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Celadon Group, Inc. | NYSE: CGI

Price Target: $0.00/share

Share Price:
$6.25

Avg Daily Volume:
440k

Market Cap:
$176.9m

Debt:
$471.9m

Enterprise Value:
$642.6m

LTM Revenue:
$1055m

LTM Adj CFFO:
-$28.9m

LTM Adj FCF:
-$48.3m

Revolver Availability:
~$54.3m (est)

Auditor:
BKD, LLP

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Prescience Point Research Opinions:

- CGI shares are worth $0.00 per share.
- Over 95% of CGI's reported tangible book value does not exist. CGI's actual TBV is no more than $.42/share.
- CGI will restate its historical results because of the issues exposed in this report.
- CGI will be bankrupt or insolvent within 1-2 quarters; existing shareholders will be wiped out.
- CGI stock should be de-listed from the NYSE.
- Regulatory and law enforcement agencies with subpoena power should launch a full investigation of the company, its accounting, and its practices.

Research Highlights:

- Disclosure of a sham 'daylight loan' transaction in the JV subscription agreement directly contradicts CGI's representations of having collected on a $31.8m receivable; in our view, it amounts to incontrovertible proof that CGI has inflated its financial position and falsified its financial reports.
- CGI's use of off-balance sheet transactions involving its JV with Element Fleet Management and related party 19th Capital inflated Q2'17 TBV and LTM profits by an estimated $104.2m, comprising 34% of reported TBV.
- CGI failed to record a $36m estimated loss from Quality equipment sales on its income statement despite its cash flow statement suggesting that such a loss was incurred
- CGI's Balance Sheets and corresponding Statements of Cash Flows do not reconcile. Discrepancies indicate CGI systematically overstated property and equipment by ~$78.8m, comprising 26% of CGI's reported TBV.
- Divergence between net income and adjusted CFFO has exploded. Net income now exceeds Adj CFFO for the first time in 8 years.
- CGI management appears to have bilked shareholders out of $4.6m when 19th Capital, a related party, was redeemed at an inflated equity value of 4.5x invested capital, just ~1.25 years after its formation. The redemption may have been paid for with cash misappropriated from CGI's balance sheet.
- CGI's sudden jump (67.4% growth) in Other Revenue from Q2'17 to Q4'16 cannot be reconciled with a reported contraction in trucking assets needed to drive that growth.
- After CGI fired KPMG as its auditor and hired a smaller regional (BKD), its audit fees rose 180%, which would make sense if it was a fraudulent company.
- Deeply negative and rapidly deteriorating FCF indicates business is fundamentally broken. Our analysis indicates CGI will be insolvent in 1-2 quarters, based on projected cash burn of $80.1m in 2H FY'17 against revolver availability of only $54.3m.
- CGI would have defaulted on its leverage ratio covenant had it not concealed operating losses; concealing losses by falsifying financial results is an Event of Default, in its own right.
- Incestuous hiring practices and nepotism may have created an environment lacking in accountability and ripe for fraud.
- Prescience Point reached out to CGI management numerous times and never heard back.

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Introduction

We believe that Celadon Group ("CGI" or "the company") is a house of cards on the brink of collapse. In this report, we present evidence, which in our opinion, indicates that CGI used a series of off-balance sheet transactions, manipulative accounting practices, and material misrepresentations to skirt covenant violations and hide catastrophic losses from shareholders and creditors. Absent these interventions, we believe that CGI's creditors would already have forced a restructuring, and its share price would be trading at pennies.

CGI initially caught our attention last year when we learned it was engaging in questionable non-arm's length transactions with 19th Capital, an off-balance sheet entity owned in-part by CGI and CGI management. Per renowned accounting expert Howard Schilit,[1]

> *"…transactions that lack a reasonable arm's-length process are sometimes appropriate. But prudent investors should bet against it. That is, most related-party transactions that lack an arm's-length exchange produce inflated, and often phony, revenue."*

Our interest was piqued when CGI announced the formation of a new off-balance sheet entity that would retire 19th Capital, resulting in a payout to management of ~$4.6m in exchange for their incentive units, based on a redemption value of >$27m. Peculiar. This entity was formed with a $6m investment, meaning that it generated a whopping return of 4.5x since its formation – only 1.25 years back! And this massive return was generated as the tractor resale market and lease utilization rates contracted, and comparable companies posted losses…? Based on our analysis, 19th Capital's equity was actually worthless at the redemption. As discussed in this report, we can't help but think the cash payout to 19th Capital's owners was misappropriated from CGI shareholders.

The more we dug, the more we found. Our investigation entailed a thorough scrub of CGI's public disclosures and filings (including ones Sell Side analysts seem to be ignoring), conversations with former CGI employees and various trucking insiders, and consultation with a 3rd party forensic accounting firm. In our opinion, Celadon appears to exhibit many of the troubling hallmarks of accounting frauds past. Its books do not seem to reconcile, and its disclosures often seem to conflict.

We were especially concerned when we discovered what, in our view, amounts to smoking gun evidence that Celadon is fabricating its financial reports. In this report we detail the basis for our research opinions, which include the following:

- CGI has used off-balance sheet entities (i.e. 19th Capital, JV with Element) and manipulative accounting practices to hide its insolvent condition from investors and creditors.
- In total, we estimate that CGI's accounting shenanigans inflated its Q2'17 TBV and LTM profits by $219m. To put that in perspective, $219m represents 71% of CGI's Q2'17 reported TBV of $305.8m!
- A sham Daylight Loan, as revealed in the JV subscription agreement, clearly shows that CGI's claim it collected on a $31.8m receivable is false – in our view, serving as incontrovertible proof that CGI has inflated its financial position and falsified its financial reports.
- KPMG forced a PP&E restatement in 2012; soon after CGI replaced KPMG with BKD, a much smaller and less reputable audit firm. CGI's audit fees since retaining BKD have risen an astonishing 179.6%, indicative of an elevated risk of accounting issues.
- Management appears to have bilked shareholders out of $4.6m when 19th Capital, a related party, was redeemed at an inflated equity value. Evidence suggests the redemption was paid for with cash misappropriated from CGI's balance sheet.

When considering the total body of evidence, we conclude that Celadon is materially misrepresenting its reported financial performance and that its management is so untrustworthy that CGI is simply uninvestable. Regardless, we expect the company to become insolvent in the next 1-2 quarters as its projected cash burn in 2H FY'17 of $80.1m far exceeds its borrowing availability of just $54.3m. We estimate CGI's 'true' TBV to be only ~$12m, meaning that we expect it cash burn to blow through this equity cushion. Thus, we initiate CGI with a price target of $0 per share.

We hope that current and future investors and creditors familiarize themselves with the risks we have addressed and take immediate action to preserve the value of their holdings. We also hope that the NYSE, regulatory and law enforcement agencies, and CGI's auditor take necessary precautions in protecting investors.

Is >95% of CGI's Reported TBV Attributable to Accounting Fabrications?

Prescience Point does not trust Celadon's reported financial statements. In fact, the following sections in this report detail why we believe that over 95% of CGI's reported TBV is suspect. We calculate CGI's 'true' TBV to be ~$11.9 million, or $0.42 per CGI share:

Prescience Point Estimate of CGI's 'True' TBV and Reported TBV Overstatement

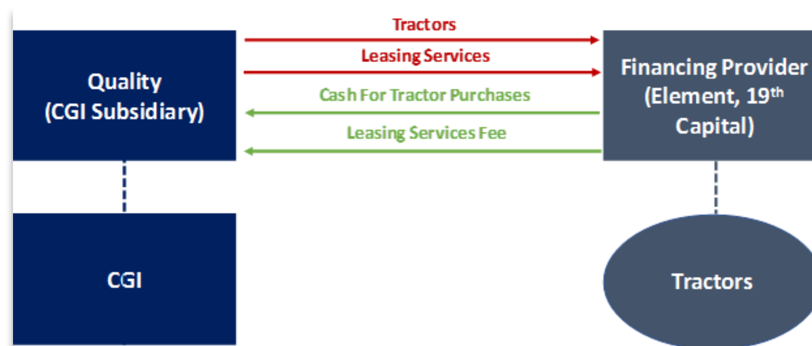
($ millions)	Reported TBV Q2'17	Adjusted TBV* Q2'17
Book Value of Equity	$368.2	
Less: Goodwill	($62.5)	
Reported Tangible Book Value	**$305.8**	**$305.8**
Less: Overstatement from Accounting Levers		($219.0)
Less: Operating Lease Liabilities		($74.8)
PP-Adjusted Tangible Book Value		$11.9
÷ Shares Outstanding	28.3	28.3
Reported vs PP-Adjusted TBV Per Share	**$10.80**	**$0.42**
Magnitude of Overstatement of Reported TBV/Share*	**25.7x**	

* Prescience Point estimates

Sources: CGI filings with the SEC

Celadon Group Makes Leveraged Bet on Tractor Resale Market; Results in Massive Losses

In 2014, CGI made a highly leveraged bet on the then-robust tractor resale market. In doing so, it pivoted its subsidiary, Quality Companies ("Quality"), to a bulk tractor purchase and resale model. Quality bought large amounts of tractors, leased these tractors to independent operators, and then sold the leased equipment to third-party financing providers.

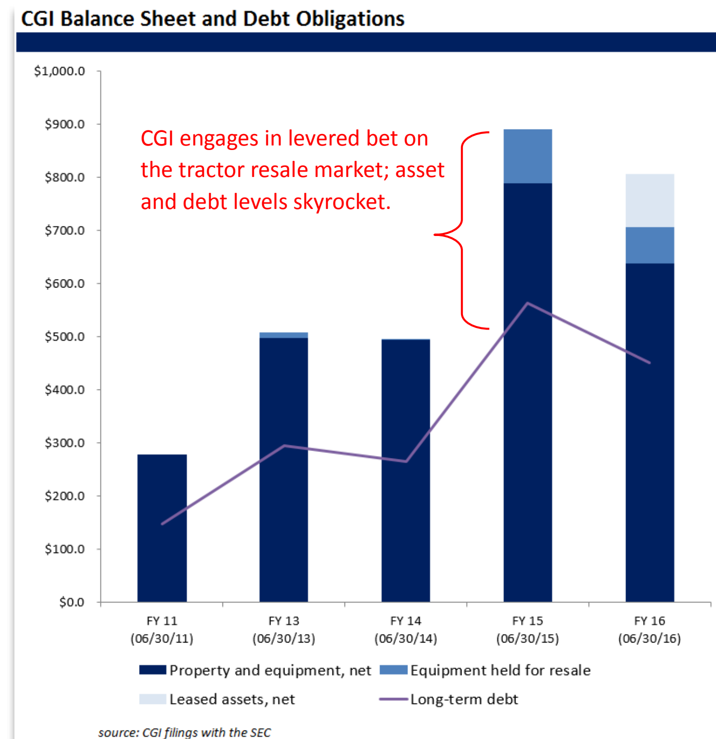


In late 2015, softness in the trucking industry caused used tractor prices and lease utilization rates to nosedive. The contraction has continued ever since. In the subsections below we detail the mistakes CGI made, which have led it to the brink of insolvency.

CGI Puts It All on the Line, Essentially Wagering its Status as a Going Concern

Per the FY'15 10-K, *"Quality has placed initial orders for 13,000 tractors… at an aggregate estimated purchase price in excess of $1.5 billion."* (CGI had just $0.5B in equipment the year prior.) By FYE'15, CGI's debt levels had skyrocketed to $587.5m. At the same time, from FY'14

to FY’15, property and equipment levels surged from $492.8 million to $788.5 million and equipment held for resale ballooned from $3.2m to $102.5m. [2]



CGI Agrees to Deal Structure with Element that Would Seal its Fate in a Downside Scenario… Downside Scenario Ensues

From April 2014 to September 2015, Quality’s tractors were purchased almost exclusively by Element Fleet Management (“Element”), a large fleet management company based in Canada. In its 8-K filed on 10/19/2016, CGI disclosed that it had “sold approximately $740 million of assets to Element.”

The terms attached to the leased tractors Quality had sold to Element were quite onerous for CGI:[3]

- CGI agreed to cover up to 10% of any losses incurred by Element from its tractor purchases. For example, if Element purchased $100m of equipment from Quality, CGI would cover up to $10m of losses on these purchases.
- CGI also agreed to cover any shortfall on the lease payments Element received from its operators. So, if an operator owed Element a monthly lease payment of $2,000 but paid just $800, the company would cover the $1,200 shortfall. CGI refers to these payments in its filings as “lease shortfall advances.”

In late 2015, used tractor prices and lease utilization rates began to nosedive. The declines have persisted to this day and, as discussed later in this report, are projected by other trucking companies and industry insiders to continue for years. As CGI explained in its FY’16 10-k (issued 9/13/16), a weakening in both factors resulted in negative cash flows, attributable to its obligations to Element:

> ***Recently, the demand for trucking services and the market for used tractors have both weakened.*** *This has negatively impacted Quality's operating results by reducing the amount of leased equipment sold by Quality to the Quality Financing Parties and resulting in a higher than expected number of unseated tractors among Quality's tractors under management.* ***These factors have depressed Quality's earnings and created negative cash flows associated with our obligation to advance certain amounts to the third party financing provider under the Lease Shortfall Advance****.*

The loss guarantees CGI provided on Element's $740m of equipment purchases required it to start posting capital to Element, translating to significant losses and cash drain:

- As used tractor prices and lease utilization rates declined, Element experienced severe losses on its tractor portfolio. As a result, in FY 2016, CGI made $74m of payments to Element to cover its 10% first loss pool liability.
- Additionally, the company was also paying Element ongoing lease shortfall payments. By the end of 2016, CGI had paid Element a total of $31.9m in lease shortfall advances.

CGI also disclosed in its FY'16 10-k that, absent a solution, its obligations to Element were "*expected to grow during fiscal 2017.*" As detailed later in this report, we have formed the belief that,

- CGI's losses in the aggregate have broken its business, and
- had a massive cover-up of financial mistakes not ensued – CGI would have defaulted on its credit agreement.

We also believe it was in creditors' interests to already have forced a restructuring toward the protection of their claims, but they were passed on the opportunity.

Based on our research we believe that, at risk of an imminent default, CGI embarked on a series of opaque off-balance sheet transactions, complimented by a plethora of accounting shenanigans, to hide losses from creditors and siphon capital out of a business in terminal decline.

Accounting Lever 1: Off-Balance Sheet JV Value Fabricated (TBV and Profits Inflated by +$100m)?

In September 2016, the company announced its intention to form an off-balance sheet joint venture with Element ("JV"). CGI highlighted this new arrangement would no longer require it to make capital shortfall payments to Element. As we will demonstrate, this 'trading-in' of its liability with Element came at steep cost for shareholders.

Element contributed $100m of equity to the JV ($667.5m of equipment, $567.5m of debt), while CGI represented that it also contributed $100m of equity to the JV ($36.4m of cash, $63.6m of equipment). Based on these reported values and its ~50% ownership in the JV, CGI marked its JV investment at $100m on its Q2'17 balance sheet. A $100m valuation would make sense, if $200m of equity had truly been contributed.

However, digging through the JV subscription agreement – which, as an SEC 10-Q Exhibit, shareholders and analysts barely noticed – we identified troubling disclosures which, in our opinion, amount to a smoking gun that CGI has made material misrepresentations and falsified its financial statements. Based on our research we have formed the following conclusions, which are thoroughly detailed below:

- **Collection of $31.8m in Lease Shortfall Advances never happened:** CGI represented that, just prior to the JV formation, it collected $31.8m of its prior Lease Shortfall Advances to Element. We believe this is a lie; based on disclosures in the JV subscription agreement, CGI received $31.8m in the form of a 'Daylight Loan' from Element, and this was immediately paid off at the JV closing. We believe this sham loan was created to give the false appearance of collection when nothing was received.
- **Smoking gun evidence CGI overstated the value of its JV investment by at least $15.9m in our view:** Of the $100m of assets that CGI reportedly contributed to the JV, $31.8m was used to pay off the Daylight Loan. Thus in actuality, CGI contributed $68.2m of equity into the JV, NOT the reported $100m. Summing CGI's (=$68.2m) and Element's (reportedly $100m) JV equity contributions means the JV equity was worth $168.2m on a book value basis. In other words, CGI's JV investment is at most worth $84.1m, and

thus CGI appears to have overstated the value of its JV investment by at least $15.9m. Again, we believe that the disclosures concerning the 'Daylight Loan' from the subscription agreement amount to incontrovertible proof that CGI has materially inflated its financial position.

- **Element equipment appears to have been inappropriately depreciated, indicating JV equity is worthless:** Element appears to have used what we view to be an overly conservative depreciation schedule. We believe the equipment contributed to the JV are overstated by $179.9m. After reducing the value of Element's equipment contribution by $179.9m, we estimate that the JV equity is worthless. Thus, we believe CGI overstated the value of its JV investment by $100m.
- **CGI incurred massive losses from the JV, while Element made out handsomely:** Based on our analysis, the JV formation destroyed $100m of CGI's TBV. The company contributed $100m of assets into the JV ($68.2m equity contribution + $31.8m Daylight Loan payoff) and in return received a stake in the JV that we believe is worthless. Element, on the other hand, made out very well in the deal – the debt it contributed to JV was, by our estimate, worth almost $80m more than the fair value of the equipment contributed. Thus, it appears that the purpose of the JV was to provide a vehicle for CGI to compensate Element for its equipment losses. This makes sense given that Element was forgoing significant Lease Shortfall Advances to form the JV.
- **Was the JV formed to help CGI hide its losses?** Instead of compensating Element via a joint venture, it seems that CGI could have simply paid Element directly. So why form a JV at all? We believe that CGI decided to form a JV as a means to hide its losses from investors and creditors. The accounting for off-balance sheet entities is rather opaque, and it appears CGI took full advantage of this opaqueness by significantly inflating the value of its JV investment.

Prescience Point Estimate of Joint Venture Equity Value As of Q2' 17

	Book Value of Equity (Max Value)			Fair Value of Equity		
($ millions)	CGI JV	Element JV	Consolidated JV	CGI JV	Element JV	Consolidated JV
Cash	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Restricted Cash	$3.5	$0.0	$3.5	$3.5	$0.0	$3.5
Unencumbered Cash	$1.1	$0.0	$1.1	$1.1	$0.0	$1.1
Cash	$4.6	$0.0	$4.6	$4.6	$0.0	$4.6
Leased equipment	$0.0	$8.4	$8.4	$0.0	$8.4	$8.4
Property And Equipment	$63.6	$659.1	$722.7	$63.6	$479.2	$542.8
Assets	**$68.2**	**$667.5**	**$735.7**	**$68.2**	**$487.6**	**$555.8**
SUBI Loan	$0.0	$8.4	$8.4	$0.0	$8.4	$8.4
Tranche A	$0.0	$471.3	$471.3	$0.0	$471.3	$471.3
Tranche B	$0.0	$87.8	$87.8	$0.0	$87.8	$87.8
Debt	$0.0	$567.5	$567.5	$0.0	$567.5	$567.5
Equity	$68.2	$100.0	$168.2	$68.2	($79.9)	($11.7)
Debt and Equity	**$68.2**	**$667.5**	**$735.7**	**$68.2**	**$487.6**	**$555.8**
CGI Ownership %			50.0%			50.0%
CGI Investment Book Vs Fair Value			$84.1			($5.9)

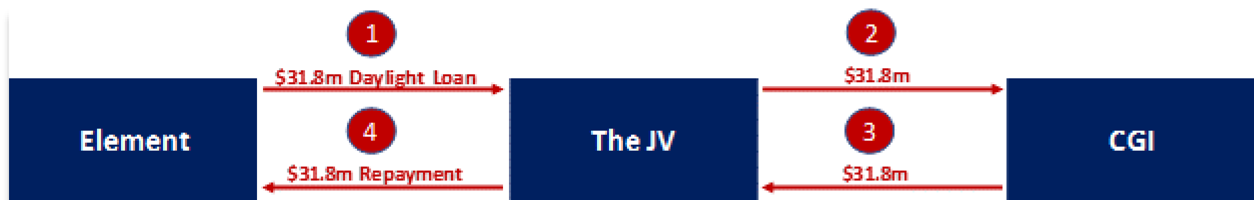
*Prescience Point Estimates
Sources: CGI filings with the SEC

Note: For the purposes of simplicity, we have excluded 19th Capital's contribution. A relatively small amount of equipment and debt from 19th Capital was also rolled into the JV. However, due to the redemption, there was zero equity remaining at 19th Capital and thus it had no impact on the JV's equity value.

CGI Lied RE Collecting on its $31.8m Shortfall Receivable. Is this the Smoking Gun that it's Falsifying its Financials?

Given that the Lease Shortfall Advances were a significant reason that cash flow had turned negative, investors were obviously concerned about these payments. CGI had highlighted that its JV arrangement would not require continued Lease Shortfall Advances.[4] Furthermore, CGI prominently highlighted in its Q2' 17 earnings release filed on 2/01/2017 that it collected $31.8m of prior Lease Shortfall Advances from Element. Unfortunately, based on information provided in the JV subscription agreement, it appears that **CGI never actually collected its Lease Shortfall Advances**.

- **CGI received a sham Daylight loan from the JV:** In the subscription agreement, CGI disclosed that Element provided a "Daylight loan" of $31.8m to the JV, the JV then gave the $31.8m to CGI, and then CGI paid the $31.8 million back to the JV to pay-off the outstanding contribution from Element. What essentially happened is Element gave CGI $31.8m and then CGI handed that $31.8m right back to Element (with the JV as an intermediary). The circular transaction created the illusion that CGI collected it Lease Shortfall Advances and made a $31.8m contribution to the JV, but this is just accounting gimmicks. No value was ever created or contributed to the JV.



The specific details of the Lease Shortfall Advance and related Daylight loans are detailed below.

- **Element required to repay the Lease Shortfall Advances:** CGI was obligated to provide lease shortfall payments to Element on an ongoing basis. By the end of Q1'17, CGI had made $31.9m in payments to Element. These payments were capitalized (i.e. not expensed) on CGI balance sheet as "Lease Shortfall Advances" within Other Assets. In its Q1'17 10-Q, CGI noted that Element was obligated to reimburse them for these payments:

> *"The financing provider is required to reimburse us for these advances and, accordingly, **we have accounted for the related receivable under other assets** on our consolidated balance sheet, in the amount of **$31.9 million** as of September 30, 2016 and June 30, 2016."*

- **CGI claims it collected its Lease Shortfall Advances from Element:** In its 8-K filed on 1/6/2017, CGI claimed its $31.9m lease shortfall receivable had been almost completely reimbursed by Element as part of the JV closing:

Net Cash Received from the JV Closing

($ millions)	Q2' 17
Cash received – redemption	$4.6
Cash received – receipt of deferred purchase price cash	$6.7
Cash received – sale of Quality equipment	$50.0
Cash received – reimbursement of Other Assets	$31.8
Cash invested in JV at closing	($35.3)
Net cash received at closing	**$57.8**

Sources: CGI filings with the SEC

- **As disclosed in the subscription agreement, Element loaned money to CGI:** We believe the JV subscription agreement indicates that no collection occurred. Specifically, the subscription agreement details that Element provide a $31.8m "Daylight Loan" to the JV (i.e. "the Company" below), and then the JV would give the $31.8m received from Element to CGI.

> *At the closing of the Element Investment,*
> *(i) Element shall transfer, convey, and assign to the Company the Element Assets;*
> *(ii) Element shall make a loan to the Company in the principal amount of $31,800,000 (the "Element Daylight Loan"), which shall be evidenced by this Agreement, and the Company shall pay $31,800,000 to Celadon in respect of the Payment; (Subscription Agreement, 02/10/17)*

- **As also disclosed in the subscription agreement, CGI immediately paid back the loan to Element:** The subscription agreement further details that (1) CGI will transfer the cash to the JV (i.e. "the Company" below) and (2) the JV would repay the loan from Element. Thus, CGI gave the cash it received from the Daylight Loan right back to Element at the JV closing. This, in our opinion, proves without a shadow of a doubt that CGI created a gimmick loan to fool investors into believing that it collected its outstanding Lease Shortfall Advances.

> *At the closing of the Celadon Investment,*
> *(i) Celadon shall transfer, sell, and assign all of its interests in the Quality Assets to the Company;*
> *(ii) Celadon shall transfer $31,800,000 in cash to an account designated by the Company, and the Company shall repay the Element Daylight Loan in full; (Subscription Agreement, 02/10/17)*

We Believe CGI Overstated the Value of Its JV Stake by ~$100m

In our opinion, the JV subscription agreement provides clear evidence the JV investment is significantly overstated. Based on our analysis, we believe CGI overstated the value of its JV investment by $100m.

In its press release dated 12/30/2016, CGI disclosed its "contribution includes cash and lease equipment totaling $100 million in value in exchange for its equity in the joint venture." As just discussed, CGI used accounting gimmicks with a Daylight Loan to create the illusion of collection. Based on this, we believe the company's JV contribution is overstated by $31.8m. After adjusting CGI's equity contribution from $100m to $68.2m, the equity of the JV declines from $200m to $168.2m. Based on this, it appears that CGI's JV investment is at most worth $84.1m ($168.2m * 50%). Thus, **at an absolute minimum, we believe CGI's JV investment recorded on its balance sheet as of Q2' 17 is overstated by $15.9m.**

Book Value of JV Equity As of Q2' 17*

($ millions)	Book Value of Equity (Max Value)		
	CGI JV	Element JV	Consolidated JV
Cash	$0.0	$0.0	$0.0
Restricted Cash	$3.5	$0.0	$3.5
Unencumbered Cash	$1.1	$0.0	$1.1
Cash	$4.6	$0.0	$4.6
Leased equipment	$0.0	$8.4	$8.4
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SUBI Loan	$0.0	$8.4	$8.4
Tranche A	$0.0	$471.3	$471.3
Tranche B	$0.0	$87.8	$87.8
Debt	$0.0	$567.5	$567.5
Equity	$68.2	$100.0	$168.2
Debt and Equity	**$68.2**	**$667.5**	**$735.7**
CGI Ownership %			50.0%
CGI Investment Book Value			$84.1

*Prescience Point Estimates
Sources: CGI filings with the SEC

However, based on the fair market value of the JV assets, it appears that the JV equity is worthless. Element appears to have used what we view to be an overly conservative depreciation schedule on the assets contributed to the JV. On 10/19/16, CGI disclosed that Element purchased a total of $740 million of equipment from Quality. In its JV subscription agreement, CGI disclosed that Element's $740 million of equipment purchases were contributed to the JV at a depreciated value of $659.1 million.[5] Element's equipment contribution of $659.1 million implies an accumulated depreciation of $80.9 million. **Based on the timing of its purchases, we believe Element's equipment should have been depreciated by a much larger amount.**

Element Equipment Contributed to Joint Venture

($ in millions)	
CGI equipment sold to Element	$740.0
Accumulated Depreciation	($80.9)
Element equipment contributed to the JV	**$659.1**

Sources: CGI filings with the SEC

- **Element equipment has an average age of 1.7 years:** Based on the timing of its purchases from Q4'14 through Q2'16, we estimated the average age of equipment Element purchased from CGI to be 1.7 years.

Element Equipment Purchases

($ millions)	Purchases (1)	Avg. Age (2)*
Q4'14	$52.6	2.6
Q1'15	$46.1	2.4
Q2'15	$81.6	2.1
Q3'15	$80.4	1.9
Q4'15	$120.9	1.6
Q1'16	$152.5	1.4
Q2'16	$121.3	1.1
Total Average Age @ 12/31/16		1.7 yrs

(1) Source: CGI Filings with the SEC

(2) Assumes purchases occurred on average at the midpoint of the quarter.

*Prescience Point Estimates

- **Element depreciates equipment by approximately 6.4% annually:** In the 1.7 years that Element owned leased equipment purchased from CGI, it recorded a mere $80.9 million in depreciation on $740.0m in equipment. We estimate this is equivalent to 6.4% annual depreciation. In its audited financial statement for the year ended 12/31/16, Element discloses that it depreciated leased equipment over 45 months (4.75 years) on average, but could depreciate for up to 10 years. The 6.4% annual depreciate rate suggests a useful life of over 15 years, which we believe is not even remotely consistent with the life of tractors.

> *Operating leases entered into by the Company are reported as "Equipment under operating leases" and are carried at cost less accumulated depreciation and are being depreciated to their estimated residual values using the straight-line method over the lease term or estimated useful life of the asset up to 10 years from the date of manufacture, with an average term of approximately 45 months.*

Peers maintain more conservative accounting policies (and are getting more conservative): In Q2'16, CGI increased the useful life of tractors from three years to four years and the salvage value of tractors from 35% to 40%. Accordingly, CGI currently depreciates its tractors at an annual rate of 15%. We note two of its primary peers depreciate their equipment at 15% and 17%. Furthermore, at least one of its peers has recently adopted a more conservative accounting policy that accelerates depreciation.

- **CVTI depreciates equipment by approximately 17% annually:** During its Q3'16 earnings call on 10/20/16, CVTI explained its decision to accelerate the depreciation of its tractors and also indicated that the used truck market would remain depressed for another 2 to 4 years. In its 10-K filed 03/14/2017, CVTI disclosed "we generally depreciate new tractors (excluding day cabs) over five years to salvage values of approximately 15% of their cost"

> *So, we looked at the rest of the group of trucks that we had that would be disposed of prior to, let's call it, January of '17 and* ***placed new salvage values*** *on those that were now instead of $10,000 to $12,000 lower,* ***$16,000 to $17,000 lower****.*
>
> *And if we believe ELDs are coming in place and those type of things and you think that there could be some trucking bankruptcies and – of the smaller trucking carriers that are the buyers of these trucks, and* ***this thing might not heal for 2, 3, 4 years****. (CVTI Q3' 16 Conference Call)*

- **WERN depreciates equipment by approximately 15% annually:** In its FY'16 10-K, Werner Enterprises ("WERN") disclosed it depreciates its tractors over a 80 months with no salvage value:

Useful Life of Werner Enterprsie Equipment as of 12/31/16

Equipment Type	Useful Life	Salvage Value
Building and improvements	30 years	0.0%
Tractors	80 months	0.0%
Trailers	12 years	$1,000

(1) Source: WERN Filings with the SEC

Element equipment should have been depreciated at a rate more consistent with CGI historical practices and/or peers: As just mentioned, CGI currently depreciates tractors at an annual rate of 15%. Before changing its depreciation rate, the company depreciated tractors over 3 years with a salvage value of 35%. This translates to an annual depreciation of a little over 20%. **Given the steep decline in used tractor prices over the past year, we believe a 20% annual depreciation rate more accurately reflects current market conditions,** and may still be conservative.

> *We depreciate our property and equipment using the straight-line method over the estimated useful life of the asset. We generally use estimated useful lives of 3 to 7 years for new tractors and trailers, and estimated salvage values for new tractors and trailers generally range from 35% to 59% of the capitalized cost. (FY 15 10K, 09/10/15)*[6]

- **Element equipment should have recorded cumulative depreciation of $252.4m (vs. the recorded $80.9m):** If the Element purchases from CGI had been depreciated by 20% annually (conservative estimate, in our opinion), we believe the equipment would have depreciated by $252.4 million.

Expected Depreciation of Element Equipment Contributed to JV

($ in millions)	Fair Value Estimate*	Calculation
Gross property and equipment	$740.0	A
Salvage value (40%)	$296.0	B = A * 40%
Depreciable base	$444.0	C = A - B
Useful life (in years)	3	D
Annual depreciation	$148.0	E = C / E
Years of depreciation	1.7	F
Expected depreciation	$252.4	G = E * F

*Prescience Point Estimates
Sources: CGI filings with the SEC

- **Element overstated its property and equipment contributed to the JV by $171.5m, in our opinion:** Given that our expectation for $252.4m in cumulative depreciation is $171.5 million higher than the actual accumulated depreciation of Element equipment, we believe the contribution to the JV was materially overstated.

Fair Value of Element Property and Equipment Contributed to JV

($ in millions)	As Reported	As Expected	Overstatement / (Understatement)
CGI property and equipment sold to Element	$740.0	$740.0	$0.0
Accumulated Depreciation	($80.9)	($252.4)	($171.5)
Element property and equipment	$659.1	$487.6	$171.5

Sources: CGI filings with the SEC

- **CGI overstated the value of its JV investment by an estimated $100m:** As reflected in the below table, when Element's equipment is assigned a more reasonable value ($487.6m), the JV equity is worthless:

Fair Value of JV Equity As of Q2' 17*

	Fair Value of Equity		
($ millions)	CGI JV	Element JV	Consolidated JV
Cash	$0.0	$0.0	$0.0
Restricted Cash	$3.5	$0.0	$3.5
Unencumbered Cash	$1.1	$0.0	$1.1
Cash	$4.6	$0.0	$4.6
Leased equipment	$0.0	$8.4	$8.4
Property And Equipment	$63.6	$479.2	$542.8
Assets	**$68.2**	**$487.6**	**$555.8**
SUBI Loan	$0.0	$8.4	$8.4
Tranche A	$0.0	$471.3	$471.3
Tranche B	$0.0	$87.8	$87.8
Debt	$0.0	$567.5	$567.5
Equity	$68.2	($79.9)	($11.7)
Debt and Equity	**$68.2**	**$487.6**	**$555.8**
CGI Ownership %			50.0%
CGI Investment Fair Value			($5.9)

*Prescience Point Estimates
Sources: CGI filings with the SEC

Accounting Lever #2: Equipment Loss Concealed (TBV and Profits Inflated by $36m)?

In its 8-K filed on 1/6/2017, CGI disclosed it received $56.7m in cash from Quality equipment sold to Element and another party at the JV closing. The company claimed it sold the equipment at book value. However, CGI's financial statements indicate this equipment was actually sold at a $36.0m loss. Therefore, we believe CGI further inflated its Q2'17 TBV and profits by $36.0m by failing to account for this loss.

- **CGI claims it received $56.7m in cash from the sale of certain Quality equipment:** In its 8-K filed on 1/6/2017, CGI disclosed it received $57.8m in cash from the JV formation and related transactions. According to its disclosure, the company received $56.7m from Quality equipment sales (highlighted in the following table). In addition, CGI claimed it disposed of this equipment at a price close to book value:

> ***Equipment with net book value of approximately $162.5 million was disposed of*** *in connection with the Transactions. These assets were primarily recorded under equipment held for sale, leased assets held for sale, and leased assets.* ***The Company does not expect to record a significant gain or loss on disposition of this equipment***.[7] *(8-K filed on 1/6/2017)*

Source and Use of Cash in Quality Equipment Sales

($ millions)	
Cash received – redemption	$4.6
Cash received – receipt of deferred purchase price cash	$6.7
Cash received – sale of Quality equipment	$50.0
Cash received – reimbursement of Other Assets	$31.8
Cash invested in 19th Capital at closing	($35.3)
Net cash received at closing	**$57.8**

Sources: CGI filings with the SEC

- **CGI financial statements indicated it collected only $20.7m in cash related to the sale of equipment:** CGI discloses the purchase and sale of Quality equipment in the operating cash flow statement in "leased revenue equipment held for sale."[8] In its Q2' 17 Cash Flow Statement, CGI recorded $20.7m of cash inflow related to its leased revenue equipment.

Cash Flow From Leased Revenue Equipment Held For Sale

($ millions)	Q1' 17	Q2' 17
Leased revenue equipment	($3.8)	$20.7

Sources: CGI 10-Q Cash Flow Statements Filed with the SEC

- **CGI appears to have overstated the value of assets sold – TBV should have been $36.0m lower:** Based on CGI's Q2'17 Cash Flow Statement, it appears that the company only collected $20.7m in cash related from the sale of equipment in Q2' 17. Accordingly, we believe the sale price of Quality equipment was overstated by $36.0m.

Loss On The Sale of Leased Revenue Equipment

($ millions)	Subscription Agreement	Prescient Point Estimates	Overstatement / (Understatement)
Cash received – redemption	$4.6	$4.6	$0.0
Cash received – receipt of deferred purchase price cash	$6.7	--	--
Cash received – sale of Quality equipment	$50.0	--	--
Cash received for the sale of Quality Equipment	$56.7	$20.7	$36.0
Cash received – reimbursement of Other Assets	$31.8	$31.8	$0.0
Cash invested in JV at closing	($35.3)	($35.3)	$0.0
Net cash received at closing	$57.8	$21.8	$36.0

*Prescience Point Estimates

Sources: CGI filings with the SEC

Accounting Lever #3: 19th Capital Redemption Value Fabricated (TBV and Profits Inflated by $4.2m)?

In response to the downturn in the tractor resale market, Element halted its equipment purchases from Quality in late 2015. As a result, CGI found itself without a buyer for the >$100m of Quality tractors remaining on its balance sheet. Desperate for a new buyer, CGI made the curious decision to form its own buyer of first-resort named 19th Capital. In September 2015, CGI teamed up with private equity firm Larsen MacColl Partners to form 19th Capital. The formation of 19th Capital set the stage for related party transactions that, in our view, were designed to hide losses and distract investors, as shareholder wealth was transferred into managements' pocketbooks. Some of our key findings are as follows:

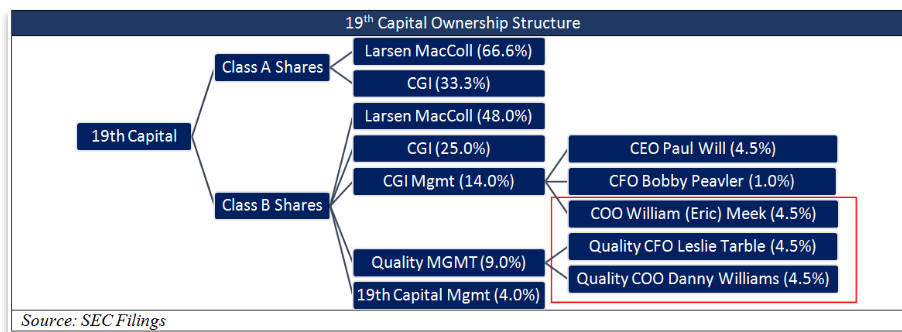
- 19th Capital was formed with a $2m investment from CGI and a $4m investment from Larsen MacColl.
- CGI management owned 23% of 19th Capital's B shares creating an obvious and troubling conflict of interest.
- Just prior to the closing of the JV with Element, 19th Capital's existing shareholders were redeemed for $27.1m, a 4.5x return in a mere 1.25 years!
- Based on our analysis, we believe 19th Capital's equity was actually worthless at the redemption. By overstating 19th Capital's value, we estimate that CGI inflated its Q2'17 TBV and profits by $4.2m.
- As we will discuss in a later section, CGI management undeservedly pocketed >$4m from the redemption, seemingly bilking CGI shareholders in the process.

CGI Forms an Off-Balance Sheet, Related Party Entity to Purchase Trucks from CGI

With Element's purchases grinding to a halt, CGI would form its own buyer of first resort – an off-balance sheet entity called 19th Capital.

- 19th Capital was a financing vehicle officially formed in September 2015 via a $2m investment from CGI and a $4m investment from private equity firm Larsen MacColl Partners.
- In return for their investments, CGI and Larsen MacColl received a 33.3% and 66.7% interest in 19th Capital's A shares, respectively. In addition to A shares, profit units in the form of B shares were also issued. **CGI management received 23% of 19th Capital's B shares** (includes Quality management).[9] (As we detail in a subsequent section, management would end up walking away with $millions!)

  The below ownership diagram of 19th Capital provides a detailed breakdown of the A and B shares:



- B shares were entitled to all profits at 19th Capital in excess of a 12% annual preferred return to A shareholders. In other words, if 19th Capital purchased $100m of equipment and received $125m over the span of a year from this equipment, $12m of profit would go to the A shares while the remaining $13m would go to the B shares.

Perverted Incentives: Management Interests Conflict with Shareholder Interests

As a reminder, CGI management owned 23.0% of 19th Capital class B shares and only owned 3.5% of CGI shares. Obviously, the management team now had a massive conflict of interest, and this alarmed many shareholders, some of whom publicly confronted CGI management about this conflict of interest at Stifel Nicolaus' Transportation Conference. As we will later explain, based on events that have since transpired, it appears that their concern was warranted.

CGI Management Team	% Ownership CGI	% Ownership 19th Capital
CEO Mr. Paul Will	1.4%	4.5%
COO Mr. William Meek	0.5%	4.5%
CFO Mr. Bobby Peavler	0.1%	1.0%
CFO Quality Ms. Leslie Tarble	--	4.5%
Other management	1.5%	8.5%
Total	3.5%	23.0%

Source: Prescience Point Estimates / SEC Proxy Filings

Was 19th Capital's Redemption Value Grossly Overstated, Unjustly Diverting $Millions to CGI Management?

In its Redemption Agreement filed on 02/10/17, CGI disclosed it received $7.1m from the redemption of its Class A and B shares, consisting of a $4.6m cash payment at the JV closing and a deferred payment of $2.5m:

> *Under the Redemption Agreement, the Company received the following consideration: (i) approximately **$4.6 million in cash**, and (ii) the right to receive approximately **an additional $2.5 million in restricted cash** when the restrictions lapse. The redemption receipts relate to the original $2.0 million that had been invested by the Company in 2015. (8-K, 01/06/17)*

Based on the $7.1m that CGI received, we calculated that 19th Capital's total equity was valued at $27.1m at the redemption. Of the $27.1m that 19th Capital shareholders received, $15.7m was paid at closing (as per CGI's Q2'17 10-Q) and the remaining $11.4m appears to have been deferred. Our calculation of 19th Capital's implied equity value is provided below:

19th Capital Redemption Vaue

($ millions)	Received	Ownership
CGI [1]	$2.3	33.3%
Other Shareholders [2]	$4.6	66.7%
Redemption Value - A Shares	$6.9	100.0%
CGI [3]	$4.8	23.7%
Other Shareholders [4]	$15.4	76.3%
Redemption Value - B Shares	$20.2	100.0%
CGI	$7.1	23.7%
Other Shareholders	$20.0	76.3%
19th Capital Redemption Value (A + B)	**$27.1**	**100.0%**

Sources: CGI filings with the SEC
(1) Represents CGI's $2m investment + 12% annual preferred return
(2) Represents Larsen MacColl's $4m investment + 12% annual preferred return
(3) $7.1m total redemption value - $2.3m A share redemption value.
(4) (CGI's B share value of $4.8m ÷ 23.7% ownership) * 76.3%.

In light of the significant ownership position of both CGI and its management team, there was significant incentive to fabricate the value of 19th Capital. Unfortunately, it appears that this is exactly what happened. Based on our analysis of 19th Capital's business model and prevailing market conditions, as well as a conversation with a former CGI employee, **we believe that 19th Capital's equity was actually worthless at redemption.**

The following provide evidence in support of our conclusion:

- **Used tractor prices declined precipitously in 2016:** According to a September 2016 FleetOwner report, used 2011 – 2013 model year tractor prices declined by 15% - 18% YTD July 2016. FleetOwner also expected the declines to continue through the remainder of 2016. In addition to this large decline in used tractor prices, trucking volumes and freight rates have declined substantially during that same timeframe. Given this extremely difficult macro backdrop, 19th Capital should have been a significant loss-making business during its lifespan (September 2015 to December 2016).

According to National Automobile Dealer Association (NADA) data posted this July, year-to-date used sleeper tractor prices dropped 15% for 2011 models, 16% for 2012 models, and 18% for 2013 models… That's only expected to worsen when the bumper crop of retail Class 8 trucks sold in the U.S. back in 2014 and 2015 of 220,000 units and 249,000 units, respectively, hit the market, Clough emphasized. (Weaker Used Class 8 Prices Ahead, FleetOwner, 09/20/16)

- **19th Capital and Element essentially had the exact same business model and should have the same results/returns:** 19th Capital and Element both (1) purchased leased tractors from Quality and (2) hired Quality to manage their tractor leasing program. In the twenty months ended December 2015, Element acquired $740.0m of equipment from Quality and generated an estimated loss of $105.9m. In the twelve-months ended September 2016, 19th Capital acquired $119.3 million in equipment from Quality and generated an estimated profit of $21.1m. **Despite having nearly identical operations, Element and 19th Capital generated wildly different returns.**

Comparison of Element's and 19th Capital's Profits

($ in millions)	Element	19th Capital
Total Equipment Purchases	$740.0	$119.3
Dates of Purchases	Apr '14 to Dec '15	Sep '15 to Sep '16
Profit / (Loss) on Purchases [1]	**($105.9)**	**$21.1**

(1) Element's losses based on $74.0m of 10% loss reserve payments + $31.9m of lease shortfall payments made by CGI.
Sources: CGI filings with the SEC

- **Recent conversation with former CGI employee confirms our suspicions about 19th Capital profits:** Below are excerpts from a recent conversation with someone ("Anonymous" hereafter) with knowledge of Quality's leasing services business. **We believe the anonymous source confirmed everything we had already suspected about the 19th Capital redemption.**

1. On average, 19th Capital's tractors were on-lease just 30% of the time. It would have been almost impossible for 19th Capital to be profitable with such a low utilization rate for its tractors.

2. There was no difference in how Quality was running the leasing program for Element and 19th Capital whether it was pricing, types of lessors, etc. This is further evidence that 19th Capital and Element essentially had the exact same business model.

3. By extension, it also means that 19th Capital should have experienced a similar level of losses as Element.

Overstatement of 19th Capital's Redemption Value Further Inflates CGI's Q2'17 Financials

At the end of Q1'17, CGI valued its 19th Capital investment at $2.4m. In its Q2'17 earnings release, CGI reported a $1.8m profit related to the redemption of 19th Capital investment:

*The decline in net income and earnings per share for the December 2016 quarter was attributable to several factors…The other factors were related to cost pressures in fuel, insurance, and equipment expense, which more than offset a **$1.8 million income from our prior ownership of 19th Capital**. (Q2'17 Earnings Release)*

Given our view that 19th Capital's equity was likely worthless at redemption, we believe CGI should have written off the investment. This should have resulted in CGI recognizing a $2.4m loss from an investment write-off in Q2'17, rather than recording a $1.8m profit. Accordingly, we estimate CGI's Q2'17 TBV and profits were inflated by $4.2m from the redemption ($1.8m + $2.4m).

Accounting Lever #4: PP&E Balance Overstated (TBV and Profits Inflated by $78.8m)?

In our opinion, CGI systematically misstated its reported PP&E balances through improper accounting methods and overly conservative depreciation. Of significant note, these accounting improprieties appear to have occurred around the same time deterioration in the Quality leasing business accelerated (i.e. middle to late 2016). We are concerned CGI may have been compelled to engage in improper accounting practices to obfuscate the deterioration in the core business and in the Quality leasing business. In the last four quarters, we believe management overstated property and equipment by at least $78.8m (we believe earnings benefitted by the same amount).

Estimated Inflation of Q2'17 Net PP&E Balance

($ in millions)	TBV Q2'17
Improper PP&E Accounting - Q3'16	$24.3
Improper PP&E Accounting - Q1'17	$13.1
Improper PP&E Accounting - Q2'17	$32.1
Change to Equipment Useful Lives - Q2'16	$9.3
Estimated Inflation of Q2'17 Net PP&E Balance	**$78.8**

Sources: CGI filings with the SEC

PP&E Inflated Via Improper Accounting Methods

In Q3’16, Q1’17 and Q2’17, CGI’s PP&E balance was $24.3m, $13.1m and $32.1m higher, respectively, than what was implied by its net purchases, capex, and depreciation. We see no logical reason for the consistently large discrepancy. Our concern about the discrepancies may have been moderated had the balance not been overstated in each period (i.e. rational discrepancies should be overstatements in some period and understatements in others). In our opinion, the consistent overstatement of the account balance lends more credence that this may have been intentional financial manipulation. We estimate that CGI’s improper accounting methods inflated PP&E by at least $69.5m ($24.3m + $13.1m + $32.1m).[10]

Provided below is a summary of our calculations:

Implied vs. Reported Net PP&E Balance

($ in millions)	Q3'16	Q1'17	Q2'17
Prior Quarter PP&E Balance	$752.8	$636.7	$628.9
Plus: PP&E Purchases	$2.6	$32.8	$10.3
Less: PP&E Sale Proceeds	($15.3)	($34.4)	($41.2)
Less: Depreciation	($19.6)	($19.3)	($19.3)
Implied Net PP&E Balance	$720.5	$615.8	$578.7
Reported Net PP&E Balance	$744.8	$628.9	$610.8
Amount PP&E Balance Overstated	**$24.3**	**$13.1**	**$32.1**

Sources: CGI filings with the SEC

PP&E Balance Further Inflated by Change in Accounting Policy

In Q2’16, CGI increased the useful life of its tractors from 3 years to 4 years and increased the useful life of its trailers from 7 years to 10 years. The company suggested the revised useful life would “better reflect the estimated periods during which these assets will remain in service.” Given the (1) rapid deterioration in the tractor market previously discussed and (2) the massive payments CGI had to make to Element because the assets it sold were not performing, we question how management concluded the value of its equipment would decline more slowly going forward.

Based on the evidence, it seems clear that CGI at the very least should have kept its depreciation schedule unchanged. In its Q2’17 10-Q and FY’16 10-K, CGI disclosed that increasing the useful lives and salvage values of its equipment reduced depreciation expense by a total of $9.3m from Q2’16 to Q2’17. Thus, **we estimate CGI’s questionable depreciation methods have further inflated its Q2’17 net PP&E balance by at least $9.3m.**

PP&E Inflation From the Increase in Useful Life & Salvage Value

($ millions)	Reduction in Depreciation
FY 16	$7.0
Q1 17	$1.7
Q2 17	$0.6
Total Inflation of PP&E	**$9.3**

Sources: CGI filings with the SEC

Large Increase in Operating Lease Liabilities in Q2’17 Supports Our Assertion that PP&E is Grossly Inflated

In Q2’17, CGI signed $31.1m of new operating leases. In our opinion, signing a large amount of equipment leases indicates CGI does not have enough tractors to sustain its operations. The existence of this equipment shortfall strongly supports our conclusion that CGI has misrepresented the amount of equipment / PP&E it has.

- In Q1’17, CGI minimum operating lease payments spiked 31.2% sequentially to $91.4m. In light of historically elevated property and equipment levels concurrent with deterioration in the macro environment, the execution of significant additional operating leases appears imprudent. In our opinion, the company may have been compelled to sign additional operating leases because it does not have as much equipment as reported on the balance sheet.

Minimum Operating Lease Payments

($ millions)	Q1 17	Q2 17
2017	$24.4	$29.7
2018	$16.7	$19.6
2019	$8.4	$14.0
2020	$7.2	$11.5
2021	$5.2	$7.4
Thereafter	$7.8	$9.3
Total minimum lease payments	$69.6	$91.4

Sources: CGI filings with the SEC

- CGI's operating lease liabilities totaled $91.4m and $69.6m at the end of Q2'17 and Q1'17, respectively (as shown above). In Q2'17, CGI reported $9.2m of operating lease expenses in the quarter. Therefore, we calculate that CGI signed $31.1m of operating leases in Q2'17:

Amount of Operating Leases Signed in Q2'17

($ millions)	
Q2'17 Operating Lease Liabilities	$91.4
Less: Q1'17 Operating Lease Liabilities	($69.6)
Plus: Q2'17 Operating Lease Expenses	$9.2
Operating Leases Signed in Q2'17	**$31.1**

Sources: CGI filings with the SEC

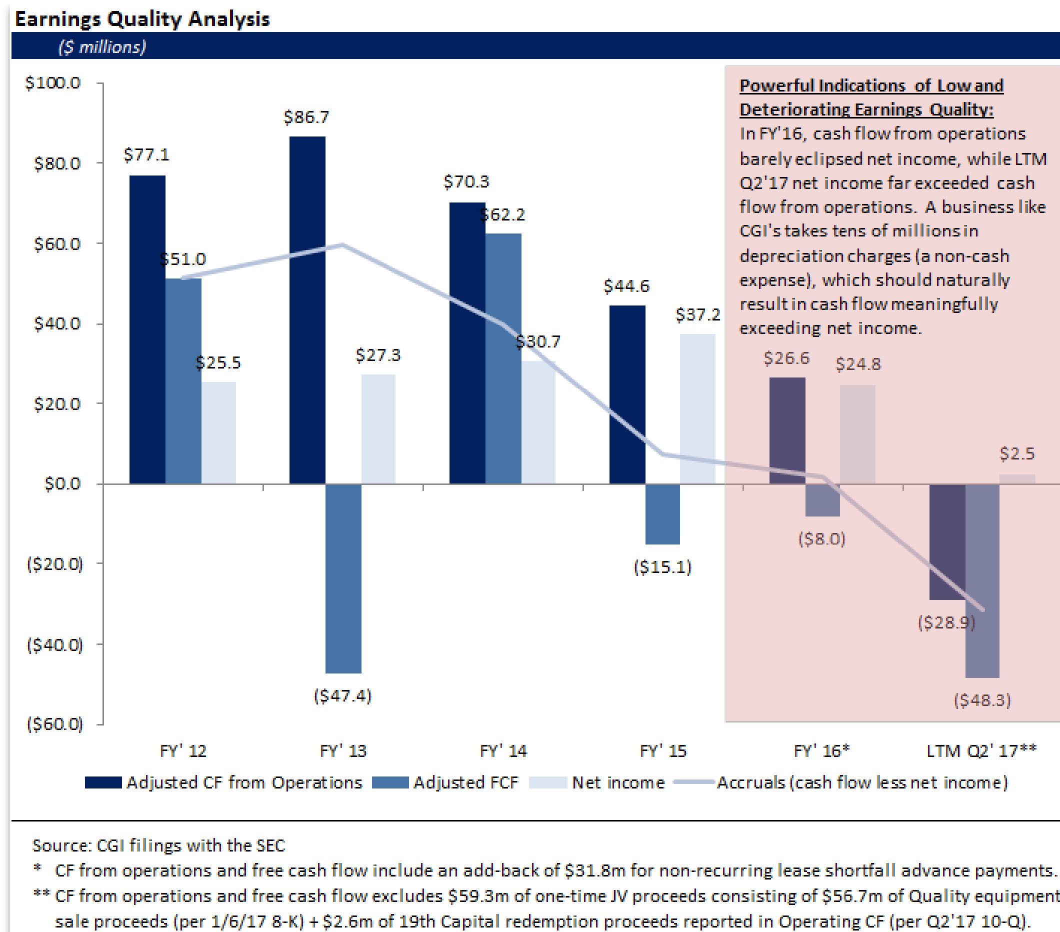
More Glaring Accounting Red Flags

We have not even come close to covering all of our concerns regarding CGI's financial reporting methods, and won't be able discuss many of them in this report. In the below sections, we will list some among the myriad of additional red flags which reinforce our opinion that **CGI's financial reporting cannot be trusted**.

#1: Low and Deteriorating Earnings Quality – Accruals are Exploding

Cash from operations is harder to fabricate than almost any other account balance. Companies either collect cash or they do not. As a result, divergences between cash from operations and net income are one of the clearest signs of manipulated earnings.

- **Powerful indications of low and deteriorating earnings quality, as net income exceeds CFFO for the first time in 8 years:** In FY'16, cash flow from operations (adjusted for non-recurring items) of $26.6m barely exceeded net income of $24.8m. In YTD 2017, adjusted cash flow from operations declined by an additional $55.5m, while net income declined only $22.3m. As a result, CGI's net income exceeded cash from operations for the first time in eight years (as reflected in LTM Q2'17 column of below graph). Because CGI takes tens of millions in depreciation charges (a non-cash expense), this should naturally result in cash flow from operations exceeding net income. That CGI is bleeding cash to such an extent that it overpowers this tendency is deeply troubling.
- In our view, the growing divergence in CGI's cash from operations and reported earnings suggests that earnings are unsustainable and detached from CGI's economic reality.



#2: Sudden Growth in Other Revenue Cannot be Reconciled with Contraction in its Fundamental Driver

CGI's reported Other Revenue increased by $10.6m, an astonishing 67.4%, over the two quarters from Q4'16 to Q2'17. In its Q2'17 Earnings Release, CGI attributed most of the change in other revenue to Quality leasing services. Over the same period of massive other revenue growth, the number of Quality tractors managed **declined** from 11,300 to ~10,000.[11] The decline in tractors under management, if anything, suggests Quality **should have reported a decline in leasing services revenue**.

> *Other revenue, as broken out in key operating statistics, increased $11.8 million from the December 2015 quarter. Approximately $4.0 million of the increase related to a change in presentation due to the newly signed service agreements for Quality's third party maintenance business and maintenance servicing for the leasing portfolio. … Other revenues associated with Quality's leasing services business increased approximately $5.0 million compared to last December quarter.*

Other Revenue

($ in millions)	Q4'16	Q1'17	Q2'17
Other Revenue	$15.7	$18.4	$26.3
$ Increase since Q4'16		*$2.7*	*$10.6*
% Increase since Q4'16		*17.3%*	*67.4%*

Sources: CGI filings with the SEC

#3: Working Capital Changes Cannot be Reconciled Between Balance Sheet and Cash Flow Statement

We discovered a number of working capital discrepancies between CGI's balance sheet and cash flow statement. In its historical 10-Q and 10-K filings, the change in many of the working capital items from quarter-to-quarter did not match between the two statements. The most egregious are examples related to equipment held for sale. From Q2'16 to Q1'17, the change in equipment held for sale on CGI's balance sheet differed by a significant amount from its cash flow statement every single quarter.

Mismatch in Change in Equip Held For Sale

($ in millions)	Q2'16	Q3'16	Q4'16	Q1'17
Inc / (Dec) in Equipment Held For Sale:				
Balance Sheet	($44.8)	$4.9	$33.9	($10.7)
Cash Flow Statement	($61.6)	$36.8	$12.0	$3.8
Difference	**$16.7**	**($31.9)**	**$21.9**	**($14.5)**

Sources: CGI filings with the SEC

We note that currency fluctuations or acquisitions can sometimes cause large working capital discrepancies; these factors are not explanatory variables in this case. The vast majority of CGI revenue is generated in USD, and CGI has not been acquisitive recently. In our opinion, the discrepancies in equipment held for sale are extremely concerning given all of the other signs of misstated property and equipment.

After Forcing Restatement, Big4 Auditor Replaced w/ Regional Firm – Fees Explode(!)

In 2012, CGI's independent audit firm KPMG required it to restate its financial statements. In 2013, CGI replaced KPMG with regional audit firm BKD LLP. Despite hiring a smaller and less reputable firm, CGI's audit fees have skyrocketed. From FY'14 to FY'16 – the period encompassing the worst of CGI's accounting shenanigans – its annual audit fees increased 179.6%. As discussed in this section, audit fees can be an indicator of audit and operational risk.

Furthermore, our analysis indicates that CGI has become BKD's largest public client in the state of Indiana, comprising almost 25% of BKD-Indiana's revenue from public companies. In the case of two of the largest financial frauds in history – Enron and Satyam – significant audit fees compromised the auditors' ability/willingness to adequately perform their duties. In light of the accounting irregularities we have identified in CGI's filings and disclosures and the disproportionate amount of revenue BKD-Indiana derives from CGI, we are concerned that BKD's independence could be compromised. In our opinion, CGI's financial reports and disclosures cannot be trusted.

KPMG Requires CGI to Restate Its Financials, Is Later Dismissed

In 2012, KPMG forced CGI to restate its PP&E and capitalized lease obligations. Per CGI's 8-K filed on 4/25/2012,

> *On April 24, 2012, the Company and the Audit Committee of the Board of Directors concluded, in consultation with KPMG LLP… that the Company should **restate its balance sheets for the years ended June 30, 2011 and 2010** and its consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three year period ended June 30, 2011… Accordingly, those financial statements should no longer be relied upon …*

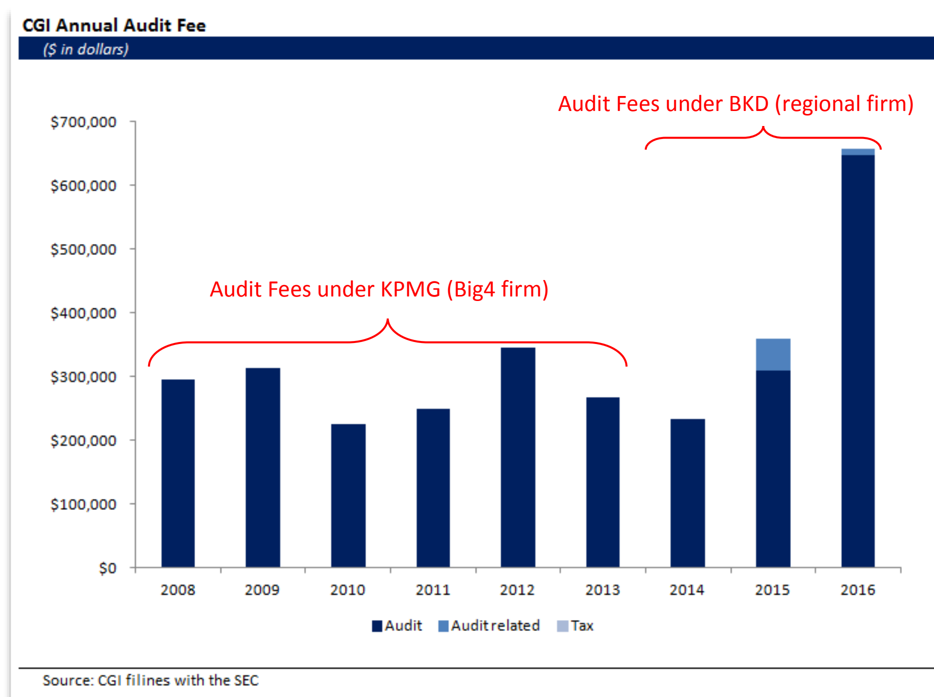
The nature of the restatement is concerning because, as we have outlined in this report, we think CGI has been systematically overstating its PP&E balance.

A little over a year later, in October 2013, CGI dismissed KPMG, a Big4 auditor, and engaged BKD LLP, a regional auditor.

BKD Audit Fees Explode After Replacing KPMG

Growing companies often switch from smaller/regional auditors to Big4 auditors as they grow. Occasionally, companies will switch from one Big4 auditor to another Big4 auditor to reduce fees. We can't think of a single reputable public company that has switched from a Big4 auditor to a regional auditor. And for good reason: Smaller firms are more resource-limited. We question why CGI would decide to switch from a Big4 auditor to a smaller/regional firm. Further, we wonder if BKD has the necessary manpower to effectively audit a sprawling, asset-intensive business like CGI.

One of the most notable red flags in the CGI-BKD relationship is that CGI's audit fees have skyrocketed from the levels prevailing during KPMG's tenure. From FY'14 to FY'16, the annual fees CGI paid to BKD increased an astonishing 179.6% from $248K to $693K. **Given the strong relationship between high audit fees and significant accounting issues, we believe CGI's auditor has implicitly highlighted the financial risk through its audit fee.**



Outsized Audit Fees Signal Outsized Audit and Operational Risk

- According to Audit Analytics, a professional research organization, auditor fees are determined by audit risk and "*audit fees can be used a risk indicator*." For example, Enron had the third highest audit fee of any US public company because its auditors believed it was their "riskiest client." Enron's audit fee exceeded companies that were significantly larger and more complicated.

  There are a number of studies in the accounting literature suggesting that audit fees can be used as a potential risk indicator. One of the most infamous examples of this arose from the first year that of audit fees disclosure. In 2000,

Enron disclosed the third highest audit fees of any US public company, behind only Citigroup and Waste Management. Both of these two companies at the top were coming off significant financial issues, which required unusually high auditor attention. Enron's audit fees also exceeded both those of GM and GE, a seemingly impossible circumstance considering the size and complexity of the latter two. Later, in court filings, it was revealed that Arthur Andersen, Enron's auditor, noted in internal memoranda that Enron was their riskiest client and that some of their accounting was troubling. Andersen could have resigned from the job, but the high audit fees compensated for the risk. This suggest two things: that ***auditors price client risk into the audit fees, and that abnormally high audit fees can potentially lead to problems with the audit****. With respect to academic studies, one study found a significant inverse relationship between audit fees and "one-year ahead" changes in the client's operating performance.*

- Furthermore, multiple academic studies have shown that elevated audit fees are associated with higher operating risk.

CGI is BKD-Indiana's Largest Public Client – Audit Quality May be Compromised

Our analysis indicates that CGI has become BKD's largest public client in the state of Indiana. We believe its audit fee accounts for nearly 25% of BKD revenue from public companies.[12] That CGI accounts for such a disproportionate amount of BKD-Indiana's revenue is highly concerning. As we show, significant audit fees affected the auditors' ability/willingness to adequately perform its duties in two of the largest frauds in history. **Given its dependence on CGI, BKD may be less willing to pressure the company on certain accounting issues.**

BKD's Public Clients in Indiana

Client	Audit Fee	% of revenue*
1ST SOURCE CORP	$438,682	14.6%
CELADON GROUP INC	$692,538	23.1%
ESCALADE INC	$333,083	11.1%
First Internet Bancorp	$216,800	7.2%
FIRST MERCHANTS CORP	$578,509	19.3%
HORIZON BANCORP /IN/	$313,230	10.4%
MUTUALFIRST FINANCIAL INC	$327,907	10.9%
West End Indiana Bancshares, Inc.	$103,361	3.4%
Total	$3,004,110	100.0%

Source: Prescience Point Estimates / SEC Proxy Filings

*Percentage of BKD revenue from public companies in Indiana

- **Enron's massive audit fee influenced its auditor:** According to this research paper, Enron was Arthur Andersen's second largest account in the year prior to the Enron collapse. The large audit fees impaired Andersen's ability to impartially audit the firm and enabled Enron to perpetuate one of the world's largest frauds.

They did not execute their duties independently because of the amount of revenue that Enron was providing them, not only in audit fees, but also in consulting fees. "In 2000, ***Enron paid Andersen $52 million****, including $27 million for consulting services" (Weil).* ***This amount was enough to make Enron Andersen's second largest account*** *in 2000. (Research Paper)*

- **Satyam's massive audit fee also influenced its auditor:** In 2007-2008, PriceWaterhouseCoopers (Big4 auditor) received an audit fee from Satyam that was nearly twice the peer audit fee. According to a research paper studying the matter, the high audit fee impaired PriceWaterhouseCoopers' ability to conduct its audit.

Price Waterhouse received an annual fee of Rs. 37.3 million (or Rs. 4.31 crore) for financial year 2007-2008, which is almost twice, as what Satyam peers (i.e., TCS, Infosys, Wipro),on an average, pay their auditors. Bhasin [15] stated, "This shows that the auditors were being lured by the monetary incentive to certify the cooked and manipulated financial statements. Events of such nature raise doubts about statutory auditors' discharging their duty independently.

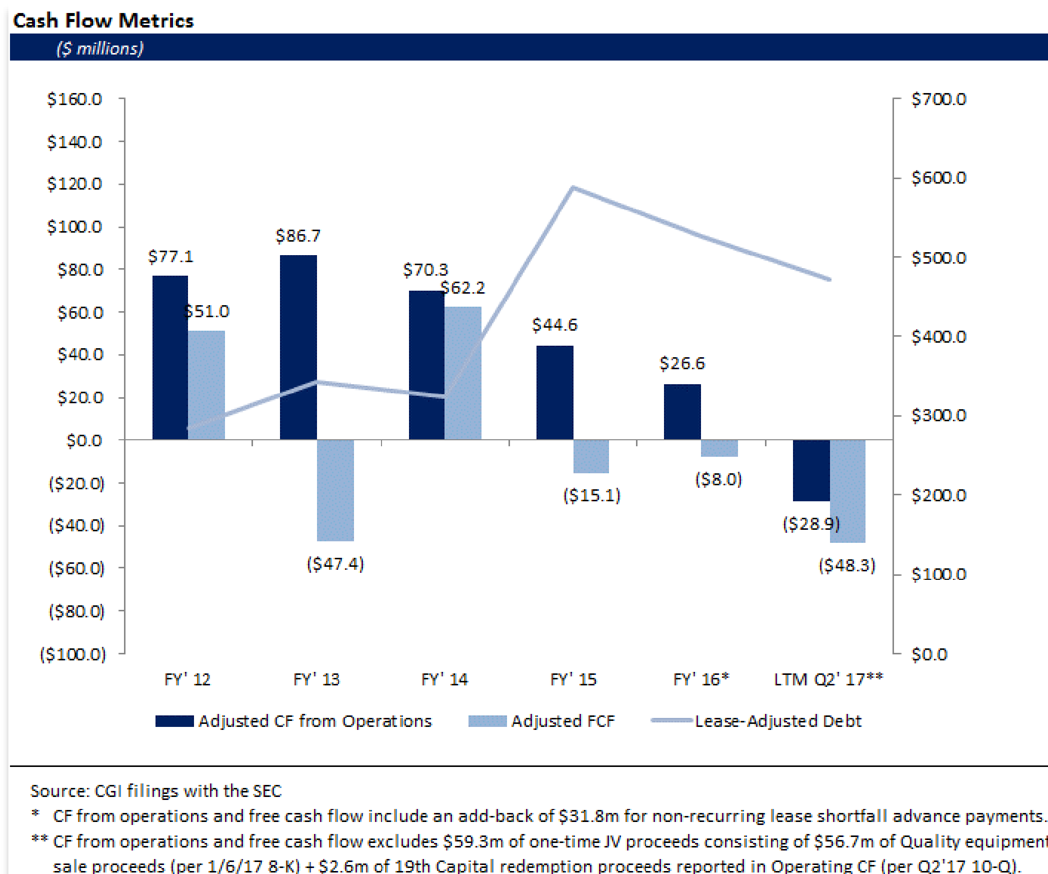
Will CGI be Insolvent in 1-2 Quarters?

Some analysts and investors have wrongly assumed that, following the consummation of its JV with Element, CGI is well-positioned for a turnaround. We can't imagine anything further from the truth. In our view, behind the veil of improper accounting CGI's financial condition is terminal – we estimate CGI's TBV to be a mere $11.6m, meaning that the value of its assets barely exceeds its debts. We also project that 2H FY'17 FCF will be a loss of $80.1m! As a result, we believe CGI has little-to-no hope of a turnaround.

CGI Does Not Generate Sufficient Cash Flow to Fund its Operations and Service its Debts

In the chart below we point out troubling trends in adjusted cash flow metrics (adjusted for non-recurring items relating to the JV and associated transactions), suggesting a broken business model.

- The accelerating, downward trajectory of CGI's CFFO has taken it into negative territory
- The company has reported negative FCF for the last 2 and a half years. Over just the last twelve months, CGI has burned $48.3m despite (1) significantly under-investing in capex and (2) liquidating large amounts of PP&E to boost FCF
- Due to a projected increase in net capex and lease payments, CGI's already large cash burn is expected to increase significantly, implying that even a turnaround in the industry will not meaningfully change the fortunes of the business



Source: CGI filings with the SEC
* CF from operations and free cash flow include an add-back of $31.8m for non-recurring lease shortfall advance payments.
** CF from operations and free cash flow excludes $59.3m of one-time JV proceeds consisting of $56.7m of Quality equipment sale proceeds (per 1/6/17 8-K) + $2.6m of 19th Capital redemption proceeds reported in Operating CF (per Q2'17 10-Q).

Equipment Shortfall Means Little to No Hope of Recovery

In the past twelve months, CGI liquidated a massive amount of equipment to fund its cash burn and based on our research, inflated its PP&E balance by an estimated $78.8m to cover-up the extent of its equipment liquidations. What remains is a depleted equipment balance, which in our opinion is strongly evidenced by its increasing reliance on operating leases – CGI reported $31.1m of new operating leases in Q2'17. In our opinion, CGI is very limited in terms of its ability to liquidate assets to raise cash to meet its obligations – it is out of bullets.

Jump in Operating Leases is Unusual and Expected to Further Pressure Cash Flow: Although the upfront payment is less, operating leases are generally more expensive than an outright purchases. For example, CGI's operating lease expenses are scheduled to increase by at least $22m on an annualized basis in 2H FY'17 relative to 1H FY'17. This huge increase in operating lease expenses means continued pressure on its cash flows – it is highly unlikely that CGI will turn a profit any time soon.

- In its Q2'17 10-Q, CGI disclosed minimum operating lease payments over the next six months increased 90.8% y/y to $29.7m.

Minimum Operating Lease Payments Over Next Six Months

($ in millions)	Q2 '13	Q2' 14	Q2' 15	Q2' 16	Q2' 17
Operating lease payment over next six months	$6.6	$10.0	$15.1	$15.6	$29.7
Y/Y Increase	--	*51.5%*	*50.8%*	*2.7%*	*90.8%*

Sources: CGI filings with the SEC

- For further context, in the previous six months (i.e. 1H FY' 17), CGI incurred $18.7m of operating lease expenses. As such, operating lease expenses are expected to increase at least $11.0m sequentially, representing a $22.1m increase on an annualized basis!

Annualized Increase in Operating Lease Expenses

($ in millions)	
2H FY'17 Operating Lease Expenses	$29.7
Less: 1H FY'17 Operating Lease Expenses	($18.7)
Increase in Operating Lease Expenses - Six Months	**$11.0**
Annualized Increase in Operating Lease Expenses	**$22.1**

Sources: CGI filings with the SEC

We Estimate CGI has a Liquidity Runway of 1-2 Quarters

CGI's liquidity runway is very short. Based on its LTM cash flow from operations of negative $28.9m, an $11m increase in projected operating lease expenses and $54.7m of projected net capex and capital lease payments, we estimate CGI's cash burn will be $80.1m in 2H FY'17. Due to its covenant constraints and equipment shortfall, CGI likely does not have enough available liquidity to fund this large cash burn. We estimate that CGI can borrow just $54.3m under its credit facility before violating its 4x leverage ratio covenant. Thus, we project that CGI will become insolvent within the next one or two quarters.

2H FY'17 Estimated Cash Burn

($ millions)

	2H FY'17
Adjusted Operating CF [1]	($14.5)
Less: Net Capex [2]	($12.5)
Less: Capital Lease Payments [3]	($42.2)
Less: Increase in Operating Lease Expenses	($11.0)
Estimated 2H FY'17 Cash Burn	**($80.1)**

Sources: SEC Filings

(1) Equal to LTM Q2'17 Adj. Operating CF loss of $28.9m * 50%.

(2) Net capex = PP&E purchases - PP&E sale proceeds. Represents average of projected net capex in 2H FY'17 of $10m - $15m (as per Q2'17 earnings release).

(3) Equal to 50% * $84.4m of current capital lease maturities as of Q2'17.

Did CGI Misappropriate Shareholder Capital?

During the formation of 19th Capital in September 2015, CGI management was handed 'incentive units' in the form of 23% of the entity's Class B interests. (Management put no capital at risk in exchange for these units.) The same management team only owned 3.5% of CGI shares. Obviously, the management team now had a massive conflict of interest. They were incentivized to inflate 19th Capital's redemption value, even if at CGI shareholders' expense.

Sure enough, CGI reported that 19th Capital's equity grew from $6m to $27.1m at redemption, a 4.5x return in just ~1.25 years! Based on the redemption value, CGI's management grew its initial $0.00 investment into a miraculous personal payout of $4.6m in just ~1.25 years.

Our analysis, as presented in a previous section, indicates 19th Capital's redemption value was egregiously inflated, and that its equity was worthless at redemption. Further, in our opinion, evidence strongly suggests that management paid for the redemption with cash misappropriated from CGI's balance sheet, which would mean that management's windfall came directly at the expense of CGI shareholders:

- **CGI indicates the redemption was paid for with 19th Capital cash:** In its press release dated 12/30/2016, CGI disclosed that the redemption was paid for with existing cash at 19th Capital:

> *The joint venture was formed through recapitalizing 19th Capital. The former owners of 19th Capital (including Celadon's former Class A and Class B interests)* ***were redeemed using pre-transaction cash of 19th Capital****, and new equity was contributed by Celadon and Element to establish the post-transaction capitalization. (12/30/16 Press Release)*

- **19th Capital would have had limited cash on hand, in our opinion:** Given our view that 19th Capital, (1) would have been a loss making business similar to Element, and (2) potentially acquired overpriced equipment for CGI given the related party nature of the transactions, we question if 19th Capital would have enough cash on hand to pay for the redemption. As such it is more likely that 19th Capital had little to no cash remaining on its balance sheet at the time of redemption.

- **Other JV partners likely did not have cash or would not have been willing to pay for the redemption:** The redemption definitively involved three parties: CGI (former & current owner), Larsen MacColl (former owner) and Element (current owner). We cannot imagine a logical reason that Element would have funded the redemption given it had no position in 19th Capital. In addition, Larsen MacColl is a very small firm whose latest fund was just $40m (raised in 2014).

- **All roads seem to lead to the same destination:** If 19th Capital could not have had the funds, and CGI's business affiliates did not provide the redemption cash, then where did the cash come from? Given the alleged accounting improprieties and immoral – not to mention, potentially unlawful – maneuvers exposed in this report, it is within reason to assume these funds were sourced from CGI's balance sheet, and that the wealth transfer was covered with yet more accounting fabrications. In fact, we believe this is the most probable scenario.

- **CGI is the only party with the cash and motivation to fund the redemption, in our opinion:** CGI had plenty of motivation to overpay for the 19th Capital redemption given managements ownership position. In addition, CGI had access to its credit facility as well as equipment that it could sell for cash.

All of these factors lead us to conclude that CGI most likely supplied the cash for the 19th Capital redemption. In accordance with our view, as CGI sits on the brink of insolvency, management may have made a landgrab for what little remains of shareholder capital.

Is CGI in Default of its Credit Agreement?

We believe CGI meets the requirements for a default under its Credit Agreement and that creditors can demand immediate payment of principle and interest. We also believe it is in creditors' interest to do so as soon possible toward protecting the value of their claims. As highlighted in this report, we estimate CGI's TBV to be at most $.42/share, and expect CGI to burn through that equity cushion in short order. As such, whether (or not) lenders enforce their rights, we believe current equity holders are going to be wiped out.

Did CGI Use Financial Statement Misrepresentations to Skirt Impending Default, Delay a Forced Restructuring?

Had CGI not concealed the losses highlighted in this report, we believe it would have already have defaulted on its Credit Agreement.

- According to its credit agreement, CGI is required to maintain on a consolidated basis the Lease Adjusted Total Debt to EBITDAR Ratio not exceeding 4.00 to 1.00 as of any fiscal quarter.
- We believe CGI hid catastrophic losses from its investors and creditors by inflating its LTM profits by an estimated total of $219m.
- As of LTM Q2'17, we calculate CGI's EBITDAR is $127.4m. By reducing this metric by $219m, we estimate that CGI should have reported LTM EBITDAR as a loss of $91.6m. Had it done so, we believe CGI would be in violation of its 4x debt / EBITDAR leverage ratio covenant.

We note that CGI's leverage ratio covenant allows for an add-back to EBITDAR for "extraordinary items." Most of the losses we believe CGI has covered up wouldn't appear to fall into this category.

- For example, CGI's net PP&E balance appears to have been inflated in at least three of the past four quarters. This seemingly consistent, quarter-after-quarter fabrication of PP&E leads us to believe that the losses being concealed are recurring, and not one-time, in nature.

- If we were to consider only the impact of these losses in our analysis, we estimate CGI's debt / EBITDAR leverage covenant ratio would already have risen to 9.4x – well in excess of the 4x threshold for default

Q2'17 Lease-Adjusted Debt / EBITDAR Covenant Calculation

	Q2'17	
	Reported	Adjusted
($ millions)		
Lease-Adjusted Debt [(1)]	$455.3	$455.3
LTM EBITDA [(2)]	$95.6	$95.6
Plus: LTM Rent Expense	$31.8	$31.8
LTM EBITDAR	$127.4	$127.4
Less: PP&E Inflation	$0.0	($78.8)
Adj. LTM EBITDAR	$127.4	$48.6
Credit Metrics:		
Lease-Adjusted Debt / EBITDAR	***3.6x***	***9.4x***
Available Borrowing Capacity	***$54.3***	***($260.9)***

Source: CGI's credit agreement filed on 2/10/2017, PP estimates.
(1) Includes $114.5m of debt, $266.0m of capital lease obligations and $74.8m of operating leases discounted to PV at a 10% rate.
(2) As per CGI's Q2'17 earnings release.

Realistically speaking, we think far more than $78.8m of the losses we have estimated would merit inclusion in this calculation, and that the ratio should be far in excess of the 9.4x calculated in the table above.

If CGI's lenders care to scrutinize the company's accounting more closely, we believe they will form the same opinion – that CGI is already defaulted on its Credit Agreement.

Financial Statement Misrepresentations are Grounds for Default

The same financial statement misrepresentations that may have allowed CGI to skirt default, are themselves a grounds for default. As a result, we believe CGI meets the requirements for a default and that creditors can demand immediate payment of principle and interest. In our opinion, doing so may be their most prudent course of action.

- CGI's financial statements contain material irregularities, as described in this report. CGI's reflection of the Element sham daylight loan on its books as JV equity value, in our opinion, amounts to the smoking gun.
- Article 8.01 (d) of the Credit Agreement dated December 12, 2014 indicates that incorrect or misleading representations – falsified financial statements – constitute an Event of Default.

> *(d) Representations and Warranties. Any representation, warranty, certification or statement of fact made or deemed made by or on behalf of Borrower or any other Loan Party herein, in any other Loan Document, or in any document delivered in connection herewith or therewith shall be incorrect or misleading when made or deemed made; or*

- Per Article 8.02 (b) of the Credit Agreement, when an Event of Default is triggered, CGI's creditor can demand immediate payment of principal and interest on all outstanding loans.

In our view, creditors should force an immediate restructuring of CGI debt to protect against the growing risk of impairment of their claims. We estimate CGI's TBV to be <$.50/share, and expect CGI to burn through that equity cushion in short order; because of this, regardless of CGI's creditors' next move, CGI shareholders are likely to be wiped out.

Can a Dysfunctional Culture Result in an Environment Primed for Fraud?

Based on a conversation with a former CGI employee and review of public filings, we believe CGI management have hired many of their friends to fill key positions at the Company. Several members of management are allegedly fraternity brothers at Franklin College. Furthermore, CGI has a history of promoting young and inexperienced people to management positions. We observe multiple instances of employees being promoted to executive positions while in their late 20s. Some were responsible for managing the massive bet that, in our view, will lead to the wipeout of current equity holders. We believe a dysfunctional culture with limited accountability can result in an environment ripened for fraud.

Information from Former Employee ("Anon") Highlights Concerns Over 19th Capital and Management Conduct

In conversation, a former employee alleged that CGI management has fostered a toxic work culture where nepotism and a lack of accountability are rampant. He also alleged that many key management positions at CGI are filled with unusually inexperienced individuals. In summary, Anon relayed the following assessments:

- CGI is run by "fresh faced college kids": Members of management are on average unusually young and inexperienced for the positions they hold.
- Nepotism is a huge problem at CGI. Management appears to be more interested in hiring their friends and family vs hiring the most qualified person. Senior management has filled numerous positions with their fraternity brothers from Franklin College. And, George Chasteen, the former President of 19th Capital, is the nephew of Paul Will (CGI CEO).
- This rampant nepotism has created a work environment with little to no accountability. Almost no one gets reprimanded or fired for failing to do their job.
- Most of the members of CGI's board of directors were picked by either Mr. Paul Will or Mr. Eric Meek, further confounding a culture of almost zero accountability.

The below is an extract from the conversation:

Question:	**What is the most concerning thing that you've seen from management or the company?**
Anon:	The biggest concern I have is that there is absolutely zero accountability within Celadon and here's why. Lauren Howard who runs Truckload Operations - is best friends with Eric's (Meek) sister and grew up together, okay. And then Nate Roberts who is the President in Sales and then the other guy, I can't remember the other guys name now, but he runs (another group). They were fraternity brothers with Bobby (Peavler) and Eric (Meek). So when they're failing they might get a slap on the hand, but in the corporate America that I'm in - If you fail the way they fail, and they fail to lead the way that they're not leading, there's accountability by seeing you out the door (firing you). And so what's gonna happen, they will continue to fail and there will continue to be no accountability.
Anon:	Steve Russell (founder of CGI), who was a great guy just an absolutely great guy and a passionate leader. And now the company's run by a bunch of fraternity boys. Literally fraternity brothers. When he (Steve Russell) died, it just seemed like at that point Paul (Will) and Eric (Meek) just kind of went roughshod. Eric made some bold moves and created a lot of debt with acquisitions.
Anon:	The biggest problem that I have is that the board of Celadon is a kangaroo board. All of them were appointed by either Eric (Meek), Paul (Will) and a couple from Steve (Russell)…It's a kangaroo board that's never gonna get rid of Paul. And until that happens, Celadon it has the ability to be a great company again, but its never going to be a great company with the current leadership. Because then you have, the guy that runs Quality who's the President of Quality is also a fraternity brother of Eric, Bobby and Nate as well. So, you have a very incestuous organization that is unlike any other public company that I've ever seen.
Anon:	These are all fresh faced college kids. Celadon is kind of like Enterprise Rent-a-Car. Where, you can get in and get your first job for $30,000 boost your resume for two years and get out. So there's not a whole lot of seniority there. There's not a lot of experience there within the accounting group. 19th Capital was basically a shell organization run by the CEO's nephew. George Chasteen is the President there, and he's about 29 years old.

We looked into Anon's allegations, reviewing CGI's proxy filings and LinkedIn profiles. As shown in the table below,

- We identified five members of management who attended Franklin College, many of them graduating in the same class. In particular, the COO and CFO both graduated from Franklin's accounting program in 2002. In addition, three executives graduated in Franklin's class of 2006. We believe these individuals may have been fraternity brothers.
- Most of the members of management, based on our estimates, are in their late 20s or early-to-mid 30s.

Management Education Overview

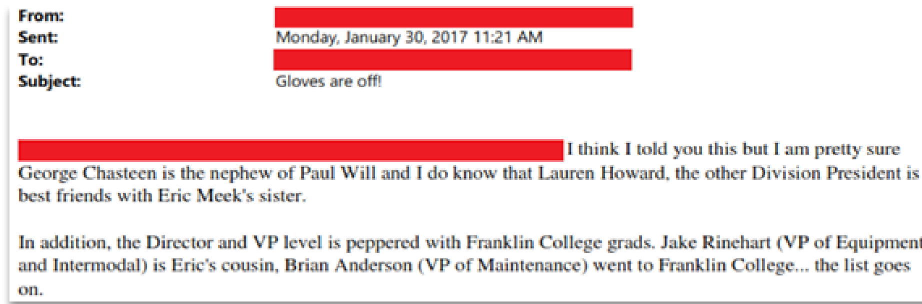
Name	Position	Age	Undergraduate University	Year of Graduation
Paul Will	Chairman & CEO	51	Indiana University	1988
Eric Meek	COO	37	Franklin College	2002
Bobby Peavler	CFO	37	Franklin College	2002
Jon Russell	President of Logistics	46	Cornell University	1993
Chad Hoffman	President of Specialized Biz	*Early 30s	Franklin College	2006
Nathan Roberts	President of Sales	*Early 30s	Franklin College	2006
Danny Williams	President of Quality Cos.	*Early 30s	Franklin College	2006
Lauren Howard	President of Truckload	*Late 30s	Butler University	2001
Michael Gabbei	Chief Information Officer	NA	IUPUI	NA
George Chasteen	President of Int'l Business	*Late 20s	Indiana U. of Bloomington	2008
Leslie Tarble	CFO of Quality Cos.	*Late 20s	Butler University	2008

Sources: CGI filings with the SEC and LinkedIn
*Age estimated based on year of graduation

We find it bizarre that CGI filled so many management positions with people from the same college. It is especially unusual considering that Franklin College has a total undergraduate enrollment of just 1,087 students.[13]

> *Franklin College is a private institution that was founded in 1834. It has a **total undergraduate enrollment of 1,087**, its setting is suburban, and the campus size is 207 acres. (US News)*

Another former CGI employee corroborated some of Anon's assertions in an email. The email (1) states that George Chasteen is the nephew of Paul Will, and (2) identifies yet more ranking managers, at the VP-level, who attended Franklin College:


From:
Sent: Monday, January 30, 2017 11:21 AM
To:
Subject: Gloves are off!

I think I told you this but I am pretty sure George Chasteen is the nephew of Paul Will and I do know that Lauren Howard, the other Division President is best friends with Eric Meek's sister.

In addition, the Director and VP level is peppered with Franklin College grads. Jake Rinehart (VP of Equipment and Intermodal) is Eric's cousin, Brian Anderson (VP of Maintenance) went to Franklin College... the list goes on.

In our opinion, deep-rooted cultural issues and managerial inexperience have been explanatory variables in countless accounting scandals and high-profile frauds.

Extremely Sloppy and Dubious Sell-Side Research is Back

The consensus price target of $11.57 values CGI at 1.1x reported tangible book value – a metric that we believe overstates CGI's 'true' TBV by 25x.

As shown in the table below, most sell side analysts are indeed anchoring their price targets to reported TBV:

Analyst Price Targets

($ in millions)	Price Target	Valuation Methodology	Rating
Avondale Partners	$11.40	1x TBV	Market Outperform
Aegis Capital	$15.00	Multiple methods; 1x TBV cited as a "price floor"	Buy
Stifel Nicolaus	$10.00	10.5x CY'19 EPS estimate of $0.96	Hold
Seaport Global	$11.00	1x TBV	Buy
Stephens	$11.00	1x TBV	Overweight
KeyCorp	$11.00	NA	NA
Average Price Target	**$11.57**		

Source: Sell-side reports

Analysts Aren't Carefully Reading CGI's SEC Filings

As a group, analysts have totally whiffed on identifying any of the egregious accounting irregularities highlighted in this report, many of which are clearly evident from a careful read of CGI's SEC filings.

We believe the sham Daylight loan highlighted in the subscription agreement should have resulted in slew of analyst downgrades. Unfortunately, it doesn't appear they made it through the JV Subscription agreement, which was attached as an exhibit to CGI's 10-Q. Instead, they've expressed overwhelmingly positive views about the JV. Sigh.

- **Stephens:** In a report dated 2/21/2017, Stephens stated the following about the JV:
  - *We are **encouraged by management's completion of the JV**, which we believe will generate modest income for CGI in the next few quarters and will further contribute to the Company's cash position.*
- **Seaport global:** In a report dated 1/12/2017, Seaport Global stated the following about the JV:
  - *We are **upgrading CGI to Buy** from Neutral with an $11 price target. **Spinning off the JV was a big step** for CGI, which now allows the company to refocus on its core trucking business.*

Analysts Reports Contain Egregious Mathematical Mistakes

If it isn't enough that analysts are assigning CGI a valuation based on its reported TBV (in our view, a fabricated number), they are also not factoring into their TBV calculations CGI's $74.8m of off-balance operating lease liabilities (at present value)!

Further damaging the credibility of analysts are the egregious mathematical errors we found in some of their reports. In a report issued by Seaport on 1/12/2017, their analyst derives his FY'17 FCF estimate for CGI of $18.2m - $36.2m, in part, by erroneously assuming $10M-$12M of capital lease payments in FY'17.

$ in millions	FY'17E		
Period Ending:	Jun-17		
	Low	Base	High
Net Income	**($0.7)**	**($0.7)**	**($0.7)**
Depreciation	$76.9	$76.9	$76.9
Net Capex	($35.0)	($30.0)	($25.0)
Cash Interest	($1.0)	($0.5)	$0.0
Cash Taxes	($10.0)	($7.5)	($5.0)
Capital Leases	($12.0)	($11.0)	($10.0)
FCF	**$18.2**	**$27.2**	**$36.2**

- **Seaport's capital lease projection is too low given that current capital lease maturities were $51.4m at the end of FY'16. When $51.4M of capital lease payments are properly deducted, Seaport's FCF estimate would be a LOSS of between $5.2M-$21.2M. Given that Seaport cited positive FY'17 FCF as one of the reasons to buy CGI shares, this error greatly damages the credibility of its analysis.**

In the same report, Seaport stated that a complete write-down of CGI's $100m JV stake would only result in a $2/share reduction in TBV:

> *Even if CGI were to write off the entire $100MM investment, which does not make sense in our opinion, it would only equate to ~$2.00/share in total.*

Again, Seaport's analysis is simply wrong. At the end of Q2'17, CGI had 28.3m of basic shares outstanding. A $100m write off would result in an almost $4/share reduction in TBV, not the $2/share reduction Seaport cited.

Until analysts begin to analyze CGI's business in a more critical and accurate manner, investors should assign little value to their reports. To be frank, we are disappointed that analysts could be so apathetic / ignorant to what are fairly obvious red flags. We hope that this report will be the catalyst for them to provide a more meaningful evaluation of CGI's business.

Endnotes

[1] Financial Shenanigans
[2] CGI FY 15 10K
[3] March 2015 Element presentation
[4] 8-K from 01/06/2017: "The new Service Agreement does not contain any payment remitting, "Perfect Pay" or similar obligation"
[5] *WHEREAS, Element desires to (i) transfer, convey and assign to the Company certain of Element's beneficial interests in the fleet described on Schedule 1(a)(i), together with the associated lease agreements, held in the Element Transportation Asset Trust, a Delaware statutory trust (the "JV SUBI Interests"), which has an **aggregate value of $659,123,151.02**…and (iii) transfer, convey and assign to the Company certain of Element's beneficial interests in the fleet described on Schedule 1(a)(ii), together with the associated lease agreements, held in the Element Transportation Asset Trust, a Delaware statutory trust (the "Equipment SUBI Interests") which has an aggregate value of $8,407,587.16; (Subscription Agreement, 02/10/17)*

[6] As discussed in more detail below, CGI extended the useful life of its equipment in FY 16.
[7] *CGI disposed of a total of $162.5m of Quality equipment in connection with the JV. Of which, $56.7m was sold for cash, $63.6m was contributed to the JV and the remaining $42.4m was used as collateral to settle prior debts.*
[8] FY'16 10-K: "*Included in net cash provided by operating activities is the change in leased and revenue equipment held for sale. The change in the account is made up of the net purchases and sales of equipment purchased only for the benefit of our equipment leasing and services segment." Note: "equipment leasing and services segment" relates to Quality.*
[9] CGI Proxy dated 10/28/2016
[10] We excluded Q4'16 since the PP&E accounting in this quarter was distorted by CGI's conversion of $69.2m of capital leases to operating leases.
[11] Per From CGI's FY'16 10-K: *On September 13, 2016, we signed a Memorandum of Understanding (the "MOU") with Quality's main third party financing provider, under which substantially all of Quality's tractors under management owned by such third party financing provider, 19th Capital, and Quality would be combined into 19th Capital as a joint venture. Under the MOU, **the joint venture would own all or substantially all of the 11,300 tractors under management by Quality that are currently owned by a combination of Quality, 19th Capital, and the financing provider**.*
Per CGI's press release dated 12/30/2016: *The joint venture represents the combination of the former equipment leasing portfolios of Celadon, Element, and 19th Capital that were managed by Quality. **The joint venture holds over 10,000 tractors for use in leasing operations**, with a business plan focused on leasing to trucking fleets.*
[12] Our knowledge of BKD's revenue is limited to its audits of public companies. BKD likely has a substantial business related to services provided to private companies. However, we believe the prestige and stature of BKD to its local private clients is impacted by its relationship with the local public companies. Therefore, we believe BKD's relationship with Celadon is likely important to the overall success of the office and the partners in that office.
[13] Per U.S. News