GlassHouse Research

03/17/16

Initiation of Tutor Perini (TPC) with a target price of sub $5.00

GlassHouse Research inaugural research report focuses on the cash burning machine known as Tutor Perini (TPC). There is mountains of evidence laid out within this report that shows management has been more than cavalier (if not fraudulent) with its recent revenue recognition policies.

Who is GlassHouse Research? GlassHouse Research is made up of former forensic accountants/analysts that have worked for prominent hedge funds on Wall Street as well as boutique forensic accounting firms. Our purpose is to expose fraudulent companies that have been taking advantage of US GAAP as well as IFRS accounting for their benefit. We seek to find companies where GAAP (or even worse non-GAAP) earnings are deviating from true economic earnings of the target firm.

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- **Tutor Perini's free-cash-flow plummets over the past five years:** The combined impact of higher AR, rising claims and falling unearned income caused cash collections to plummet over 2012, 2013, 2014, and now 2015.

- **Ineptitude of TPC's lackluster work exposed by looking at their accounting:** While management continues to downplay the firm's work delays and contract disputes on their conference call, the 10-K reveals a different story of bloated unapproved change orders and claims.

- **Lawsuits litter TPC's 10-K filing attributable to shoddy work and exorbitant pricing invoiced to customers:** Tutor Perini's 2015 Annual Report details 10 lawsuits against the firm all due to contract disputes with previous customers.

- **Secret "other" assets accounts may be being used to hide bloated AR:** The company's "other current assets" and "other assets" accounts spiked 58% and 130% YOY, respectively. With no explanation given in the firm's 10-K, we believe these accounts

could be used to either 1) hide some of the already bloated unbilled AR on the balance sheet and/or 2) capitalize operating expenses similar to WorldCom in the early 2000s.

- **Cost in excess of billings trends a harbinger for low quality backlog:** The decline in cost in excess of billings suggest that TPC is taking less upfront payments on their work in order to entice customers. In our view, this as unsustainable going forward.

- **Debt levels cannot be repaid and default looms over the company:** Already in violation of debt covenants, we call into concern TPC's ability to repay contractual obligations in 2018.

- **Accounting of Joint Ventures leads to many questions with no answers.**

- **Insiders jumping ship in 2015 concurrent with stock price decline:** Key executives Robert Band (President) and Michael Kershaw (CFO) bail at an opportunistic time.

TPC's Non-Existent Free-Cash-Flow

	2015	2015	2013	2012	2011
Cash From Operating Activities	$14.1	-$56.7	$50.7	-$67.8	-$31.6
Free Cash Flow	-$21.8	-$131.7	$8.3	-$109.0	-$98.3
Non-GAAP Earnings	$59.1	$107.9	$87.3	$70.3	$86.2

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- As shown above, TPC has a major free-cash-flow problem. While the company has been able to report positive non-GAAP earnings of $0.91 (2015), $2.20 (2014), $1.80 (2013), $1.46 (2012), and $1.80 (2011), can we truly believe any of these figures???

- Revealing the subjectivity to TPC's earnings, we provide this excerpt from the 10-K:

(c) Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect reported amounts. These estimates are based on information available through the date of the issuance of the financial statements. Therefore, actual results could differ from those estimates.

(d) Construction Contracts

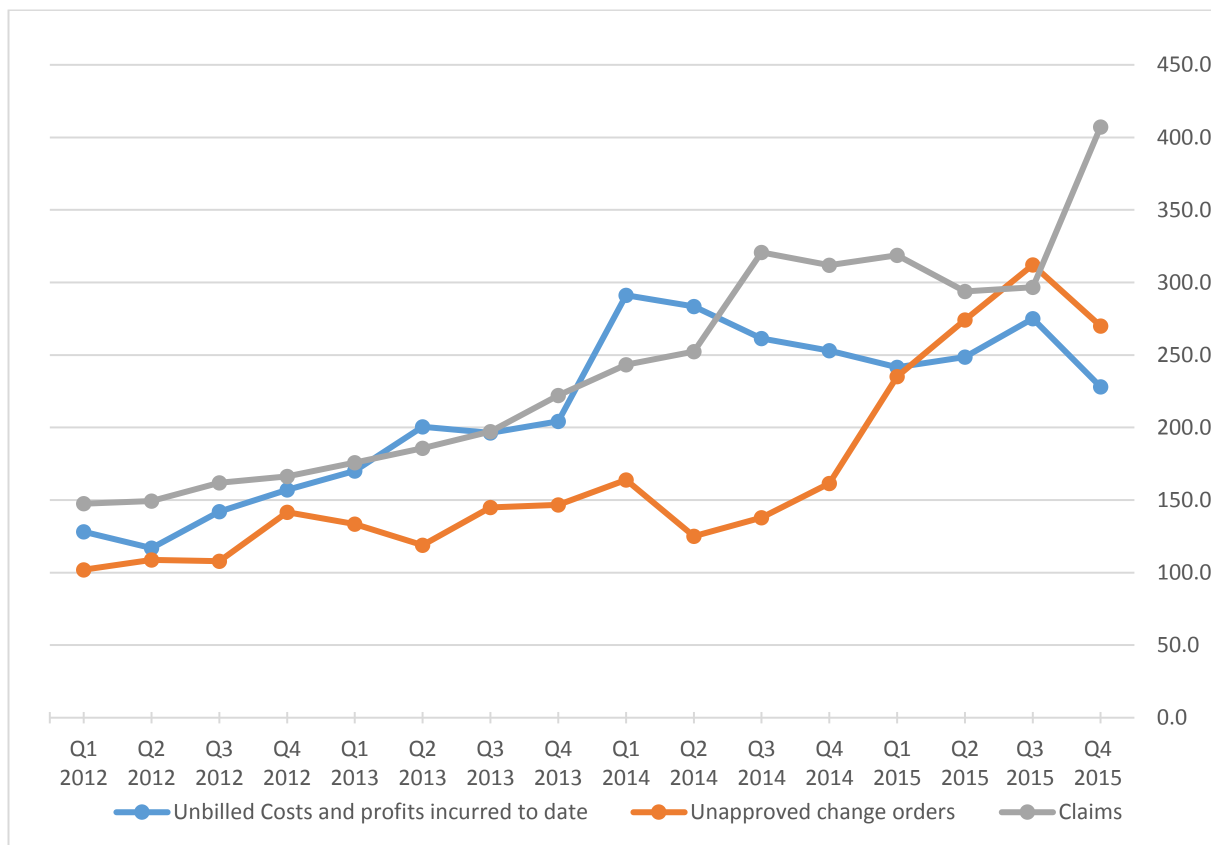
The Company and its affiliated entities recognize construction contract revenue using the percentage-of-completion method, based primarily on contract cost incurred to date compared to total estimated contract cost. Cost of revenue includes an allocation of depreciation and amortization. Pre-contract costs are expensed as incurred. Changes to total estimated contract cost or losses, if any, are recognized in the period in which they are determined.

- How has management done with their estimates??? Well let’s just take a look at this small footnote in the 2015 10-K:

(a) During the year ended December 31, 2015, the Company had a decrease of $0.53 in diluted EPS due to unfavorable adjustments on various Five Star Electric projects in the Specialty Contractors segment. In addition, there was a decrease of $0.28 in diluted EPS due to unfavorable adjustments to the estimated cost to complete a Building segment project in New York.

- So how does management get away with this? Simple, due to percentage-of-completion accounting, management has the discretion to recognize revenue even though the firm is way behind on its projects! More in the next section.

Unapproved Change Orders and Claims Dominate the Balance Sheet



- What are unapproved change orders and claims and why are they important?

  According to the company they are: Both unapproved change orders and claims are amounts *subject to pending litigation or dispute resolution proceedings*. These amounts

are *management's estimate* of the probable cost recovery from the disputed claims considering such factors as evaluation of entitlement, settlements reached to date and experience with the customer. In the event that future facts and circumstances, including the resolution of disputed claims, *cause a reduction in the aggregate amount of the estimated probable cost recovery from the disputed claims, the amount of such reduction will be recorded against earnings in the relevant future period.*

- In layman's terms, TPC can recognize revenue on the income statement for sales that have not been invoiced or even agreed upon by the customer yet!

- In fact, unapproved change orders and claims are the worst of these receivables and they are up 67% and 31% YOY, respectively in the last quarter! Put another way, TPC recognized $110.6 million in QOQ claims on the income statement this last quarter on sales that the company is in dispute with the customer!
- So what's going on here? With simple analysis of TPC's accounting, we can see that the company is missing major milestones within their projects over the past 5 years. But instead of recognizing less revenue like a conservative manager should, TPC continues to recognize the full amount like nothing happened! This game can only last so long.

- This is all corroborated with TPC's plethora of lawsuits listed in the annual report. What are all these lawsuits about? You guessed it, shoddy work that the company has done in the past (google MGM & Tutor Perini).

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Other Assets Accounts Provide No Disclosures

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TUTOR PERINI CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	As of December 31,	
	2015	2014
ASSETS		
CURRENT ASSETS:		
Cash, including cash equivalents of $1,696 and $12,044	$ 75,452	$ 135,583
Restricted cash	45,853	44,370
Accounts receivable, including retainage of $484,255 and $382,891	1,473,615	1,479,504
Costs and estimated earnings in excess of billings	905,175	726,402
Deferred income taxes	26,306	17,962
Other current assets	108,844	68,735
Total current assets	2,635,245	2,472,556
PROPERTY AND EQUIPMENT, at cost:		
Land	41,382	41,307
Building and improvements	123,600	120,796
Construction equipment	431,080	426,379
Other equipment	181,940	159,148
	778,002	747,630
Less - Accumulated depreciation	254,477	220,028
Total property and equipment, net	523,525	527,602
GOODWILL	585,006	585,006
INTANGIBLE ASSETS, NET	96,540	100,254
OTHER ASSETS	202,125	87,897
TOTAL ASSETS	$ 4,042,441	$ 3,773,315

- TPC lists two line items on its balance sheet (other current assets and other assets) and provides not disclosures for in its filings.

- While no disclosure in itself isn't concerning, it's the rapid growth of these two accounts that boggles the mind. Specifically, other current assets is up 58% YOY to $108.8 million. While LT other assets are up an astonishing 130% YOY to $202.1 million.

- While these two accounts may sound innocent enough, remember it was WorldCom that got into issues with capitalizing operating expenses on the balance sheet in the early 2000s. The same issues may apply here.

- While CFO has to make payments each quarter to suppliers for normal operating expenses, the CFO has discretion to capitalize these expenses on the balance sheet instead of letting them flow through on the income statement.

- Also, there is a risk here that management has just decided to reclassify many of the questionable receivables down in the "other" line item to be unnoticed!

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Backlog and Deferred Revenue Trends Will Lead to Top Line Decimation

- While the firm's noted backlog decline has been documented by the company. It's the deferred revenue trends that are most telling about the company.

- This tells us how much upfront cash customers are willing to give TPC before the project starts. Think of it as a down payment. Deferred revenues are now down 3 quarters in a row by double-digit YOY declines. Even worse, relative to sales, DR is now down in 13 of the last 14 quarters on a YOY basis!

- Relative to total backlog, DR is now down in 11 of the last 14 quarters on a YOY basis. So as we can see, management is trying to entice customers to give them awards based on a lower upfront payment, but as we can see from award trends, this is not working.

- This is quite telling from the firm's quarterly book-to-bill ratio that has been under 1.0x for the last 5 periods (average of 0.9x). What does this mean? This means that TPC is taking more from its well of orders (total backlog) and not replenishing it fast enough with new orders.

TPC's already modified debt covenants may increase incentives to manage earnings

- In addition to the financial risks inherent to a company adding more debt to its capital structure, we are concerned about its potential impact on quality of earnings. In this regard, academic research indicates that high debt firms may be motivated to make more lenient accounting choices in an attempt to avoid violating its debt covenants

- **Tutor Perini just violated a bank loan covenant and required a waiver:**
  In November, Tutor Perini had an earnings conference call for analysts that was notable for what it was missing – the earnings. Tutor ended up filing its required quarterly financial statements a week late. It needed the time to include a last minute court decision that caused it to take a small write-off. Tutor failed to mention on the (non) earnings call that they also needed the week to work out things with their bank creditors, as they were in non-compliance with their bank covenants, according to the 10q SEC filing.

- **The bank loan size was increased last year and covenants eased to accommodate Tutor's need for more debt:**
  In 2014, Tutor Perini was getting very low on cash. The company needed to borrow more from its banks and reduce the payments on its existing debt so they renegotiated their bank loans in June 2014. Because of the additional debt, there was no way to comply with the existing bank covenants. The key restriction on Tutor Perini was a ratio of its debt to the earnings available to pay the debt, called the "Consolidated Leverage Ratio".

Quarter ending:	Pre – 2014 limit	After 2014 restructuring
June 30, 2014	3.25	3.75
September 30, 2014	3.25	3.75
December 31, 2014	2.75	3.75
March 31, 2015	2.75	3.75

June 30, 2015	2.75	3.5
September 30, 2015	2.75	3.5
December 31, 2015	2.75	3.5
March 31, 2016	2.75	3.5
June 30, 2016	2.75	3.25

- While the specific financial figures in the bank loan documents make it difficult to calculate the ratios exactly, we estimate that Tutor's debt was $886 million and the adjusted earnings figure was $240 million for the September 30, 2015 period. This is a ratio of 3.69, above the 3.5 requirement.

- The banks gave Tutor Perini a waiver – but the California High Speed Rail Authority and investors should still be concerned.

- First, the write-off wasn't that big. This means it was not a one-off occurrence. Tutor is in danger of violating its covenants again. Tutor's debt has continued to grow over the last couple of years, despite a couple of very large cash inflows from longstanding legal disputes that just got settled. They have been forced to sell off assets at losses and have a limited ability to take on new debt.

- Second, this is a write-off that should have been taken two years ago. A Tutor Perini subsidiary lost a lawsuit as part of a consortium that had failed to complete a tunnel project in Washington State. They had actually handed over the cash to the plaintiff for their share in 2013, but decided they were "owed" the money and booked a future payment in accounts receivable for the same amount while the case was being appealed. This is extremely aggressive accounting. While it may not have been material as a percentage of Tutor Perini's annual revenues, it was just enough to make sure that Ronald Tutor met the threshold for corporate earnings to receive his multi-million bonus in 2013.

- **Why did the state of California agree to pay Tutor Perini $32 million before they were required to?**
  The violation of the debt covenant should draw attention to a change in the payment terms for the CP 1 construction contract (first segment of the California high speed rail project) this summer. The "earned value" / invoiced amount of the contract jumped suddenly this summer. Project officials said that this did not represent additional work that had been done, but rather a change in how Tutor Perini was being compensated. The September 2015 operations report stated," The increase in CP 1 earned value during the August pay period is primarily a result of revising the way the Contractor is compensated for administrative overhead incurred to date." This was a substantial change.

- In August 2015, the remaining contract value only decreased by $6 million, while the amount invoiced to date jumped from $134 million to $172 million. This suggests that the state of California, out of the goodness of their heart, allowed Tutor Perini to frontload an additional $32 million in payments. While Tutor Perini did not disclose this payment or how they accounted for the windfall cash, it would have been enough to keep them in compliance with their bank covenants for the third quarter. Why did the state make this payment? Why did they agree to this arrangement? Is there anything the state is getting, formally or informally, for helping Tutor out of a sticky situation?

- This gets particularly concerning as Tutor Perini needs to disclose any changes in their financial status, including bank waivers of covenants, as part of their bid for CP 4, a 22 mile construction segment.

- The Authority should provide additional information about the change in contract payments.
  It should also require a full explanation from Tutor Perini about their need for additional debt, given the fact they are showing accounting profits. In particular, the agency should request detailed information about what comprises the accounts
  receivable category. Unlike all other large construction firms, Tutor's ability to collect from its customers has declined substantially and consistently over the last couple of years. This either is a sign of a poorly run company or an indication that Tutor is saying people owe them money that maybe they don't.[1]

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[1] (Analysis done by CARRD. Californians Advocating Responsible Rail Design)

Does the company's current joint venture with a director, Raymond Oneglia, create a conflict of interest?

- The Vice Chairman of O&G Industries (O&G), Raymond Oneglia, also serves as a director for TPC, where O&G occasionally participates in joint ventures with the company. While the total amount or revenue earned from the joint venture with O&G is currently marginal compared to total revenue, we remain concerned regarding a potential conflict of interest pertaining to contracts, especially if the joint venture starts to engage in larger projects together and/or disagreements with clients emerge.

- Specifically, TPC shares of revenue from the joint venture amounted to $10.7 million, $7.0 million, $6.9 million, $19.3 million, $5.5 million and $1.2 million in 2015, 2014, 2013, 2012, 2011 and 2009, respectively. Also disclosed in the 2015 10K, as of 12/31/15 the company has a 30% interest in a joint venture with O&G as the sponsor for a highway construction project with an estimated total contract value of approximately $357.0 million. In addition, we note that O&G's cumulative holdings of TPC's stock as of 12/31/15 were 500,000 shares.

- Again, we observe that while the current revenue generated from this joint venture with O&G may be minimal, we see that there is potential for the JV to earn substantially more revenue in the future. And if this is the case, we question whether contracts made with O&G can truly be made at an "arm's length" transaction with Mr. Oneglia as the Vice Chairman of O&G.

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- In addition, the use of the proportionate method of accounting here instead of the equity method is highly questionable in this situation as the firm owns less than 50% of the JV. This leads to decreased disclosures regarding the JV as well as no quarterly earnings data given from this JV.

Conclusion:

In light of our concerns regarding lackluster free-cash-flow generation, outsized growth in unapproved change orders/claims and a declining deferred revenue balance, we find the current stock price highly egregious with default risk on the horizon. Furthermore, we see added risk regarding the company's limited disclosure regarding its joint ventures. Accordingly, we are initiating coverage on Tutor Perini a sub-target price of $5.

Disclaimer: GlassHouse Research is currently short Tutor Perini (TPC) and will be for the foreseeable future. Please do not trade on this report alone but corroborate with your own analysis.

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