3D ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
Governance: Corporate Governance Issues
✓ **Fundamentals:** Analysis of fundamentals

Profits Still Elusive and Exec Behavior Still Bearish
Shaw Group Inc. (NYSE:SGR) Update

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Business Description

The Shaw Group Inc. offers engineering, technology, construction, fabrication, environmental, and industrial services to various companies worldwide. The Company is organized into 5 operating segments: Fossil and Nuclear, Environmental and Infrastructure, Energy and Chemical, Fabrication and Manufacturing, and Maintenance. The Company's customers include multinational oil companies and industrial corporations, regulated utilities, independent and merchant power producers, governmental agencies, and other equipment manufacturers. It markets its services through an in-house sales force and through independent contractors. The company was founded in 1987 and is headquartered in Baton Rouge, Louisiana.

Summary of 3DAdvisors Findings for SGR

- **Accounting:** Choppy profits frequently affected by "one-time" charges
- **Accounting:** Westinghouse "investment" continues to burden results
- **Accounting:** Given weak results, POC accounting still a concern
- **Insider Trading:** CEO and former CFO further trim actionable positions
- **Fundamentals:** With backlog growing rapidly, is Shaw really ready to execute?

Discussion of 3DAdvisors Findings for SGR

As we stated in our initial report on Shaw Group Inc. on 02/08/08, the Company seems to be in all the right businesses at the right time. You would think that the Company's design, engineering, construction and consulting services to the global fossil and nuclear power generation industries would have it perfectly positioned to cash in on the burgeoning need for electric generation capacity, particularly in the nuclear arena with oil and coal prices continuing to make new highs. The conundrum, however, is the fact that, as operators, Shaw management consistently has problems delivering profits. In each successive period, big and unplanned charges are reported that dent profit numbers, significantly so in some quarters. In addition, the continuing drain from its Westinghouse investment (although primarily due to a strong yen and weak U.S. dollar), still causes the Company to want investors and analysts to pretend it's not there by presenting results without its 20% equity interest. Regardless, the investment in Westinghouse has increased interest costs significantly, and because the related debt is yen dominated, the strength of the Japanese currency has caused direct hits to income in every quarter since 4Q07. And while we acknowledge that the dollar has firmed against the yen in recent weeks and looks likely to head higher, the question remains: how far, how soon?

And now, with crude pushing past $130 a barrel in recent sessions and talk raging on about positives for nuclear construction as carbon dioxide emissions limits (currently debated in Congress) loom, Shaw shares have rebounded sharply and are up almost 25% since hitting a recent closing low of $47.14 on 03/31/08. We, however, remain skeptics as the shares have not yet broken out of the down trend that began last November, although the rebound off the lows amidst recent energy-related news has prompted us to do this update and remind our clients that many of the issues covered in our earlier report remain. For instance, the Company's 2Q08 results exhibited many of the same characteristics we outlined in February: lack of profitability, persistent hits from write-offs, questions about earnings quality, and the ongoing drain from Westinghouse are all still present. Add the fact that CEO **Jim Bernhard**, who insists that a "nuclear renaissance" is at hand, reduced his actionable holdings further in April, and we remain unconvinced that sustainable, high quality earnings will materialize anytime soon.

Accounting: Choppy profits frequently affected by "one-time" charges

It seems that each sequential quarter's results contains a number of charges that consistently hamper Shaw's profits. Indeed, the occurrence of these "one time charges" is so repetitious and reliable one may choose to consider them regular events. The events itemized below from the last three quarters exclude the drag on results created by Shaw's Westinghouse investment (more on this below):

- ➡ **2Q08:** $9 million charge due to under-performance on the Environmental Infrastructure Group; $13 million in charges and contingencies on other projects. These charges translated into a $0.27 per share hit to Operating Earnings. To this add an additional $0.03 charge due to an unanticipated tax adjustment.

- ➡ **1Q08:** $2.6 million in receivables written off in the Energy and Chemicals (E&C) segment; $2.8 million "nuclear investment" representing charges that have been expensed but not yet chargeable to contract; $1.9 million due to an "unsigned change order" which was to come "in the near future" but has yet to surface after four months; $2.1 million in receivables written off in the Environmental & Infrastructure (E&I) segment. In total, $0.12 per share in Operating Earnings lost.

- ➡ **4Q07:** $3 million in severance charges; $6 million in Restatement Related charges; $5.5 million "Change Order Signing Gap"; $7.5 million "nuclear investment" (explained above). In all $0.18 per share in Operating Earnings penalized.

Given the Company's reliance on Percentage of Completion accounting, albeit appropriate, we must remind clients of the substantial risk to Shaw's receivables especially given the number and frequency with which write offs and charges seem to take place. As of 2Q08, there are $60 million in revenues not assured of collection and are probably dispute related. There is another $30 million that has been included in revenues based on achievement of certain project incentives.

When one reads MD&A section in Shaw's SEC Form 10-Q for 2Q08, there can be no doubt that the Company's markets are going to continue expanding, but the question remains as to whether the it can make money through its participation in those markets. Past experience indicates this is a major problem for Shaw. Frequently in the segment remarks management points out that the current year's improvement is due in part to write downs taken in prior periods, simply meaning that profits reported in periods before those write downs were not real and obviously overstated, which again leaves one to wonder how much faith can be realistically put in the results from recent periods, even though those results show just meager profits to begin with.

<u>Accounting: Westinghouse "investment" continues to burden results</u>

Shaw continues to position its earnings and balance sheet as if its substantial investment in 20% of Westinghouse does not exist. Every presentation of Shaw results features not only the segregation of substantial Westinghouse-related charges but also the overlooking of the related $1.2 billion in debt as if it did not exist. Indeed, CFO **Brian Ferraioli** touts Shaw's "Total Debt" as of 02/29/08 (Q2) to be negligible. The asterisk though is a big one for even should Shaw choose to put its Westinghouse-related debt back to Toshiba after 2010, the Company would have incurred a 3% penalty (read: discount) from its original purchase price, which is denominated in Yen. At today's Yen conversion, this would equate to roughly $40 million.

But again, Shaw treats the Westinghouse debt as inconsequential and even breaks out the related interest expense from the Company's other interest charges. Seemingly, the Company would like us to believe that Shaw's interest expense dropped 33% in 2007 (to $12.8 million) and 42% in the first six months of 2008 (to $4.5 million). In reality, however, including Westinghouse debt in the calculation shows a substantial increase of 120% (to $43.4 million) in 2007 and 68% for the six months ending 02/29/08 (Q2) to $22.6 million.

Interest expense though, as most of our interested clients know, is only part of the drag created by Westinghouse. Currency hits related to the Yen denominated debt have been eating up much of Shaw's profits for the past three quarters. This problem was initially telegraphed by Shaw in 3Q07 when Ferraioli's prepared comments revealed that "Q4 will include a one-time non cash currency translation loss on the Westinghouse debt". When Q4 results rolled around, this "one-time" loss came in at $33 million. Without the loss, Shaw's $19 million loss for the year would have looked quite different.

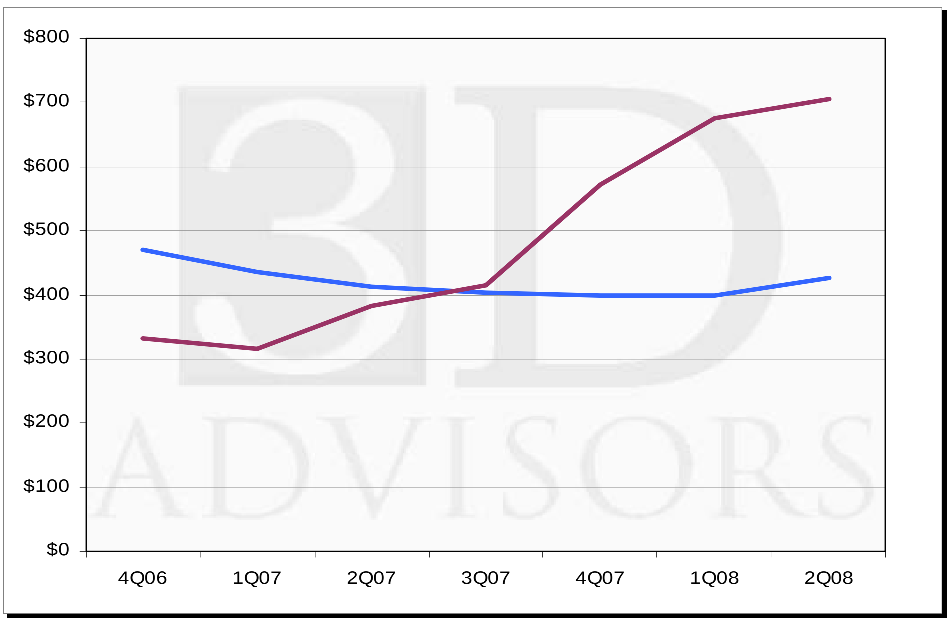
So much for "one-time" translation loss, as future quarters would bear out. In 1Q08, this ballooned to $57.2 million, eating up the vast majority of operating profits for the period. Ditto for 2Q08, where Westinghouse currency translation losses cost yet-another $40.6 million and, again, the lion's share of Shaw's profits. Granted, the Company is quick to mention that these losses are "non-cash". The other side of that reality though is that Shaw's recorded Yen-denominated debt has risen accordingly and has moved from $1.08 billion to $1.14 billion as a consequence of these translation hits.

Given that the meager earnings contribution from the 20% Westinghouse stake ($2.2 million in 2007 and $6.9 million for the first six months of 2008) in no way offsets the investment's related translation losses and interest expense, it seems that presenting financials as if Westinghouse is not there is somewhat akin to a man with an albatross around his neck saying that his neck feels fine.

Accounting: Given weak results, POC accounting still a concern

It comes as no surprise that the use of Percentage of Completion accounting employed by Shaw offers many opportunities to distort or manipulate reported earnings. In recent periods, we have been monitoring rapid growth in Deferred Income (Shaw calls this "Advanced billings and billings in excess of costs and estimated earnings on uncompleted contracts") which has been quite pronounced and has significantly outpaced Unbilled Receivables (Shaw calls these "Costs and estimated earnings in excess of billings on uncompleted contracts, including claims"), and by a large margin.

Figure 1. SGR Deferred Revenue (Red Line) and Unbilled Receivables (Blue Line), 4Q06 through 2Q08, Millions $. Source: SGR SEC Filings.



Clearly, this bodes well for revenue bookings downstream. At the same time, it provides plenty of cookie jar-type cover for earnings management. All this makes things much more interesting given Shaw's marginal profitability. Shaw management speaks of earnings improvement in both the current three and six months of 2008 as compared to prior year periods, but with huge losses in prior periods, any earnings represent improvement, no matter how small. Obviously having taken large write-downs in the prior year periods gave impetus to at least some positive numbers in the current periods.

In addition, CEO Jim Bernhard does much touting of bookings and backlog as well as his claims for expected growth but says little about how all of this is going to do translate to better performance for the bottom line. The fact is, Shaw turns over billions of dollars, but simply does not make a great deal of money. Indeed, after posting losses in 2007, 21% of the Company's net income before taxes for the first six months of 2008 came from currency gains *other than the yen*.

Earnings quality is a significant issue. One cannot look at the all of the charges the Company has had to take each year as one-time events. In many cases those charges were wiping out earnings that had been recognized and thought to be solid and proper. Looking at some of the points made in the recent SEC Form 10-Q, there is plenty of potential for more of the same.

Perhaps Bernhard summed this up the best during Shaw's 3Q07 conference call [bolding is ours]:

> **Analyst:** Okay. Turning back to Nuclear, I was hoping you might be able to give us some insight, some thoughts as these new projects and you move toward EPC contracts in some of this work. What can we expect in terms of the methodology for adding that work to bookings, given the long timetable there? Have you had any additional thoughts, in terms of how that work is going to lay out over the next decade or so?
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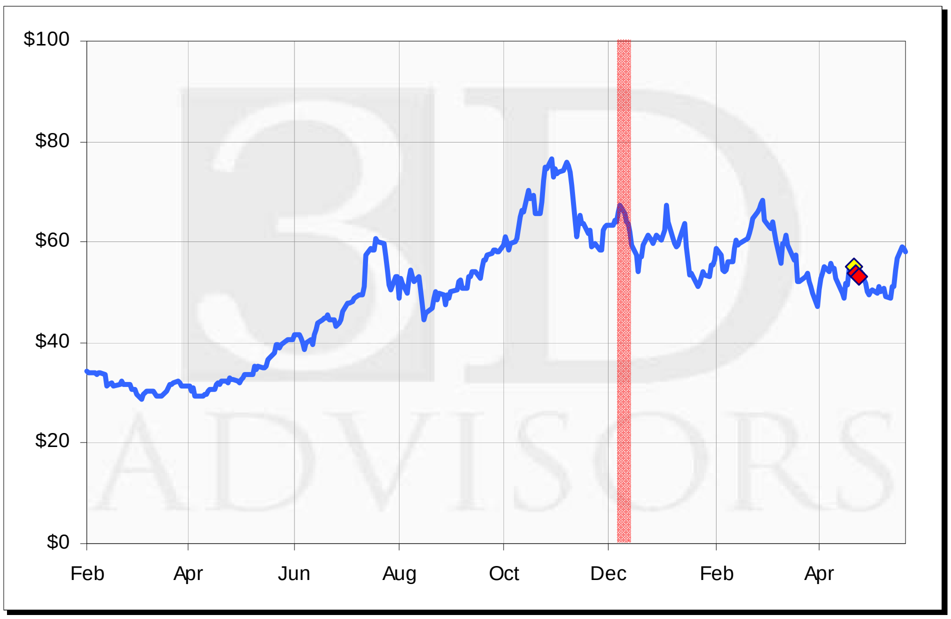
> **Jim Bernhard, CEO:** Well, I think, let me just talk about a couple things, first of all. When we talk about the first reactor coming online January 1st of 2016, and backing up from there, there is a tremendous amount of work that has to be done to get there. And you know what we are looking at, module facilities have to be built, we have four sites that we are actively working on-site today. There is a lot of on-site work to prepare for a nuclear power plant that can be done today.
>
> Some of them have a massive amount of earth work that has to be done before the COLA is completed. So we are going to put in backlog in accordance with accounting principles, and we had an address of how it is going to backlog, or half of it goes in backlog, all of it goes in backlog, none of it goes in backlog. **What we have been really concentrating on is getting the jobs, and the accountant will figure out where it goes.**

With Shaw's track record for "one-time adjustments" and heavy POC cover, one can easily suspect that those accountants can be quite creative.

<u>Insider Trading: CEO and former CFO further trim actionable positions</u>

As mentioned in our full report on 02/08/08, Shaw insiders have timed their trades well, taking profits at opportune times, sometimes just ahead of significant volatility in the shares. At the time of our February report, we had noted how four of the Company's top insiders had dropped upwards of 75% of their actionable positions in December (see red shaded area in Figure 2 below). Not only were these holdings reductions significant, as they would be for any group of insiders, but the sales took place into softening prices, an interesting point given the fact that it is rare to see heavy insider selling in an issue in the month of December when just a few weeks wait would defer related gains and the associated taxes into the following year. Following that round, Shaw insider ownership would be down to just 2.9% of the outstanding shares, far from the 30% held in 2000 or even the 12% held in early 2006. All in all, the December activity took on a different look than past Shaw insider selling where it was more common to see the selling into strength, not weaker prices.

Figure 2. SGR Daily Closing Price, 02/01/07 through 05/21/08. Red shaded area is where 9 insiders sold 1,909,516 shares; Yellow diamond is where Robert Belk sold 66,000 shares; Red diamonds are where Jim Bernhard sold 443,400 shares. Source: Reuters and SGR SEC Filings.



Since our report in February, we have observed some additional insider trading behavior that is worth mentioning:

- **Jim Bernhard (53) -** Chairman, President and CEO. Though his ownership reduction was not as heavy as the others, we took particular note, in February that CEO Bernhard had surfaced after a long silence to sell 40% of his actionable position in December along with the others. Prior to that sale of 989,000 shares, into successively lower prices, Bernhard had not been seen selling since April of 2006. On 04/22/08 and 04/24/08, Bernhard picked up where he left off in December, this time selling 443,400 shares at prices between $52 and $55. **And now, since December, he has managed to sell off 1.43 million shares, or 53% of his holdings.**

- **Robert Belk (58)** – Executive V.P. Belk had been the Company's CFO 1998 into 2007 when he took a brief medical leave in July of 2007. Upon his return, and in the midst of Shaw's controls and procedures problem (see the full report from 02/08/08), he was given a new job function that involves responsibility for oversight of government affairs activities, along with a three-year contract extension. In December Belk had sold 75% of his holdings by monetizing eight different option series with expiration dates ranging from October 2008 to November 2016. At that time those sales covered three times the amount he had sold in total over the past 10 years. Along with Bernhard, Belk surfaced again on 04/21/08 to sell an additional

66,000 shares at prices between $53 and $54. **In total he has sold 417,300 shares since December, representing 85% of his holdings.**

We are monitoring Shaw closely to see whether the recent rebound in its shares will pull out more insiders.

Fundamentals: With backlog growing rapidly, is Shaw really ready to execute?

With its backlog up to $14 billion and holding since 4Q07, up from $9 billion in 2006, Shaw seems to be grappling with a number of issues regarding staffing. In conference calls, it is evident that Shaw must add a lot of headcount in order to fulfill backlog. Either that or call on current resources to do the job. In this exchange, an analyst asks about where all the talent will come from, and in his answer, the CEO goes on to brag about all the talent in the Company, but seems to miss the whole point of the question:

> **Analyst:** All right, Jim. Chris certainly you've talked about -- just want to get a sense of the personnel add that you guys are going to have to be anticipating here relative to the nuclear build out. I know you've talked about as many as 3500 incremental people you're going to have to add. Is that increasing as you look to these new awards that are coming through here, just trying to get a sense of whether or not you are going to have to be pulling talent from other areas of F & N to try to execute on these? Could you give me a sense of the scale of the personnel add in anticipation of this big build out?
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> **Jim Bernhard, CEO:** It touches all on aspects of our company from an environmental permitting process, our company is involved. When we start to build these plants, it's certainly the design of the balance of the plant, the off site, and significant amount of engineering work. And, you know, 20 million man hours of construction is approximately on some of these projects, is a significant amount of construction work. In that, you know, there's probably two to three million man-hours of module fabrication that we'll be doing as well, and that bodes well for our company. And the structural and piping fabrication is very significant on the nuclear plant. So, you know, it touches all phases of our company besides the energy and chemicals group. And it's a significant award. We talk about engineering talent, we talk about recruiting quality engineers, which certainly is a forefront of some of these nuclear projects, but that's not the major emphasis in terms of work to be done on the construction of these because we plan on doing duplicate units on the power island. And most of this is construction talent to manage the construction phases of the project. And to my knowledge and belief of all the major E & C contractors out there today, that this company employs more direct hire craftsmen than any company in the engineering construction business. [Less] -- including our outage work and our major scrubber plants and six coal plants, a lot of this work is direct hire, not subcontracted. So, we're unique to the business in that we're able to perform on a direct-hire basis.

So whether the Company hires outside or presses its staff, resources will be taxed, which makes one wonder whether the existing credit revolver will need yet another stretch. Despite the recent increase in that credit facility, there is not a great amount of borrowing available due to so much of its being tied up in Letters of Credit

(LOC) and other restrictions. Though Shaw discloses the amount of performance LOC's outstanding as $567 million, which is covered by the facility, it makes no assessment of the likelihood of having to make payments on any of them. With over $100 million of such LOC's with one customer, one must assume some liability. In addition we consider it very likely that Shaw will have to take down the remaining $263 million available from its revolver in the near term as more business is going to require more LOC's which continue to soak up revolver activity. This situation should be considered in light of the fact that Shaw is forecasting a weaker cash flow number for 3Q08.

To this, add the fact that there has not been a nuclear plant constructed in the U.S, since 1974 and, since that time there have been 68 plant cancellations when inflationary pressures, amongst other issues, made their continued construction unfeasible. This translates into a probable shortage of nuclear talent out there available for new hiring, which could put strain on Shaw's existing resources when it already has a history of having a difficult time with profitable execution.