GlassHouse Research

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Tutor Perini's Accounting Woes Will Continue into H2 2016

GlassHouse Research inaugural research report focuses on the cash burning machine known as Tutor Perini (TPC). There is mountains of evidence laid out within our reports 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.

Summary:

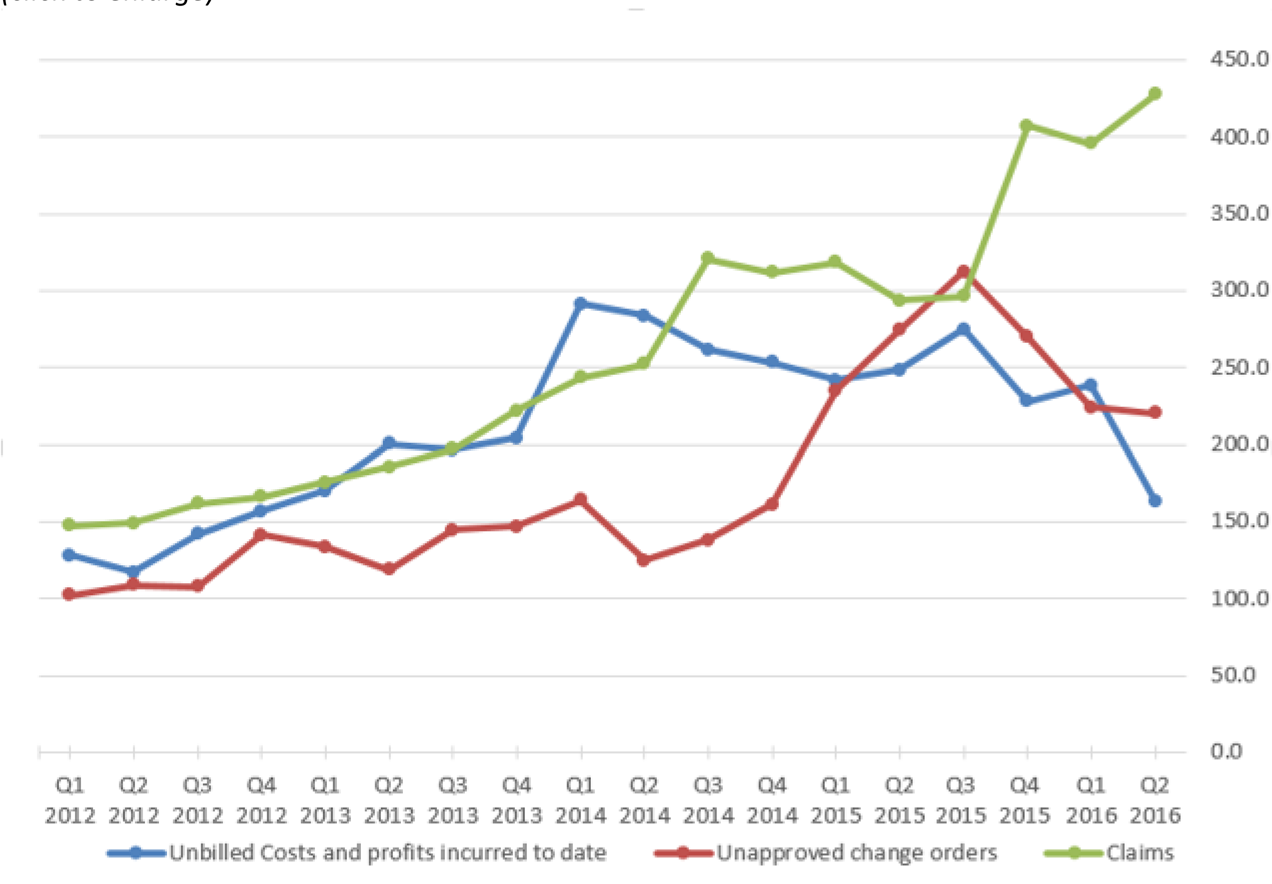
- TPC finally recognizes unbilled receivables issues, but claims continue to skyrocket.
- Bloated other assets line item on the balance sheet may be hiding LT receivables.
- TPC's book-to-bill falls well below 1.0x with new awards of $418.4 million in Q2 putting H2 guidance at risk.

Percentage-of-completion accounting was the harbinger for recent slowdown

While management has finally admitted to problems with collections on the Q2 conference call. Smart reviewing of its percentage-of-completion accounting would show that these problems stemmed long ago dating back in 2012 and now it's starting to rear its ugly head. Analyzing the footnotes of the filings, TPC reports its unbilled receivables, including the subsections "unbilled costs and profits, unapproved change orders, and claims". Basically the further we go down the line the more "at-risk" each receivable is. One thing to realize is that all these at-risk receivables have been already recognized on the income statement at the discretion of.... you guessed it! Management! In fact, it's important to note that these already recognized receivables *have not* yet been confirmed with the client yet! That means TPC has not invoiced nor agreed upon scope and/or pricing on a material amount of work.

How bad has it been? Let's take a look below:

(click to enlarge)



As you look at the green line (Claims), we now find out how serious this is. The highest risk form an unbilled receivables (you guessed it) is claims, where neither scope nor pricing is agreed upon with the customer. In fact, a lot of these claims are under litigation with the client, but yet TPC still counts this as revenue!

Getting into the specifics about how material the spike in these numbers are let me point out that total unbilled receivables relative to quarterly sales is at 74.6% the highest it has ever been for TPC. This ratio was only 13.5% at the end of 2009 when the ascent began.

As aforementioned, management finally admitted to working on these collections in the upcoming quarters, but what they won't tell you is that as they are doing so, earnings will take a substantial hit to the downside. Net income and free-cash-flow work inversely for the most part with percentage-of-completion accounting. As the company works to bring down its receivables and improve free cash flow, earnings will plummet in the meantime. But don't take my word for it, take a look at new orders section below and see how abysmal they were in Q2.

Growing "other" assets line item may be being used to hide bloated AR

TPC's "other current assets" and "other assets" accounts spiked 57.2% YOY in Q2. With no explanation given in the firm's 10-K, we believe these accounts could be used to either 1) reclassify some of the already bloated unbilled AR on the balance sheet and/or 2) capitalize operating expenses similar to WorldCom in the early 2000s.

While no disclosures in itself isn't concerning, it's the rapid growth of these two accounts that boggles the mind. To understand how management can be artificially inflating margins I will give the following scenario. While the 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. Where the correct journal entry should be a Debit to expense (an income statement item) and a Credit to cash, the CFO can instead Debit prepaid expenses (a balance sheet item) and Credit cash. However, this game can only be played for so long as eventually these capitalized expenses will need to flow through the income statement and decrease margins at an accelerated rate.

Depressed new awards amount in Q2 puts H2 guidance at risk

With new awards falling 67.1% YOY to only $418.4 million in the Q2 period, management may have played a dangerous game re-affirming its guidance of revenue of $5.1 to $5.6 billion and EPS of $1.90 to $2.20 (new orders are a harbinger for future revenue and earnings). Furthermore, let me put into perspective how bad of a quarter Q2 was. Specifically, TPC averaged new awards of $1.33 billion each quarter over the last year; that would put the $418.4 million amount 68.5% below the average amount. This caused TPC's book-to-bill ratio to drop to 0.32x, again a 67.0% YOY decline from its previous value of 0.97x.

Related to the new awards, TPC's backlog fell 6.2% YOY to $7.27 billion (down sequentially by 10.9%). So for all the enthusiasm in Q1 where new awards jumped 73.9% and caused the stock price to jump from the mid-teens to the mid-twenties, we find that looking on a H1 2016 vs. H1 2015 basis, new awards were *down* 4.3%.

Worst part about the decline in new orders, was that TPC's highest margin segment, the Civil segment, reported the lowest amount of new orders of the company at only $93.5 million. This represented a decline of 62.7% YOY.

TPC is a value trap that will have its "E" drop drastically in the next 2 quarters

With many of sell-side analysts selecting TPC for its value like numbers with "expected" growth, what these analysts do not understand is how the percentage-of-completion method of accounting impacts future earnings. With the spiking of receivables to this magnitude, it will continue to negatively impact earnings for the long-term. On top of that, who is to believe that this company is able to collect on all the claims and unapproved changes orders that it already has recognized! We shall see in the upcoming periods.

<u>Conclusion:</u>

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.