables due to improvement in our billing and collection timing.

Contract assets were also discussed later on in the same 10K filing:

December 31,	2022	2021 (1)
Costs in excess of billings and estimated earnings	$ 80,357	$ 14,158
Contract retention	161,559	131,279
Total contract assets	$ 241,916	$ 145,437

(1) These balances do not include amounts held for sale (see Note 2).

The increase in contract assets is primarily due to unresolved disputed work and increased retention balances related to certain ongoing projects. As of December 31, 2022 and 2021 , contract retention receivable from Brightline Trains Florida LLC represented 11.7 %, and 17.2 %, respectively, of total contract assets. No other contract retention receivable individually exceeded 10% of total contract assets at any of the presented dates. The majority of the contract retention balance is expected to be collected within one year.

While H2 2023 is in the future, with contract assets still elevated through H1, we believe Curtis' statement is overly optimistic based on current metrics. Furthermore, we find it peculiar that management has not discussed in depth during the earnings call the issues the firm is facing with its Brightline Trains Florida project detailed in the excerpt above.

Q1 2023

At the start of the year, management finally addressed major projects that are behind schedule in addition to its contract assets and claims. However, they put most of the blame on precipitation throughout the Mountain and California regions.

"During Q1, we typically use cash as many regions across the company are largely shut down due to cold and wet weather, CEO Larkin said in the Q1 2023 earnings call. "This year, extreme weather prevented projects and materials plants from generating cash. This was compounded by the timing and collection of claims and outstanding retention balances."

While GHR does not dispute the fact that Q1 2023 received an abnormal amount of rain in those regions, this does not explain the continued rise in contract assets/unbilleds throughout 2022 and H2 2023.

Surprisingly, this was the first time CEO Larkin brought up the sizeable project weighing on the firm's financials, the I-64 high-rise bridge in Virginia.

"Construction gross profit was impacted by the weather as well as a write-down on the I-64 high-rise bridge project in Virginia. The I-64 project is winding down but we experienced additional cost to maintain the project schedule," CEO Larkin said.

The I-64 Interstate widening and bridge project in Virginia was initially a $205 million award slated to start in November 2017 and end July 2021. The enduring project has still not wrapped up as of Q2 2023. And we find it peculiar that a project of this size was not discussed prior to this date.

Q2 2023

Finally in the latest period, the company stated in its Q2 2023 10Q filing:

> As of June 30, 2023, we had \$2.0 million of receivables and \$29.0 million of contract retention receivables from Brightline Trains Florida LLC ("Brightline") (see Note 7 of "Notes to the Condensed Consolidated Financial Statements"). As of the date of this report, \$1.9 million of the Brightline receivables have been collected and the remaining \$0.1 million are current. Brightline has experienced delays in securing additional funding in the past, therefore the timing and probability of future payments may be affected and our liquidity impacted if Brightline faces additional funding difficulties.

CEO Larkin also spoke in depth on projects the company was behind on in the Q2 2023 earnings call:

> While the Central Group has substantially derisked its current CAP, I am disappointed to report that the Construction segment was again impacted by the I-64 High-Rise Bridge Project. While this project continues to move towards final completion, which is now scheduled for early in the fourth quarter, the project suffered cost increases. This resulted in a \$21 million impact to gross profit in the quarter with a net impact to Granite of \$10 million after noncontrolling interest.
>
> Winding down these types of risky projects has been a long journey. We remain focused on completing the project as soon as possible. The challenges we have faced on the project are a stark reminder of why we intentionally derisked our portfolio away from these types of large, complex design-build projects where project risks are shifted to the design builder…
>
> In the second quarter, Construction gross profit was adversely impacted by a write-down on the I-64 High-Rise Bridge Project. The impact to gross profit in the second quarter was \$21 million, and the impact after noncontrolling interest was \$10 million. For the 6 months ended June 30, 2023, the I-64 impact to gross profit was \$32 million, and the impact after noncontrolling interest was \$16 million. The impact was primarily due to scheduled delays driven by weather, unexpected site conditions and utility conflicts encountered, as we work to close the project out.

> Additionally, a few projects experienced delayed starts in the California and Central groups and have pushed to the right.

Referring to unfavorable trends in claims, Mr. Larkin stated, “Well, I mean we're working through them. I wish we could share the progress we're making. But it's – we're continuing to chase down a lot of the cash that we think we're entitled to. I think it's – we're going to – I believe we're going to get that money that we're due. It's just a matter of the timing. And so we are making progress, but nothing we can report today.”

We believe management has downplayed the magnitude of their cost overruns on their major projects. With the contract assets, unbilleds and claims balances spiking to balances well above average, we believe that they were finally forced to discuss the headwinds in 2023.

Granite's Free-Cash-Flow Numbers Plummet into Negative Territory

Digging into Granite's cash-from-operating-activities (CFOA) and free-cash-flow (FCF) numbers, we find a company that has reported negative FCF figures in six consecutive TTM periods. While management has provided the generic "we expect to generate cash flow in the back half of the year" statement, a premature recognition of revenue and a lack of customer advances have been material factors in the lack of cash generation in recent years.

Our thesis also revolves around GVA management winning major projects in recent years by bidding on extremely low margins; thus, deviating from the company's objectives of expanding margins in future periods. If Granite was winning projects with high margins, we would expect the firm's free-cash-flow to follow the upward trend as well. However, we find a much different story when looking at the firm's total cash generation over time.

- In the first half of 2023, GVA reported –$119.0 million in cash from operating activities and an even worse free-cash-flow figure of –$188.1 million. While the company routinely reports cash losses in the first half of the year, the magnitude of these losses has dwarfed past fiscal years.

- When looking at longer-term TTM and annual metrics, we find that both CFOA and FCF have been on a consistent downtrend since a peak in 2020 where the company reported $268.5 million and $191.9 million, respectively.

- Since this time both CFOA and FCF have plummeted to only $55.6 million and –$39.9 million, respectively, at the end of 2022. This negative trend has persisted into H1 2023, with TTM CFOA and FCF coming in at $40.0 million and –$66.8 million, respectively (see Chart 5 on Page 26).

- CFO Elizabeth Curtis opined on Granite's current cash situation in the latest earnings call:

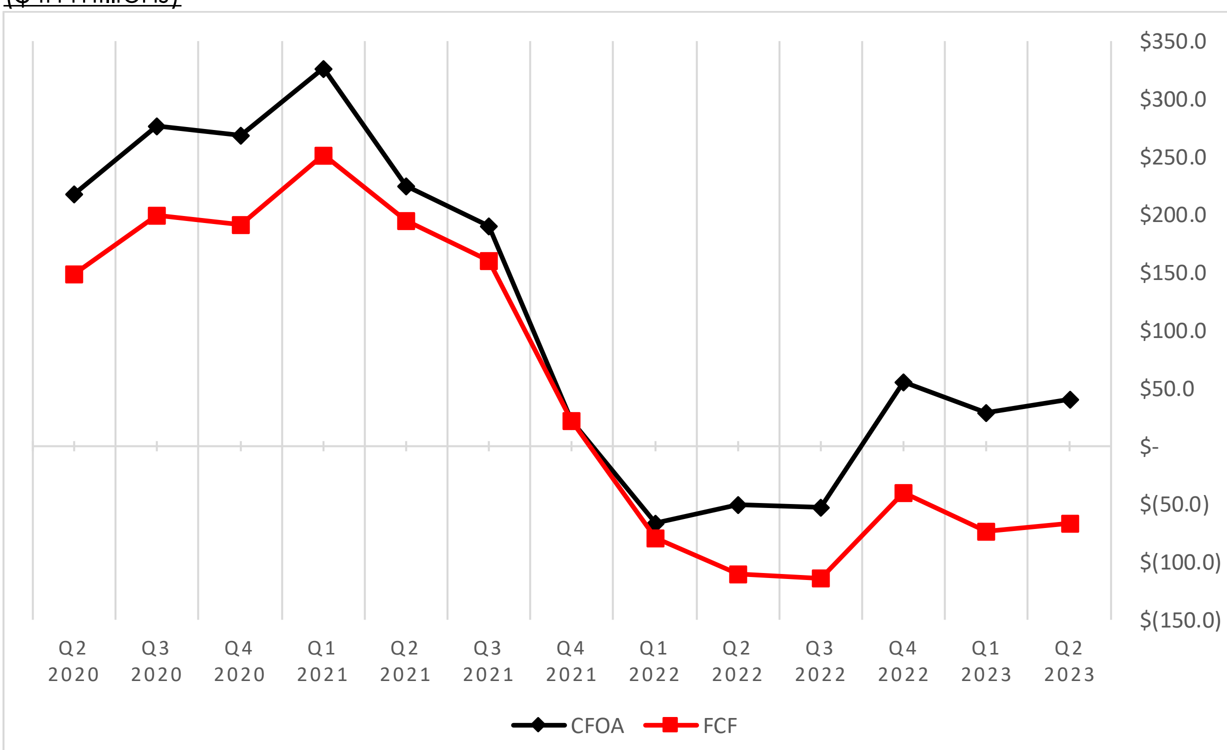
> At the end of the second quarter, our cash and marketable securities totaled $251 million. Historically, our cash decreases in the first half of the year as the construction season ramps up, and we generate cash in the second half of the year. The weather-impacted first quarter further exacerbated this pattern with projects and plans having a slower start to the year. This, in turn, drove higher cash usage and receivable balances. I expect that we will see a reversal of this trend in the third quarter in line with our traditional seasonal cash flow pattern...

So for full year, so we're still anticipating $100 million to $120 million CapEx expenditures for the full year. So that piece has not changed. So when we think about free cash flow for the year, that's a component that we've talked about related to our strategic plan and remains a focus area to ensure that as receivables increase that we're timely collecting, ensuring that our contracts are structured so that the cash flow is managed across the life of the project and then just ensuring as we end the year from a retention perspective that those balances are collected.

GlassHouse believes Granite is in a much worse cash flow situation than management is leading on and is not close to historical norms. <u>We believe that the firm's cash degradation has stemmed from the following items which are corroborated by the firm's annual report:</u>

1. <u>Missed milestones and delays causing clients not to be invoiced.</u>
2. <u>A stagnation of customer advances on new projects.</u>
3. <u>Extremely low margins on new large projects/awards won.</u>

<u>Chart 5: TTM CFOA and FCF Trends</u>
<u>($ in millions)</u>



Granite's Financial Statements Cannot Be Relied Upon

As we delved further into the financials and business practices of Granite Construction, a pattern emerged revealing the company's recent track record of late regulatory filings, restatements and formal complaints. Below is a chronological list of these occurrences:

- **June 8th, 2017**
  The SEC initiated correspondence with Granite Construction, specifically inquiring about the company's accounts receivable turnover. Although the communication did not assert any misstatements, it sought a comprehensive understanding of the factors influencing the receivable turnover and requested additional insights into the company's operational cash flow.

- **February 20th, 2020**
  Granite faced an amended class action lawsuit alleging violations of federal securities laws. This complaint, filed on behalf of the Police Retirement System of St. Louis and those who acquired Granite stock between April 30, 2018, and October 24, 2019, contends that Granite breached GAAP by intentionally inflating its revenue, subsequently adjusting the figures in a later period, leading to a substantial decline in its stock price.

  The complaint primarily focuses on four specific projects. During these projects, Granite deviated from GAAP guidelines regarding the percentage of completion method, omitting known costs when calculating revenue. Consequently, Granite's revenue was artificially inflated by hundreds of millions of dollars.

  Simultaneously, Granite communicated to investors that it was appropriately handling setbacks and transitioning toward smaller, less risky projects. This mirrors the company's current claims. Recent earnings calls have featured statements about Granite's efforts to de-risk its CAP by shifting away from large, complex projects.

  The complaint also highlights Granite's practice of delaying negative news until favorable developments could offset it. However, the company eventually had to acknowledge these losses and recorded a charge exceeding $100 million in a single quarter, leading to a substantial decline in its stock price.

- **March 3rd, 2020**
  Granite filed form 12b-25 to the SEC, indicating a delay in the submission of their forthcoming 10-K report. Subsequently, an 8-K disclosure was promptly filed to explain the underlying reasons for this delay to

investors. The company found itself under internal scrutiny, as its Audit & Compliance Committee initiated an investigation into the reporting practices within the Heavy Civil Operating Group. It is noteworthy that this investigation was likely prompted by the complaint filed against the company. Evidently, Granite's auditors (PwC) failed to identify the reporting irregularities until they were brought to their attention by external sources.

- **May 12th, 2020**
  Before the company's 10-Q was expected to be released, Granite again had to notify the SEC that the report would be late. This subsequent late filing was directly associated with the ongoing investigation into the Heavy Civil Operating Group, indicating a continued ripple effect on the company's reporting schedule.

- **July 22nd, 2020**
  Following consultations with their auditing firm PwC, Granite issued a Form 8-K in which they declared that a multitude of previously published financial reports should be deemed unreliable. The affected reports encompassed the 10-K for the fiscal year 2018, as well as the 10-Qs for the initial three quarters of 2019. The identification of these inaccuracies was precipitated by the ongoing investigation into the Heavy Civil Operating Group.

  These misstatements caused a significant reduction in net income reported in the 2018 annual report. Granite also articulated its intention to restate financial statements encompassing all affected reporting periods.

- **August 11th, 2020**
  Granite reported yet another late filing to the SEC due to the on-going investigation of the Heavy Civil Operating Group.

- **August 26th, 2020**
  A subsequent Form 8-K, issued in consultation with PwC, invalidates the reliability of the 2017 10-K due to identified misstatements. The inaccuracies, discovered by the ongoing investigation into the Heavy Civil Operating Group, have now extended their purview to encompass projects spanning from 2017 through 2019. Importantly, Granite has stated that the investigation remains ongoing.

- **November 10th, 2020**
  Granite delayed the filing of yet another financial statement. Indicating that it had reached a stage of substantial completion. The company conveyed its ongoing efforts to finalize the publication of prior financial reports and to undertake the process of restating reports that had previously contained material misstatements.

- **February 16th, 2021**
  Granite notified investors that the investigation of the Heavy Civil Operating Group was complete.

- **March 2nd, 2021**
  Granite stated that it would file the annual report for year-end 2020 late due to the effects of the Heavy Civil Operating Group investigation.

- **August 25th, 2022**
  The SEC lodged a formal complaint against Granite. The complaint delineated a series of critical internal control deficiencies and detailed how Granite had, between the years 2017 and 2019, engaged in the practice of both overstatement and understatement of revenues. The SEC's documentation further outlined Granite's creative accounting techniques orchestrated with the intention of veiling the adverse financial performance of the Heavy Civil Group.

  While the complaint singularly identified former Senior VP Dale Swanberg as the individual responsible for manipulating financial estimates, the SEC underscored that Swanberg had been subjected to substantial internal pressures within Granite to enhance the profitability of the Heavy Civil Group. Given that projects under this group consistently encountered delays and cost overruns, Swanberg's modus operandi necessitated the deferral of projected costs to align with the company's management expectations. It was alleged that Granite maintained two distinct sets of financial records, one reflecting actual costs and another reflecting lower, manipulated costs, which were employed in the preparation of Granite's financial statements.

  Ultimately, the complaint culminated in Granite reaching an agreement with the SEC, in which the company, without admitting or denying culpability, consented to a settlement. As part of this settlement, Granite was required to remit a civil penalty of $12 million.

- **February 21st, 2023**
  In Granite's most recent 10-K, PwC issued the statement, "Also in our opinion, the Company did not maintain, in all material respects, effective internal control over financial reporting as of December 31, 2022, based on criteria established in Internal Control - Integrated Framework (2013) issued by the COSO because a material weakness in internal control over financial reporting existed as of that date related to not designing an effective control to assess the impact of significant and unusual discrete items on the interim tax provision, such as the divestiture of a business".

> The material weakness in the internal controls is mentioned throughout the report with PwC stating that there is a "reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis".
>
> Granite also points out this weakness in internal control stating, "We have identified a material weakness in our internal control over financial reporting which could, if not remediated, adversely impact the reliability of our financial statements, result in material misstatements in our financial statements and cause current and potential stockholders to lose confidence in our financial reporting, which in turn could adversely affect the trading price of our common stock".

Granite's Management and Board of Directors are Not Qualified to Handle Their Complex Percentage-of-Completion Accounting

GHR favorite shorts arise from small family-run businesses that end up outgrowing their expertise level and eventually succumb to poor internal controls (i.e., Tutor Perini, Cubic & Granite!). Due to the influence of the CEO/founders, these enterprises frequently experience pervasive nepotism within their management hierarchies, coupled with inadequately staffed accounting departments lacking the crucial segregation of duties.

Until 1987, the company remained under the stewardship of the original founding families who assumed control in 1936. In 1987, Dave Watts assumed the role of CEO, maintaining his position until 2003 when he was succeeded by Bill Dorey, who had been part of the organization since 1968. Following Dorey's tenure, Jim Roberts assumed leadership in 2010. It is noteworthy that Jim Roberts was the nephew of Dick Roberts, a venerable and lifelong employee of the company. Subsequently, in 2021, Jim Roberts was succeeded by Kyle T. Larkin, a long-time employee of Granite Construction.

Current Granite Board of Directors:

- Kyle T. Larkin (51), President and CEO
- David C. Darnell (70)
- Celeste B. Mastin (54)
- Molly C. Campbell (62)
- Michael F. McNally (68)
- Laura M. Mullen (62), CPA
- Patricia D. Galloway (65)
- Alan P. Krusi (68)
- Jeffrey J. Lyash (61)
- Louis E. Caldera (67)
- David H. Kelsey (72), Chair of Audit/Compliance Committee
- Gaddi H. Vasquez (68)

When we research Granite's Audit Committee Chairman and noted "Financial Expert", we find David Kelsey is not a listed CPA. The audit committee only consisted of a single CPA, Laura M. Mullen. Ms. Mullen previously served as an audit partner with KPMG LLP from 1996 to 2020.

While her background should somewhat pacify our accounting concerns at Granite, albeit this is only one person on the entire Board with their CPA. Not to mention, chair of the audit committee, Mr. Kelsey, was in charge of the audit committee when multiple accounting restatements happened, and the company was brought under fire for incorrect accounting practices. We find it highly dubious that Mr. Kelsey kept his Audit Chair position after the first complaint and reported accounting errors/restatements. Due to these aforementioned restatements, we find it hard to believe that we can trust Mr. Kelsey as Audit Chairman to sniff out any accounting financial engineering done by management.

The lack of sufficient accounting staff throughout Granite's C-Suite and Board of Directors would be concerning at any company. However, when factoring in the volatile past of Granite's related to its revenue recognition policies, GHR remains on high alert for future accounting violations based on their past and current earnings quality metrics. Not to mention the current weakness in internal control pointed out by the company's auditor.

Another noteworthy aspect pertaining to the board is the recent resignation of Jeffrey J. Lyash, a member who held positions within the audit and risk committee. Mr. Lyash had occupied a role on the board since 2018, with his tenure originally slated to persist until the culmination of the fiscal year 2025. However, his unexpected and precipitate departure from the organization materialized in the month of September 2023. It is worth noting that no explicit reason was given for his resignation. Though it is intriguing to observe that the audit committee and the risk committee, the two facets of the board responsible for addressing the concerns delineated herein, were the precise committees to which Mr. Lyash was affiliated.

After all the calamities that Granite faced over the years, we believe that the company should have hired an outside CEO while the CFO, audit board members and auditors should have all been held accountable. Its accounting staff should also have been mostly replaced. This did not happen. Based on these poor decisions, we find it highly likely that Granite's past transgressions will repeat themselves.

Poor Internal Controls + Accounting Red Flags Could Lead to Substantial Downside and Restatements

The bull case regarding Granite's stock price revolves around the following tenets that we believe the sell-side community has misunderstood:

- Analysts/investors have rewarded the company for a growing CAP balance that has reported double-digit gains since Q4 2022.
- Analysts believe that the company has shunned complex projects that have hindered itself in the past.
- Many analysts believe that GVA's prior accounting issues are a thing of the past.

As stated in a prior formal complaint, this story has been told by the same team back in 2018, when the company shied away from difficult projects that hounded them in the past. Based on recent balance sheet account trends and an unearned revenue CAP balance (non-CGMC projects) that has increased since 2020, we do not believe them.

In fact, we believe that management turned to accounting gimmicks in order to unsustainably boost earnings in the near term. We believe the sell-side community is not accurately pricing in the magnitude of our earnings quality concerns.

Based on our analysis, we believe that much of the recent sales growth was attributable to prematurely recognizing revenue. With respect to the company's already diminished cash flow figures, we believe a reversal to generate meaningful amounts of free-cash-flow will be a painful one for Granite.

We believe the spike in contract assets suggests that management is behind on major long-term contracts and has not reached milestones determined by its own project managers. Furthermore, the stagnation in customer advances suggests a low quality of revenues that will be a material topline headwind going into H2 2023 and beyond.

Accordingly, we are initiating coverage on Granite Construction Incorporated (GVA) with a Strong Sell Opinion.

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