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All in the family

Soaring revenues paired with plunging cash flows is a hallmark of the San Francisco high-tech elite—and, curiously, of a Coral Gables, Fla.-based engineering and construction giant. Now unfolding is a good hard look at MasTec, Inc. (MTZ on the Big Board). In preview, *Grant's* is bearish.

MasTec can trace one branch of the corporate family tree back to the laying of the first underwater telephone cable between Florida and Puerto Rico after World War II. Another branch participated in the rebuilding of the south Florida telecommunications infrastructure after Hurricane Andrew blew through the Sunshine State in 1992. MasTec is the product of the 1994 merger of the cable-laying business, Burnup & Sims, Inc., with the Andrew beneficiary, Church & Tower, Inc.

"Mas" is the surname of the family that controls the combined entity. Jorge Mas and José Ramon Mas, the chairman and CEO, respectively, together own 19% of the outstanding shares. Other members of the extended family are believed to hold an additional 10% of the stock.

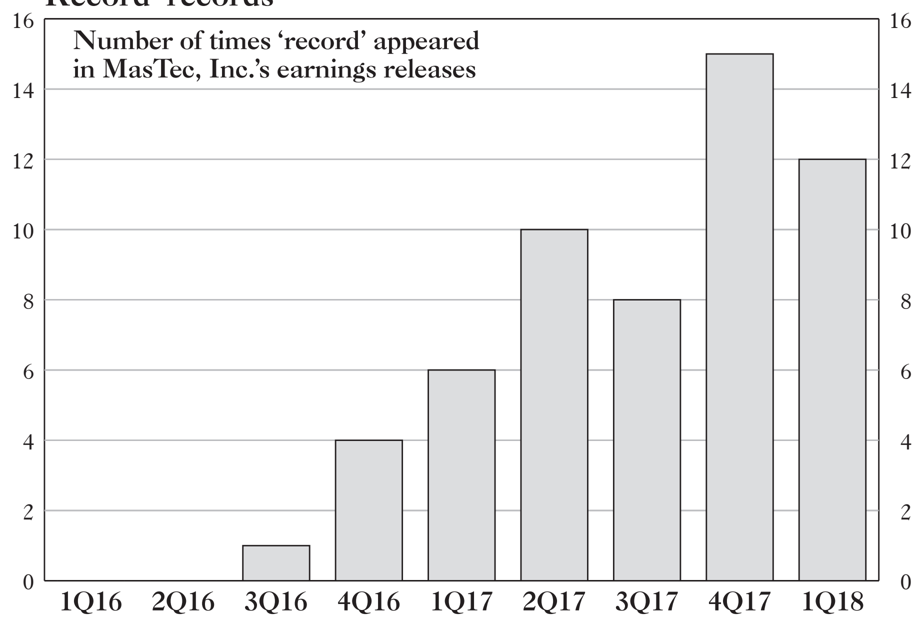
With 17,300 employees and $6.8 billion in revenues over the past 12 months, MasTec is one of the leading infrastructure construction firms in the United States. An almost purely domestic American operation, the company earns 89% of its revenue and 93% of its EBITDA (that's earnings before interest, taxes, depreciation and amortization) in communications and energy.

Building and maintaining wireless, wireline and fiber-optic infrastructure, and performing home-installation services for satellite provider DirecTV, constitute the heart of the communications division. It's a business very largely beholden to one customer: In 2017, AT&T, Inc., accounted for 68% of communications revenues and 25% of total revenue. The energy segment focuses on the construction of oil and gas pipelines. Here, too, one customer dominates. In 2017, Energy Transfer Partners, L.P., delivered 76% of oil and gas revenue and 40% of the corporate top line.

Naturally, the two big divisions feature in the bullish narrative. Fifth-generation (5G) wireless technology isn't just going to build itself; only vast outlays on fiber-optic lines and cell towers will get the job done. Observe, the bulls remind us, that AT&T last year secured a U.S. government contract to build the FirstNet network, a dedicated communications system for first responders. Through this transaction, MasTec's No. 1 customer stands to garner $6.5 billion in success-based payments over the next five years.

"In oil and gas pipeline, we believe we are in the early stages of a multiyear upgrade cycle of mainline pipeline infrastructure that began in the back half of 2016," Noelle Dilts, who rates MasTec a buy for Stifel Nicolaus & Co., Inc., tells colleague Evan Lorenz. "MasTec picked up many of the major projects that came out of the cycle thus far. The first big project that the company completed was the Dakota Access for Energy Transfer Partners,

Record 'records'



which was the foundational job for 2016. In 2017, the company moved into the Rover pipeline project, also for Energy Transfer. They are finishing this job now."

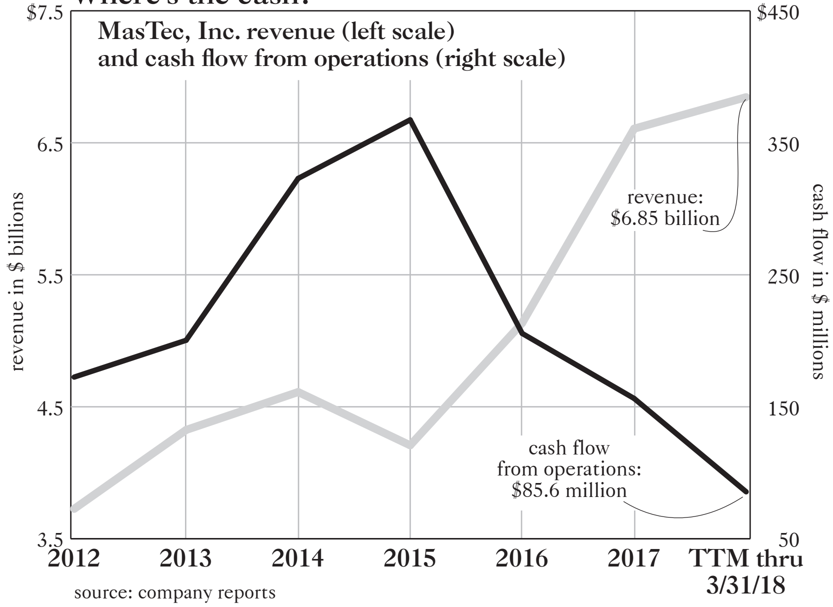
Revenues have been on a tear, up by 22% in 2016 and 29% in 2017. In each year, top-line growth in the oil and gas business—higher by 35% and 73% in 2016 and 2017, respectively—set the pace. No such fervid expansion is on the immediate horizon. Analysts project revenue gains of 5% this year and 7% in 2019—but, by way of compensation, a fattening in adjusted EBITDA margins, to 10.2% in 2019 from 9.8% last year.

No surprise, then, that the Wall Street pep squad is nearly universally bullish, with 12 buys and one hold. Whether or not the analysts have cracked the new 10-K report—the footnotes to the balance sheet and the related-party section make especially interesting reading—they have surely scanned the first-quarter earnings release. In that cheerful document, the word "record" appears a dozen times. MasTec changes hands at a valuation that, considering the many corporate vulnerabilities, must be judged rich, i.e., at 17.9 times trailing adjusted earnings and 13.1 times the estimated 2018 figure.

Borrowings, too, are setting records; debt, net of cash, totaled $1.4 billion on March 31, up 48% from a year earlier, though net debt stands at a manageable 2.4 times trailing EBITDA, while, over the past four quarters, operating income covered interest expense by six times. Standard & Poor's assigns the bonds a rating of double-B, near the pinnacle of junk.

The bearish brief starts with the uncertain pace of progress in telecommunications. While behemoths like AT&T may well need to invest, they don't have to do it on the construction firms' timetable. Thus, Dycom Industries, Inc. (DY on the New York Stock Exchange), the largest provider of engineering and construction services to the telecom industry—and, like MasTec, heavily reliant on AT&T—recently owned up to dwindling growth. See if you can find the relevant admission: "We continue to experience effects of a strong overall industry environment during the quarter, which saw moderation from two large customers, revenue declines from certain other customers as well as impacts from prolonged winter weather conditions," CEO Steven E. Nielsen told dialers-in on the May 22 earnings call. "Organic revenue, excluding storm restoration services, declined 10%." Pleasant though was the CEO's tone, the shares plunged by 20%; this was two Tuesdays ago.

Where's the cash?



source: company reports

New competition in the telecom-construction industry is another amber light. Late in 2012, Quanta Services, Inc. (PWR on the NYSE) sold its telecom-infrastructure division to Dycom for $265 million. As part of the deal, Quanta agreed to a four-year non-compete agreement. Time's up now: "[L]ast year we re-entered the United States communications infrastructure services market," Quanta CEO Duke Austin told analysts on May 3. "This initiative has been well-received by our customers and our U.S. communication operations continue to gain momentum."

As for oil and gas revenue, it, too, has been on the hop, though note well the past tense, "has been." As always, for Mr. Market, what's past is irrelevant, and it may just be that the best of the energy-building boom is behind us. "I think generally the pace is coming down, although new projects continue to be announced," Simon Lack, the managing partner of SL Advisors, LLC, a management company that runs mutual funds focused on master limited partnerships, advises by email.

So much for the top-down approach; the heart of the case against MTZ derives from MasTec's own regulatory filings. The first quarter's superficially dazzling 33% jump in future bookings, to $7.6 billion, is a case in point. At a glance, you may assume that the prospective revenue is virtually in the can. A more considered look raises doubts. Thus, in 2017, 36% of revenue stemmed from master service agreements. MSAs are multiyear contracts that define the scope of work that MasTec may perform but not necessarily will. They guarantee no volume of work—indeed, guarantee nothing. As of March 31, 45% of MasTec's backlog consisted of revenues that, via MSAs, may or may not come to fruition. It's just a guess.

"In past years, when MSA-bloated backlogs and MSA-derived revenues diverged," Lorenz observes, "it was revenue growth that suffered. Thus, in 2013 and 2014, the proportion of backlog derived from MSAs totaled 75% and 69% of the total; over the same period, 46% and 49% of total revenues stemmed from MSAs. Revenues contracted by 9% in 2015, after growth of 7% in 2015 and 16% in 2014. In 2015 MSA-derived backlogs and MSA-derived revenues were roughly matched, with 50% and 48% of their respective totals."

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"The biggest problem with MasTec," Lorenz goes on, "is cash flow, or, rather, the lack thereof. Cash flow from operations (CFFO) declined to $85.6 million in the four quarters ended March 31, from a peak of $367.4 million in calendar 2015, despite a 63% rise in revenues. Free cash flow, i.e., CFFO less capital expenditures, tumbled to negative $31.5 million from positive $283 million over the same period.

"Nor does this paint the full picture of how much cash generation has deteriorated. Acquiring equipment through capital leases is a technique that deflates reported capital expenditures. In 2015, MasTec secured $27 million worth of equipment through capital leases; over the prior four quarters, it has acquired $146 million through such means. Had management paid in cash rather than through capital leases, free cash flow would have registered negative $177.5 million over those four periods compared with the $256 million for similarly adjusted free cash flow in 2015."

For revenue recognition on big construction projects, MasTec employs the percentage-of-completion method. Revenue recognition is an inexact science in any case. The percentage-of-completion method fairly tips that science into the realm of art, especially when documentation is lacking to support management's claims as to when a dollar of income landed on the profit-and-loss statement. MasTec has encountered just this problem, which led to the restatement of 2014 quarterly results and the late filing of the 2014 10-K.

In that context, consider the boom in revenue stemming from work not specified in a customer contract. Sales dollars from this source, known in the trade as unapproved change orders, jumped to $142 million in 2017 from $4 million in 2016. To judge by the growth in receivables related to change orders, it appears that MasTec booked $134 million in revenue from unapproved change orders in the first quarter of 2018 alone. (Calls and emails to MasTec seeking comment on this and other points went unreturned.)

"The more aggressive booking policy seems to stem from a subtle, but important, change in revenue-recognition policies," Lorenz points out. "Here is what MasTec said in the 2015 10-K report: 'Changes in job performance, job conditions and final contract settlements are factors that influence our assessment of total contract value and total estimated costs to complete those contracts and, therefore, our profit recognition.'

"In the 2016 10-K, the language shifted. The phrase 'management's assessment of expected contract settlements' appeared in place of the three words 'final contract settlements.' You have to ask yourself if management's assessment is more likely to err to the upside or to the downside."

You can't say that MasTec hasn't warned you; footnotes in the 2017 10-K might as well be printed in gothic letters and embellished with skulls and crossbones. Thus, under the section headed "Critical Accounting Estimates" appears a note with a forthright message: "Actual results could, however, vary materially from these accounting estimates."

"Scroll through other footnotes," Lorenz proceeds, "and you will see that accounts receivable consist of three balances: contract billings, retainage and costs and earnings in excess of billings (CEEB). Contract billings are exactly what they sound like: invoices sent to customers for work performed. Retainage is an offshoot of billings. On some large projects, a customer may pay a certain percent, say 90%, for work in progress and pay the balance on the completion of construction; the balance is called retainage. CEEB are the opposite of contract billings: The company records them on the P&L statement before it invoices the customer. First comes the cart, then the horse."

The No. 1 source of weak cash flow from operations is the growth in accounts receivable. From Dec. 31, 2015 through March of this year, receivables popped by $794.1 million, to $1.7 billion, up by 87%. Over the same span, revenues grew by 63%, paced by a $400.1 million surge in funds expected but not yet invoiced, i.e., CEEB.

If you find the CEEB line item problematical, so does management. At least, the CEEB balance that MasTec reports is net of an allowance for doubtful accounts. If you dig deeper through the company's audited reports, you will find the allowance for doubtful collections has increased to 4.5% of CEEB as of year-end 2017, from 2.1% of CEEB as of year-end 2015.

"At that," Lorenz posits, "the bulge in accounts receivable may (we are speculating) understate the cash-flow problem. When the work of collecting receivables is expected to take more than a year, MasTec moves the past-due amounts into the catchall descriptor 'other long-term assets.' OLTA climbed to $204 million on March 31 vs. a five-year average of $61.5 million.

"Then, too," Lorenz continues, "MasTec sells a portion of its receivables, at a discount, in order to boost cash flows. In the years ended Dec. 31, 2015 and 2016, MasTec factored in $12 million and $60 million worth of receivables. In 2017, such disclosure stopped, though MasTec continues to report the discount it pays to sell receivables, which is included in the net interest expense. In 2017, the discount charge increased to $6 million from $2.7 million in 2016. In the first quarter of 2018, the discount charge rose to $1.9 million from $0.9 million in the first quarter of 2017. In other words, it appears that MasTec is selling greater and greater amounts of receivables, which puts a gloss on cash flows."

Predictions of a rebound in cash flows have become a front-office staple over the past several quarters. On the Nov. 3, 2017 earnings call, CFO George L. Pita told analysts that full-year 2017 cash flow from operations would be in the "$350 million range"; in fact, MasTec's 2017 CFFO came in at $156.3 million, less than half the projected figure. On the Feb. 28, earnings call, Pita said that accounts receivable would normalize in the first half of the year and that CFFO for full-year 2018 would "approach over $500 million." The target got pushed out further in the first-quarter call. Quoth Pita on May 1: "As we indicated last quarter, we expect working capital to normalize during the second half of the year, which should generate a record level of cash flow from operations during the full-year 2018 period."

MasTec, hardly alone among public companies in 2018, has convinced the Street to focus on adjusted, rather than GAAP, earnings. In the first quarter, adjusted EBITDA amounted to $107.8 million, $6.3 million more than conventionally calculated EBITDA. MasTec, however, has done its public peers one better. It may, indeed, be unique for the question it was obliged to field from the Securities and Exchange Commission at the end of April 2017.

"We note," the SEC wrote, "your non-GAAP financial measures, Adjusted EBITDA, Adjusted Net Income, and Adjusted Diluted EPS, appear to only exclude charges." MasTec, in reply, said that one-time benefits, like the gain on sales of equipment, are part of the ordinary course of business. Maybe so, but the gain on sales of equipment amounted to $3 million or 8% of pre-tax profit in the first quarter of 2018 vs. a rounding error in the first quarter of 2017.

Reading the related-party section of the latest 10-K, one gains a deeper sense of the family-centric nature of the MasTec culture. Many a company owns corporate jets, sometimes to the dismay of an investor who himself flies in the middle seat. MasTec does not own such a controversial aircraft. Rather, it rents one—from a company owned by chairman Jorge Mas; in 2017, Mas billed MasTec $2 million for airfare. MasTec contracts with and leases equipment from a number of family-owned businesses and leases MasTec employees to work at Mas-family-owned firms. The company spent $40.6 million in the third quarter of 2017 and $5.4 million in the first quarter of 2018 to buy Mas-family businesses; the earn-outs for these transactions could cost an additional $61.2 million. MasTec likewise leases property from Irma S. Mas, the mother of the chairman and CEO.

"Give MasTec insiders their due," Lorenz acknowledges: "In their own shares, at least, they have proven most savvy investors. Between April 2, 2014 and Aug. 25, 2015, the share price spiraled down by 67% to $14.67 from $44.23 amid the collapse in energy prices and the aforementioned accounting difficulties. In August and September 2015, insiders bought 828,347 shares for $13.4 million at an average price of $16.22. At the current price of $47.33, those clairvoyants are sitting on a net paper gain of $26.1 million."

In the past 12 months, insiders have sold 123,998 shares worth $6.3 million at an average price of $50.81. No officer or director has purchased shares in the past year. Bears, who do read the financials and the footnotes thereto, have been more active, as short interest constitutes 13.8% of the MasTec float.

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