SIENAcollege

BJORKLUND FUND

March 23, 2018

Sterling Construction Co Inc.: (STRL)

Emilien MARY

Sector: Materials
Industry: Infrastructure Construction
Current Price: $11.35
Target Price: $15.00

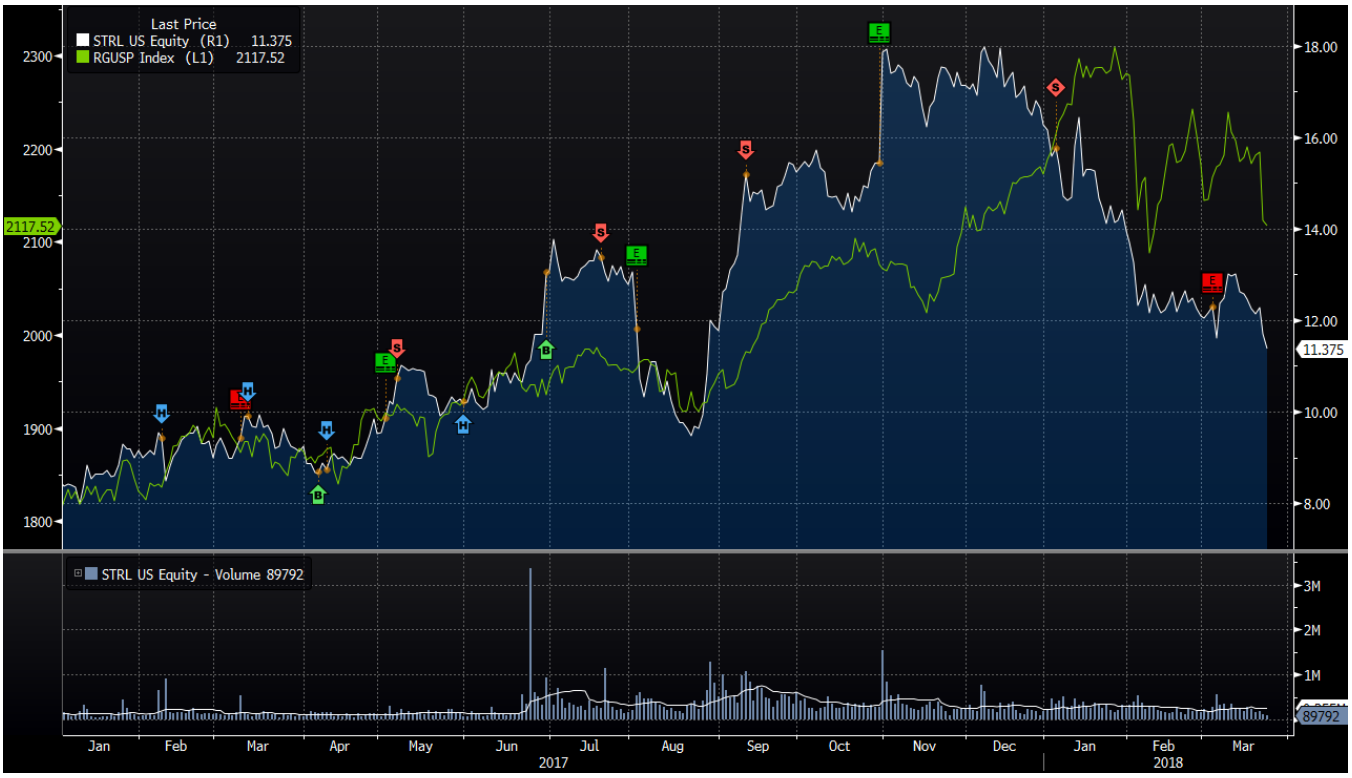
Company Description: Sterling Construction company specializes in the building, reconstruction, and repair of transportation and water infrastructure. It is a heavy civil construction based company and its main market is the infrastructure construction for public sector clients from California to Texas.

BUY

Current Price:	$11.30
Target Price:	$15.00
Market Cap:	299.54M
Beta:	1.10
YTD Change/%	-5.20/-31.94%
OPM	2.7%
Prtx Mrgn	1.7%
ROA	3.0%
ROE	9.3%
T12M EPS	0.43
Est EPS	0.90
Next Announcement Date	05/01/18

Conclusion:

- Efficient management who revert the negative earnings to positive earnings for the first time since 2010.
- Margin Upside: Diversification of their revenue and customers with higher margin work in 2017.
- Long-term Revenue Upside: US market is stimulate by the Trump's government fiscal policy and the requirement of maintenance of infrastructures.

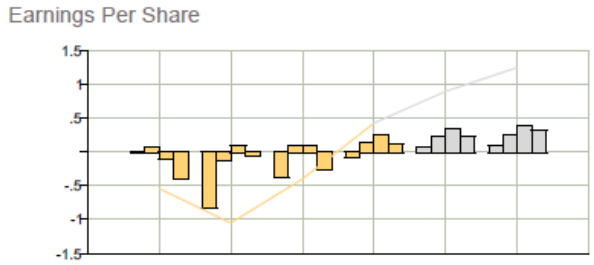


Thesis:

The recent turning strategy of the company with more diversification products through higher margin work and financial improvements reflect the stabilization of the company and its ability to catch future opportunity growth in the coming years. Its huge presence on growing market from California to Texas permit to the company to be well positioned for the forecasting growth.

Earnings Performance:

Due to significant issue to obtain a positive net income during the last years, the company has reported bad earning performance except for the last year where the EPS FY was 0.43, a positive earnings for the first time in many years.



	2014	2015	2016	2017	2018	2019
FY	-0.54	-1.05	-0.40	0.43	0.90	1.25
Q1	0.01	-0.82	-0.37	-0.08	0.08	0.10
Q2	0.07	-0.12	0.09	0.15	0.24	0.27
Q3	-0.09	0.09	0.10	0.26	0.36	0.39
Q4	-0.39	-0.06	-0.25	0.11	0.23	0.33

As the result of their effort to reduce their cost and to improve their bid discipline, the company has generates a positive EPS of $0.43. This is an increase of 83 cents compared to 2016. This gain is mainly due to the acquisition of Tealstone in April 2017 which provide a product diversification and higher margin product.

Financial improvement:

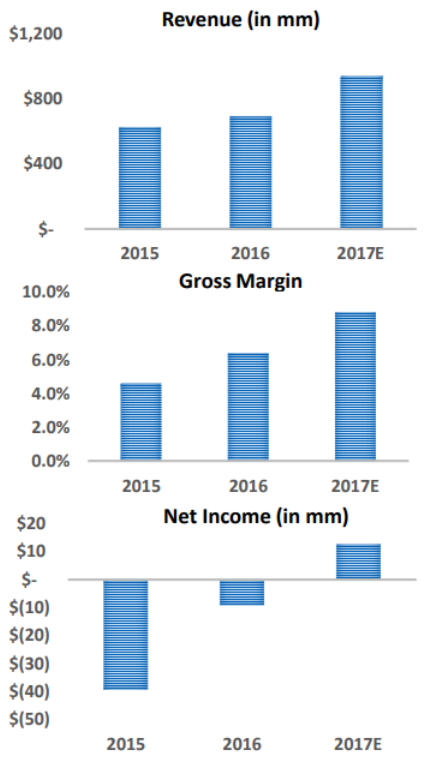
The financial improvement of the company reflects the improvement operated by the company after many years of negative income.

In 2017, the company has declared a positive adjusted net income of $12.1 million, an increase of $21.3 million compared to the -$9.2 million adjusted net income of 2016. The last adjusted positive net income of the company was in 2011 with an amount of $5.5 million.

During the last two years, Sterling Construction Company has focused its effort on solidifying the core business of the company and it has led to significant improvement in financial performance.

Their focusing was on the improvement of their bidding process that result in higher margin, a stronger execution in sterling's core heavy highway business, cost reductions, liquidity and balance sheet improvements, and the acquisition of residential business.

As a result of Sterling efforts, the revenue has significantly increased to a point the company now creates profit for a first time since 2011 with a positive net income of $12.1 million.



The restructuration of the debt with an $85 million senior secured term loan credit facility will provides flexibility, liquidity and improved cost to sustain their future growth.

By 2019, the company forecast to diversify its revenue with higher margin products and to reach 50%Non-heavy highway-50% heavy highway in 2019. The current part of heavy highway revenue, is around 65%.

In addition to internal improvement, the company forecast to enter into new market area such as the Gulf Coast area, a growing market. This strategy will increase the footprint of the company into southern states. Its facility at proximity of this area may greatly contribute to the expansion into adjacent markets.

Margin Upside:

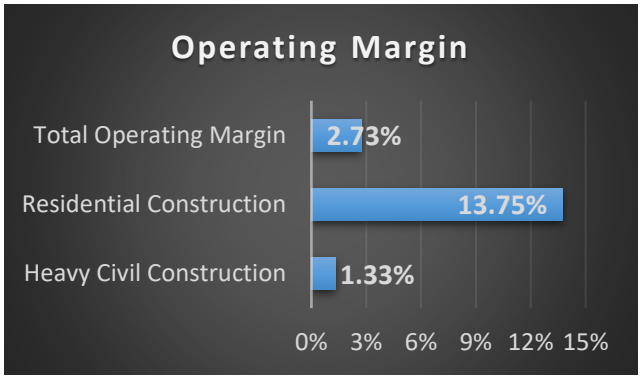
The acquisition of Tealstone in April 2017 is a significant move for the company profitability with benefit already incorporated in the 2017 results.

The first notifiable improvement of the company's margin is with its most important segment: Heavy civil construction. In 2017, operating income for this segment turn to be positive at $11.322 billion compared to a loss of $4.729 billion in 2016. The second improvement is directly related to the acquisition of Tealstone.

Segment Results

	Year Ended December 31,			
	2017	% of Total	2016	% of Total
Revenue				
Heavy Civil Construction	$ 849,966	89%	$ 690,123	100%
Residential Construction	107,992	11%	—	—%
Total Revenue	$ 957,958		$ 690,123	
Operating Income (Loss)				
Heavy Civil Construction	$ 11,322	43%	$ (4,729)	100%
Residential Construction	14,854	57%	—	—%
Total Operating Income (Loss)	$ 26,176		$ (4,729)	

The operating margin provided by its heavy civil construction segment is at 1.33%, while its operating margin for residential construction is at 13.75%. The residential segment is the new source of revenue provided by the acquisition of Tealstone. This acquisition provided 11% of the total revenue of the firm in 2017. However, due to higher margin work, the residential construction account for 57% of the operating income with operating income of $14.854 million for the year ended December 31, 2017 resulting of an operating margin of 13.75% compared to the operating margin of 1.33% for the heavy civil construction segment.



The low risk and complexity and the high margin work combined with a strong exposure to high growth residential markets provide immediate business and long term strategic investment to Sterling Construction Company.

Their strategy of focusing on risk mitigation, improving bid discipline, execution, and further reducing costs in all business units is going to continue the improvement of the margin of the heavy civil construction.

As a result, the margin of the company should significantly improve during the following years and provide higher operating margin to the company with an increase estimated at 100-120 bps in operating margin and profit margin.

Long-term Revenue Upside:

The government transportation spending has been decreasing under Obama's administration to $82.7 billion in 2016 from $86.0 billion in 2013 (source: federal-budget.insidegov.com). As a result, the gap between the requirement fund needed for surface transportations and the fund allocated has significantly increased to 1.1 trillion dollars needed for the period 2016-2025 (source: ASCE). This underinvestment leads to additional cost of maintenance such as more frequent inspection on aging infrastructure.

However, the first year of the Trump's government has marked a turning point in the industry. This emphasis the logic of the trump's government policy to increase the transportation spending with an increase of 6.65% in 2017 to $88.2 billion and to prepare an infrastructure bill around $1.1/1.7 trillion, a cash cow for this industry if the bill is approved. The materials industry is now able to see a bright future, one of the first time since the crisis, a decade ago.

And this industry growth has already started. The Fast Act, Fixing Americas Surface Transportation Act, is the first long-term transportation funding bill signed by the government for a decades. It will provide long-term contract with funding of $305 billion between 2016 and 2020. Public and private bridge spending is forecast to increase from $149.7 billion to $167.2 billion.

In addition, States have taken measure to increase future spending in transportation and infrastructure and this result are planned to impact the market in the coming years. In 2017, Texas approved two laws that increased transportation from $4.0 to $4.5 billion annually. In 2016, Utah approved a gas tax increase of five cents/gallon that should result in an increase of over $75 to $85 million in additional spending. In addition, the state of Utah also approved in 2017 a $1 billion bond package for infrastructure improvements. In California, the states approved in 2016 a $3 billion bill a year for local road, bridge and transit projects.

All these law approvals are long-term opportunities for the infrastructure market and Sterling Construction Company Inc. and they will drive the long-term growth to the business over time.

In addition to the heavy civil construction market, Sterling Construction operates through residential construction market primarily in Texas, the Dallas-Fort Worth area and its surrounding communities.

The residential market is forecasted to grow at a faster rate than before. For the next two years, the growth in building permits monthly averages is forecasted to be between 5.65% to 5.81%, compared to a 3.94% growth in 2017. For residential construction, southern and western region growth was at 21.07% and 5.85%, respectively. This growth is supported by employments gains, rising GDP (target of 2.2%/year for 2014-2024), low mortgage rates, and growing populations (#1: California, #2: Texas, #10: Arizona).\

The company should benefits from the residential market through of its recent acquisition of Tealstone to diversify its revenue and customer base with higher margin work. Their strategy to extend their operating into Houston area is another driver for the company long-term revenue upside for 3 years or more period.

Upcoming Catalysts: Forward looking projections that call for positive/negative outlook that will strengthen your thesis. Example:

- Short Term (within the year): Margin expansion through improvement of financial performance such as improving bid discipline, execution, and reducing costs in all business units and the expansion in adjacent residential market.
- Mid Term (1-2 years): Diversification into higher margin markets with the leverage opportunities with Residential Construction.
- Long Term (3+): It will depend of their ability to combine high margin products and expand into adjacent markets.

Management Profile:

The recent performance of the company is tightly link to the new management team. They have made major progress in the financial consolidation of the company with a significant turning point during the last 2 years with a significant improvement of the financial statement and a new strategic business that provide higher margin.

Mr. Cutillo, 52 years old, has recently been promoted CEO of Sterling Construction Company, Inc in April 2017. Prior to that, he joined the company has VP of strategy and business development. He has a strong understanding of emerging opportunities in heavy civil construction, industrial, and water infrastructure markets, key area for Sterling Construction Company.

Ms. Davenport, 64 years old, is the Executive Director of Genesys Works since 2014 and her committees are Corporate Governance and Nominating (Chair) Compensation. She contributes to improvement of the company through her excellent background as a lawyer, with experience in corporate governance and securities compliance.

Competitors Comparison:

Sterling Construction is a small cap company compared to its peers. Compared to its peers over the last year, Sterling Construction was ranked #4 over 13 with a 1 yr. total return of 19.78%. LAYN and PGTI, to other small caps, are far above the industry average with 1 yr. total return of 85.22% and 76.33%, respectively.

We can see the revenue growth of the company is the highest with a 1 yr. growth of 38.81%. Otherwise, the company's margin ratios are always below the industry's median. This below ratios combined with the significant improvement of the margin emphasis the upside potential of the company.

	Name (BICS Best Fit)	Mkt Cap↑ (USD)	Last Px	Rev - 1 Yr Gr:Y	EPS - 1 Yr Gr:Y	P/E	Rtrn on CE Adj:Y	Grs Mrgn Adj:Y	OPM:Y	EBITDA Mrgn Adj:Y	NI Mrgn Adj:Y
	Median	3.74B	45.20	14.76%	16.31%	28.45	12.95%	13.12%	5.95%	8.80%	3.38%
100)	STERLING CONSTRUCTIO...	299.54M	11.08	38.81%	--	25.89	9.73%	9.30%	2.73%	4.51%	1.26%
101)	LAYNE CHRISTENSEN COM...	289.59M	14.54	-11.86%	17.61%	--	-41.41%	16.60%	-4.02%	0.45%	-7.25%
102)	PGT INNOVATIONS INC	908.95M	18.25	11.46%	10.10%	31.64	19.64%	31.21%	12.63%	16.45%	5.92%
103)	PRIMORIS SERVICES CORP	1.27B	24.66	19.18%	175.58%	16.81	13.62%	11.70%	4.06%	6.84%	3.01%
104)	DYCOM INDUSTRIES INC	3.22B	103.97	14.76%	15.01%	31.00	24.01%	21.59%	8.97%	13.79%	4.81%
105)	MASTEC INC	3.74B	45.20	28.67%	55.27%	16.67	17.69%	13.04%	5.95%	8.80%	3.38%
106)	QUANTA SERVICES INC	5.12B	33.21	23.72%	37.02%	20.27	7.27%	13.12%	4.67%	6.95%	2.74%
107)	FLUOR CORP	7.67B	54.85	2.54%	-8.81%	18.84	12.29%	3.17%	3.52%	4.67%	2.04%
108)	SBA COMMUNICATIONS C...	19.67B	168.87	5.79%	2.25%	149.31	--	74.17%	29.38%	66.60%	7.92%

Conclusion:

Sterling Construction Company Inc. has efficiently management its financial performance over the last 2 years and revert the negative earnings to positive earnings in 2017, the first time since 2011. The margin upside of the company is significant through their new strategy of diversification of their revenue and customers with higher margin work (acquisition of Tealstone in April 2017). The close locations of all their facilities permits to the company to provide complementary products in each of their area. In addition, the long-term revenue upside is stimulate by the expansion of the US infrastructure market mainly drive by the Trump's government spending and the requirement of the investment in infrastructure.

SIENAcollege

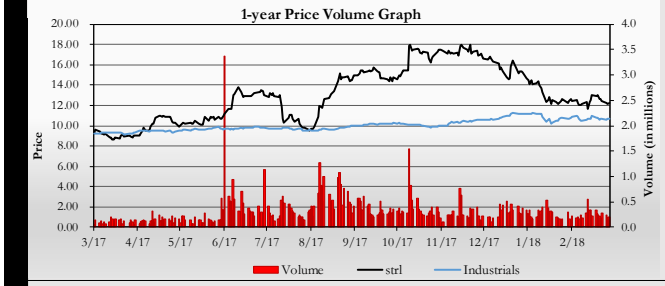
BJORKLUND FUND

CENTER FOR GLOBAL FINANCIAL STUDIES

Sterling Construction Company, Inc. (strl)

BULLISH

Analysis by Al Capone	Current Price:	$11.31	Intrinsic Value	$12.72	Target 1 year Return: 32.63%
3/23/2018	Divident Yield:	0.0%	Target Price	$15.00	Probability of Price Increase: 100%



Description

Sterling Construction Company, Inc., together with its subsidiaries, operates as a heavy civil and residential construction company in Arizona, California, Colorado, Hawaii, Nevada, Texas, Utah, and other states in the United States.

General Information

Sector	Industrials
Industry	Construction and Engineering
Last Guidance	February 12, 2018
Next earnings date	May 1, 2018

Market Assumptions

Estimated Equity Risk Premium	5.00%
Effective Tax rate	21%

Market Data

Market Capitalization	$316.57
Daily volume (mil)	0.10
Shares outstanding (mil)	27.03
Diluted shares outstanding (mil)	26.71
% shares held by institutions	109%
% shares held by investments Managers	57%
% shares held by hedge funds	18%
% shares held by insiders	5.05%
Short interest	3.69%
Days to cover short interest	3.69
52 week high	$18.90
52-week low	$8.54
Volatility	52.02%

Past Earning Surprises

Quarter ending	Revenue	EBITDA
12/31/2016	0.21%	73.53%
3/31/2017	13.64%	18.33%
6/30/2017	7.84%	22.96%
9/30/2017	15.37%	-4.11%
12/31/2017	14.84%	-36.45%
Mean	**10.38%**	**14.85%**
Standard error	1.1%	5.1%

Market and Credit Scores

Recommendation (STARS) Value--0
Recommendation (STARS) Description--0
Quality Ranking Value--C
Quality Ranking Description--Lowest
Short Score--1
Market Signal Probability of Default % (Non-Ratings)--10.513%
CreditModel Score (Non-Ratings)--b+

Industry and Segment Information

LTN Revenues by Geographic Segments	LTM Revenues by Business Segments
United States--100%	Residential Construction--11%
--	Heavy Civil Construction--89%
--	--
--	--
--	--

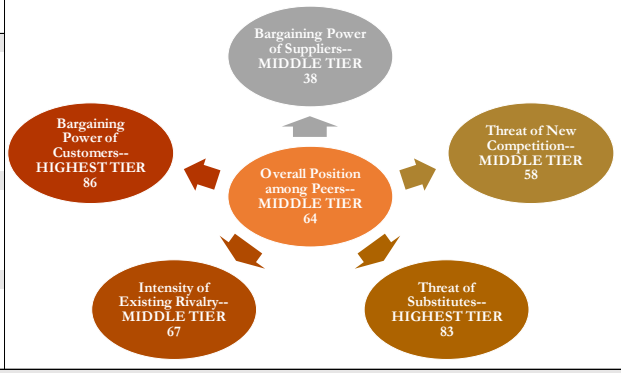
Peers

Aegion Corporation	IES Holdings, Inc.
Primoris Services Corporation	Dycom Industries, Inc.
Granite Construction Incorporated	Great Lakes Dredge & Dock Corporation
Layne Christensen Company	Willbros Group, Inc.
Orion Group Holdings, Inc.	Black Peony (Group) Co., Ltd.

Management	Position	Total Compensations Growth	Stock Price Growth During Tenure
Cutillo, Joseph	CEO, President & Director		0% per annum over 0y
Ballschmiede, Ronald	Executive VP, CFO, Chief Accounting Officer & T	12.51% per annum over 1y	39.14% per annum over 1y
Wadsworth, Con	Executive VP & COO	-100% per annum over 1y	39.14% per annum over 1y
Blair, Kevan	Senior Vice President of Corporate Finance	-100% per annum over 1y	39.14% per annum over 1y
Maxwell, Jennifer	Director of Investor Relations		
Chandler, Richard	Executive VP, General Counsel & Secretary		

Profitability	strl (LTM)	strl Historical	Peers' Median (LTM)
Return on Capital (GAAP)	23.0%	-6.57%	3.48%
Operating Margin	2%	-1.67%	7.22%
Revenue/Capital (GAAP)	9.20	3.94	0.48
ROE (GAAP)	8.7%	1.3%	10.3%
Net margin	1.0%	0.3%	4.1%
Revenue/Book Value (GAAP)	8.92	3.78	2.54
Invested Funds	**strl (LTM)**	**strl Historical**	**Peers' Median (LTM)**
Cash/Capital	37.5%	10.7%	14.8%
NWC/Capital	1.8%	12.6%	23.1%
Operating Assets/Capital	22.7%	38.3%	49.5%
Goodwill/Capital	38.0%	38.4%	12.6%
Capital Structure	**strl (LTM)**	**strl Historical**	**Peers' Median (LTM)**
Total Debt/Market Capitalization	0.46	0.14	0.48
Cost of Debt	20.5%	40.8%	8.0%
CGFS Rating (F-score, Z-score, and default Probability)	B		
WACC	25.8%	45.1%	11.1%

Porter's 5 forces (Scores are percentiles)



Valuation

Forecast Assumptions	Explicit Period (14 years)	Continuing Period
Revenue Growth CAGR	13%	2%
Average Operating Margin	4%	4%
Average Net Margin	2%	2%
Growth in Capital CAGR	11%	2%
Growth in Claims CAGR	3%	2%
Average Return on Capital	13%	12%
Average Return on Equity	14%	12%
Average Cost of Capital	17%	18%
Average Cost of EquityKe	19%	19%