PRESCIENCE POINT

CHICAGO BRIDGE & IRON | CBI

INVESTMENT RESEARCH REPORT

Acquisition Accounting Gone Nuclear

RECOMMENDATION: ***STRONG SELL***

Chicago Bridge & Iron Co N.V. | NYSE: CBI

Prescience Point believes:

Shares of Chicago Bridge and Iron Co N.V. ("CBI", or "the company") are grossly overvalued. CBI has used creative acquisition accounting to conceal losses, resulting in GAAP financial statements divorced from its economic realities. After acquiring Shaw Group in 2013, CBI made unusual and repeated retroactive adjustments to its purchase price allocation. Doing so enabled it to amass a ~$1.56B reserve that can be converted directly into gross profit to offset future costs, thereby inflating profitability. For example, we estimate that CBI's 2013 reported Gross Margin was inflated by 27%, and EBITDA and reported Adj EPS were overstated by 36%, and 52%, respectively; absent the non-cash benefit from this reserve, CBI would have reported a -10% contraction in pro-forma EPS, not +47.4% growth, as it did. CBI is struggling with certain Shaw contracts that may prove to be severely loss making, and the reserve is being used to mask their impacts and CBI's increasingly fragile financial condition. Q1'2014 results confirm our expectations that CBI continues to face headwinds, including continued losses, divergence of earnings and cash flow, and a rising dependency on debt. CBI likely has no excess cash, and is already overleveraged. While CBI has $1.35B of revolver availability, this may prove temporary: We believe CBI will be forced into a goodwill write-down or financials restatement, either of which would trigger debt default, heightening the risk of a liquidity crisis or dilutive equity raise.

Meanwhile, Wall Street analysts are missing the forest for the trees, anchoring their projections to CBI guidance without knowledge that CBI is using cookie jar accounting to 'close the gap' on achieving it. We believe CBI has presented itself to the investing public in a highly questionable manner and that, as a result, it has been successful in its efforts to inflate its stock price beyond reasonable measure. ***Based on our analysis, CBI stock is worth ~$37 per share, ~49% below current trading levels.***

Research Highlights

Key Data

Conclusion:		**Strong Sell**
Current Price:	$	73.58
Price Target:	$	37.38
% Downside		***(49)%***
Ticker:		CBI
Exchange:		NYSE
Capital Structure		
Basic Shares o/s		108.1
Dilutive Options & RSUs		1.0
Fully Diluted Shares		109.1
Market Capitalization	**$**	**8,028.34**
Add: Total Debt	$	2,034.75
Add: Minority Interest	$	173.79
Less: Unrestricted Cash	$	(420.16)
Enterprise Value	**$**	**9,816.73**

Street Consensus

	Fiscal Year Ended Dec 31,		
($ millions)	**2013A**	**2014E**	**2015E**
Sales	$11,095	$13,134	$14,370
Gross Profit	$ 1,199	$ 1,416	$ 1,625
% Margin	*10.8%*	*10.8%*	*11.3%*
EBITDA	$ 960	$ 1,132	$ 1,274
% Margin	*8.7%*	*8.6%*	*8.9%*
Adj. EPS	$ 4.91	$ 5.07	$ 5.94
Valuation	**2013A**	**2014E**	**2015E**
EV/Sales	0.9x	0.7x	0.7x
EV/EBITDA	10.2x	8.7x	7.7x
P/EPS	15.0x	14.5x	12.4x

Source: CapitalIQ
Note: Street estimates overstate CBI's economic potential, as they fail to adjust for aggressive accounting assumptions

Diversified Balance of Accounting/Non-Accounting Red Flags is Concerning

- *Use of Creative Acquisition Accounting Conceals Financial Problems, Inflates Profitability:* We believe by using creative acquisition accounting, CBI inflated its 2013 gross margin by 27% and reported EBITDA and Adjusted EPS by **36% and 52%**, respectively, and can continue inflating its profitability for years. CBI coincidentally wrote-up its backlog by $1.8B.
- *CBI Appears to be Concealing Losses from Certain Contracts:* CBI is struggling with certain Shaw contracts that may prove to be severely loss making, and Prescience Point believes this reserve is being used to mask the negative financial impacts of those contracts; however, based on our estimated use of the reserve in Q1'2014 results, even a reserve so large may not suffice to protect the bottom line.
- *Signs of Deception / Lack of Transparency:* Despite financial statements showing that the SHAW acquisition was at best an utter failure and at worst an attempt to hide declining profitability, CBI touts the success of the transaction, which we believe is misleading. CBI does not disclose that its underlying financial performance is dramatically different from what it reports to investors; CBI does not disclose by exactly how much income is inflated by its release of the reserve or why the reserve was created in the first place. CBI also appears to misrepresent the nature of the Contracts in Progress account, to which the adjustments were made, and blames increasing backlog on currency movements instead of the adjustments.
- *Pattern of PPA Adjustments Raises Red Flags; May Point to GAAP Violation*: CBI made incessant pre-acquisition assurances of having thoroughly vetted the Shaw nuclear projects and reiterated its confidence post-acquisition, which is why the pattern of CBI's PPA adjustments is bizarre: $1.2B of the total ~$1.56B reserve was created in Q3 and Q4, 8 to 11 months after the acquisition & ~18 months after CBI and Shaw entered a definitive agreement in July, 2012.
- *Flawed Corporate Governance May Encourage Earnings Manipulation:* Management comp is skewed towards their success at generating as much in earnings as possible, regardless of quality, and the adjustment may have allowed them to pay themselves over 200% more than they should have been paid in FY2013.

How We Expect the Dominoes to Fall

- CBI is more leveraged than it appears, and in our view overleveraged given its risk exposures. On our adjustments, we estimate LTM Q1'14 leverage to be 3.0x EBITDA, ~50% higher than indicated by its reported financials. Meanwhile, CBI's $420m cash balance is misleading – its net Contracts in Progress liability is effectively a direct claim on this cash.
- CBI likely has no excess cash; if CBI continues taking cash losses, as it has been, and/or bookings decline, which we anticipate, CBI would be forced to depend further on its revolvers, as it did in the most recent quarter: In Q1'14, CBI reported income of +$89m, which we estimate was boosted by reserve release of +$134m, meaning CBI would have reported a net loss of -$46m absent the noncash boost. Our calculation of a quarterly loss is reflected by reported CFFO of -$145.7m. CBI drew on its revolver, increasing total debt from $1.84B in Q4'13 to $2.034B, enabling it to report a flat cash balance. CBI still has $1.36B of available capacity under its revolving credit facilities.
- However, we believe CBI will be forced to write-down its grossly overstated goodwill, which CBI wrote-up to offset its repeated write-downs of Shaw's book value, but at a time when Shaw's value was declining. CBI's write-down of Shaw goodwill is likely to trigger a debt default, heightening the risk of a liquidity crisis or a pre-emptive dilutive equity raise.

CBI equity is overvalued on almost every metric

- As is evident in the 1Q2014 results, non-cash income released from CBI's loss reserve has led to a significant detachment between reported net income and operating cash flows. The reality of CBI's business without the Shaw adjustments leads PP to initiate CBI with a $37 price target, or 49% below the current share price.

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Executive Summary

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Meanwhile, Wall Street analysts are missing the forest for the trees, anchoring their projections to CBI guidance without knowledge that CBI is using cookie jar accounting to 'close the gap' on achieving it. We believe CBI has presented itself to the investing public in a highly questionable manner and that, as a result, it has been successful in its efforts to inflate its stock price beyond reasonable measure. ***Based on our analysis, CBI stock is worth ~$37 per share, ~49% below current trading levels.***

Acquisition Accounting Gone Nuclear! Shenanigans Distort CBI's True Economics: After acquiring Shaw Group in 2013, CBI made repeated retroactive adjustments to its purchase price allocation. Each adjustment amounted to a write-down of Shaw's book value, by our estimates enabling CBI to amass a ~$1.56B reserve for the purpose of offsetting future costs; when used to cancel out costs, this reserve is effectively converted directly into gross profits, which inflates CBI's profitability and conceals from shareholders that it is struggling with the acquired nuclear contracts that may prove to be severely loss making. And the gift of this reserve can keep on giving; based on our estimates it,

- amounts to ~5 years of Prescience Point-adjusted CBI net income, and
- equates to a ~3x increase in the gross margin for the acquired nuclear projects

For 2013, we estimate CBI's reported Gross Margin was inflated by 27%, and EBITDA and reported Adj EPS by 36%, and 52%, respectively, resulting in a dramatic deterioration of its earnings quality: CBI reported the highest earnings in its history as a public company and the lowest level of and first year of negative reported CFFO in its history. Had income not been inflated we believe CBI would have reported a -22% miss – not the +17% beat – of 2013 Wall St consensus EPS; it would have reported a -10% contraction in 2013 pro-forma EPS, not the +47.4% growth it did. CBI also made retroactive adjustments to backlog – the principal driver of valuation for E&C companies – acquired from Shaw, increasing it by $1.8B with the strike of a pen.

Furthermore, CBI is more leveraged than it appears, and in our view overleveraged given its risk exposures. On our adjustments, we estimate LTM Q1'14 leverage to be 3.0x EBITDA, ~50% higher than indicated by its reported financials. CBI is an overleveraged outlier in an industry that tends to keep funded debt balances low because of highly volatile cash flows. Meanwhile, CBI's $420m cash balance is misleading – its net Contracts in Progress liability is effectively a direct claim on this cash. We believe CBI's inflated financials are masking an increasingly fragile financial position.

CBI Appears Deceptive in Informing Shareholders of its Realities: We believe CBI is knowingly or recklessly failing to disclose that its underlying financial performance is dramatically different from what it reports to the investing public. CBI does not disclose by exactly how much income is inflated by its release of the reserve or why the reserve was created. Worse, despite financial statements showing that the Shaw acquisition is a failure, CBI touts the success of the transaction, which we believe is misleading. Management also appears to mislead analysts when asked why backlog could not be reconciled with its fundamental drivers, blaming currency movements and making no mention of their having written-up the Shaw acquired backlog (i.e. the real reason). Furthermore, management appears to misdirect investors and analysts in stating that Shaw's Contract in Progress liability is was created entirely as a function of upfront payments received, a blatant lie likely stated to avert drawing attention to the liability's non-cash component – the PPA fair value adjustment CBI is using to inflate income without disclosure.

Q1'2014 Results Signal Continued Losses, Income-to-Cash Flow Divergence and Increasing Reliance on Debt: CBI is struggling with certain contracts that may prove to be severely loss making, and PP believes the reserve is being used to mask the effect of those contracts. CBI's Q1'2014 results confirmed our expectations, signaling continued losses and income-to-cash flow divergence. CBI reported Q1 net income of $89m and EPS of $0.82, missing consensus of $1.11 by -26%. We estimate the results were boosted by $134m of non-cash income from release of the reserve, far greater than we would have expected based on our straight line estimates (i.e. $286m per year, or $71.5m per quarter); this raises the question of whether future losses will exceed what the reserve can cover, therefore flowing to the bottom line. Excluding the non-cash income boost, we estimate CBI would have reported a net loss of -$46m, or -$0.43 per share. Our calculation of a quarterly loss is reflected by CBI reported negative quarterly CFFO of -$145.7m.

The Q1'2014 results indicate an increased reliance on debt to cover cash losses, with CBI drawing on its revolver, taking total debt from $1.84B in the previous quarter to $2.034B and enabling it to maintain a flat cash balance.

This reliance may continue growing. We believe CBI's $420m net cash position is misleading, in that the company is likely to have no excess cash. CBI will have to spend a significant amount of that cash, if not all of it, to actually "earn" the deferred revenue balance sitting on its balance sheet. Continued cash losses or a decline in bookings would necessitate CBI increase its dependency on its revolver. While the company has $1.36B of available capacity under its revolving credit facilities, we believe CBI will be forced to write-down its bloated goodwill balance, triggering a default on its minimum net worth covenant and heightening the risk of a liquidity crisis.

Goodwill Grossly Overstated; a Write-down Would Trigger Debt Default: We believe CBI's balance sheet is bloated by a grossly overstated goodwill balance, the direct result of CBI's PPA fair value adjustments, which elevates the risk of a goodwill write-down and a consequent default on its debt covenants. As of Q1'2014, CBI's $4.2 billion goodwill balance equates to 162% of its $2.441B book value. $3.3 billion of that goodwill balance, or 126% of the consolidated company's book value, is attributed directly to the Shaw acquisition. CBI has a covenant that as of March 31, 2014, requires it to maintain a minimum net worth of $1.762B. CBI's current net worth is $2.441B, meaning that a goodwill write-down of only $679m would result in a debt default. We believe a goodwill write-down is necessary and a likely event, as the evidence suggests that Shaw deteriorated substantially in 2013 under CBI ownership, while at the same time CBI wrote-up Shaw goodwill as an offset to its PPA adjustments.

Bizarre Pattern of FV Adjustments Raises Red Flags; May Point to GAAP Violation: There is no way for outsiders to know with certainty whether CBI's adjustments to Shaw's financials are reasonable; but, it is surprising that CBI needed to make any post-acquisition adjustments in the first place. Prior to the acquisition, it incessantly assured investors it had thoroughly vetted the Shaw nuclear projects, repeatedly expressing confidence in its 3 month due diligence process and affirming that, 1) "*the risk profile and expected profit of the nuclear projects is consistent with Shaw public statements,*" and 2) the "*nuclear contracts were well-structured from the perspective of protecting Shaw (and thus CB&I post-Transaction) in the event of overruns, increased input costs, or performance delays…*" And because the nuclear projects are public works with information describing their progress freely available, CBI should indeed have been able to complete a thorough due diligence process. Furthermore, for months after the acquisition, CBI continued to maintain its confidence in the conclusions drawn from its pre-acquisition due diligence.

This is why the pattern of PPA adjustments appears bizarre. CBI made $1.2B of the total ~$1.56B (>75%) fair value adjustment in Q3 and Q4 alone, eight to eleven months after the deal was completed and nearly 18 months after CBI and Shaw entered into a definitive agreement in July 2012.

In sum, in light of the completeness of CBI's pre-acquisition due diligence and its reassurances in its due diligence process months after the acquisition, the pattern of CBI's fair value adjustments – with the lion share of the total adjustment being made in Q3 and Q4 – appears to indicate they were made in response to post-acquisition events. If so, the PPA adjustments are not legitimate and CBI has violated GAAP by not taking charges against its earnings. Additionally, CBI having made the adjustments in response to post-acquisition events in violation of GAAP is supported by the existence of a litany of post-acquisition events which, we think, should have negatively impacted CBI's guidance and financial statements, but never did.

Flawed Corporate Governance May Encourage Earnings Manipulation: The PPA adjustment feeds right into the core driver of CBI's incentive structures – Adjusted EPS. As this measure rose sharply in 2013, management realized both, 1) a large payout of annual incentive, and 2) an acceleration in the vesting of CBI shares doled out as part of CBI's long-term incentives plan. With the bulk of cash incentive compensation tied to Adjusted EPS targets, the Shaw acquisition could serve to reward CBI management lavishly with annual cash bonuses that leave little long-lasting accountability for shareholders, and in turn, incentivize further empire-building at the expense of long term cash on cash returns for shareholders.

CBI of course defines Adjusted EPS as "EPS excluding merger and acquisition costs," but its calculation does not appear to exclude the non-cash benefit from recognition of the PPA fair value adjustment. This translates to a management capability to artificially inflate CBI's underlying earnings, meet EPS bonus targets, and get paid out of shareholders' pocket books; from a moral standpoint, it is akin to a theft.

Decisions made by CBI's board also seem to evidence a tacit acknowledgement that it is moving past looking at CBI's ability to generate cash earnings. In 2013 it made a change to the management annual incentive structure, reducing the weighting of Free Cash Flow as a determinant of bonuses, from 20% – where it was set in 2011 and 2012 – to 10% in 2013, amounting to a reorientation toward lower quality earnings vs. higher quality, cash-based earnings. We note that CBI had not achieved the minimum FCF target requirement in either 2012 or 2013; further, CBI was so far off from its minimum FCF targets in 2012 ($130m actual vs. $987m min target) and 2013 (-$203m actual vs. $500m min target) – even though the minimum FCF target was slashed by 50% from 2012 to 2013 – that the misses raises serious questions as to the health of the underlying business and the quality of its earnings!

The board's position can also be gleaned from its recent decision to award CBI's CEO with a $2m discretionary bonus for the 'successful integration' of Shaw in 2013, the same year the company generated the lowest level of free cash flow in its history.

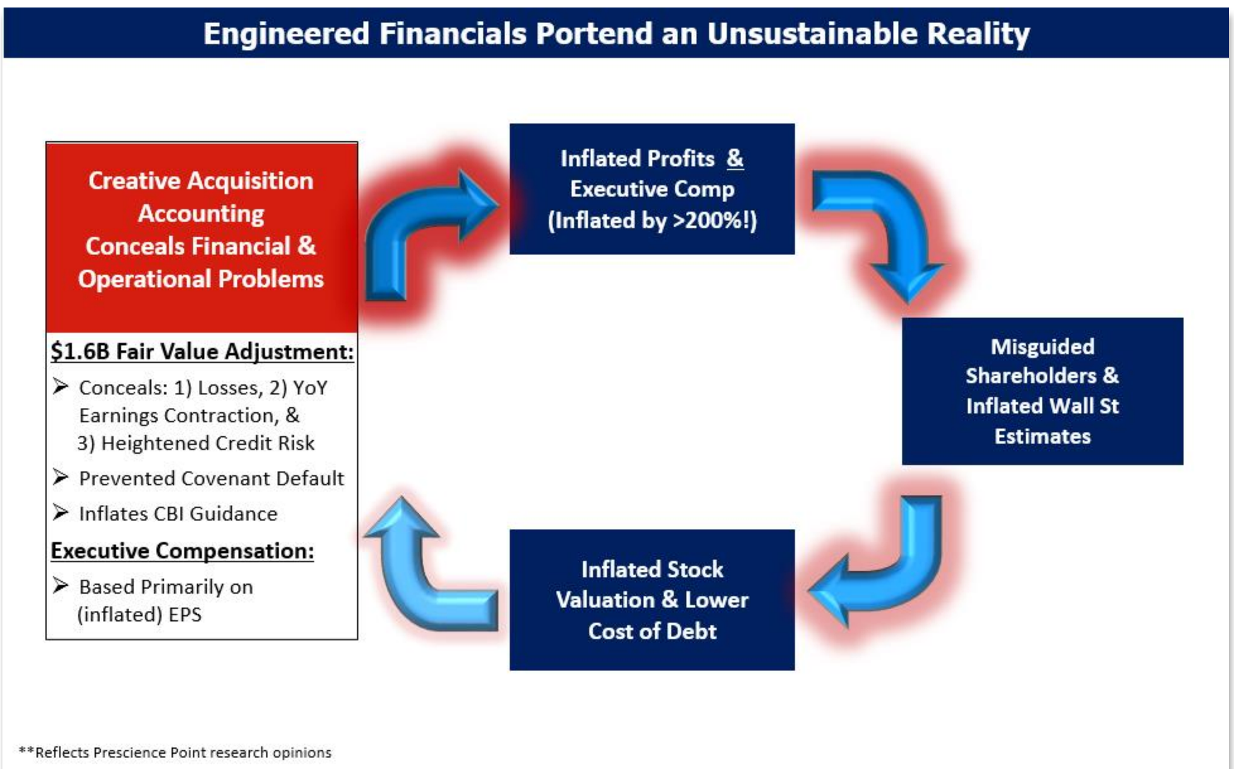
Prescience Point Call with Management Confirms Creation of Reserve & Use Primarily to Offset Costs: Given the gravity of our findings, we arranged calls with CBI Investor Relations (IR) for more clarity. We spoke with a CBI IR contact on 2 occasions (3/26/14 and 5/14/14). He was helpful in answering questions and had a working knowledge of the PPA adjustments, although we asked several questions he either did not know the answer to or just did not want to answer, asking that we follow-up by emailing him a written list of these and other questions we might have. We found it interesting that, even though we contacted the company anonymously, without prompt they asked to review anything we might plan to publish. We requested two different times to have a follow-up call with the CFO but these requests were not met. Following our 5/14/14 call, we emailed IR our follow-up questions, which dove deeper into the financial statement impacts of the PPA adjustments and accounting impacts of unapproved change orders. We have not heard back.

Regardless our contact with management confirms the core of our thesis – that CBI is offsetting costs, and thereby inflating its profitability, made possible by its post-acquisition adjustments to the Shaw PPA.

CBI is Overvalued, and on Almost Every Metric: The mirage of CBI's reported gross margin, EBITDA, and EPS, has existed for long enough to result in the levitation of its stock price to a valuation that defies reasonable measure, reflecting an extreme disconnect from its business realities. On the surface, CBI appears to be trading at moderate multiples of 8.7x and 14.5x 2014E EBITDA and reported Adj. EPS, respectively. However, both EBITDA and EPS fail to reflect the true costs of CBI's business; they are inflated by CBI's release of non-cash income from its loss reserve to offset costs. By adjusting these metrics accordingly, we estimate that CBI is selling at true 11.6x 2014E EBITDA and 22.4x EPS, meaning that CBI is the most expensive (and in our view the highest risk) E&C in its sector – *truly preposterous*. CBI's E&C comparables on average trade at 8.3x and 17.3x 2014E EBITDA and EPS, respectively – much lower valuations.

"Creative Acquisition Accounting – Let me turn now to the second gimmick. In recent years, whole industries have been remade through consolidations, acquisitions and spin-offs. Some acquirers… have used this environment as an opportunity to engage in another form of "creative" accounting… The creation of large liabilities for future operating expenses to protect future earnings -- all under the mask of an acquisition."

Former SEC Chairman Arthur Levitt, "The Numbers Game"



Acquisition Accounting Gone *Nuclear*! Shenanigans Distort CBI's True Economics

CBI created a loss reserve using acquisition accounting that we believe results in a highly misleading portrayal of its true economics, rendering its reported financial statements useless toward evaluating its business. Based on our analysis, excluding the non-cash income boost resulting from creative accounting reveals that,

- CBI's reported Gross Margins, Adjusted EBITDA, and reported Adjusted EPS are all significantly inflated: For example, 2013 gross margin was inflated by 230 basis points, or 27%, and Adj EBITDA and reported Adj EPS were overstated by 36% and 52%, respectively.
- CBI would have reported a -22% miss – not the +17% beat it did report – of the 2013 Wall St consensus Adj EPS target: While CBI reported a beat, with 2013 reported Adj EPS of $4.91 handily surpassing the guidance midpoint (i.e., $4.17) and Wall St's consensus estimate (i.e., $4.18) by over +17%, CBI would have reported a severe miss of each.
- CBI would have reported a 2013 pro-forma EPS contraction of -10%, not the pro-forma EPS growth of +47.4% that it did report.
- Wall St analyst estimates are severely inflated, as their consensus targets are anchored to CBI's reported Adj EPS and guidance.
- CBI appears overleveraged, with its leverage ratio as of Q1'14 exceeding 3.0x, ~50% higher than represented by its financials.
- CBI has made retroactive adjustments to backlog – the principal driver of valuation for E&C companies – acquired from Shaw, increasing it (and therefore its consolidated backlog) by $1.8B, seemingly with the simple strike of a pen!

The table below contains the summation of our adjustments to CBI's reported financial statements, each of which we detail in the sections that follow.

Prescience Point Adjusted Financial Statements for CB&I

($ in millions)	2013	2014E (1)	2015E (1)
CBI Revenue	$11,094.5	$13,134.3	$14,370.4
CBI Gross Profit	**$1,199.0**	**$1,415.9**	**$1,625.3**
(-) Non-Cash Benefit from Loss Reserve (2)	($252.3)	($286.7)	($286.7)
Prescience Pt Adj. Gross Profit	**$946.7**	**$1,129.2**	**$1,338.6**
Prescience Pt Adj. Gross Margin	*8.5%*	*8.6%*	*9.3%*
CBI Reported Gross Margin	*10.8%*	*10.8%*	*11.3%*
Gross Margin, % Overstatement in CBI Reported Financials (4)	***27%***	***25%***	***21%***
CBI Adj. EBITDA	$960.3	$1,131.6	$1,273.9
(-) Non-Cash Benefit from Loss Reserve (2)	($252.3)	($286.7)	($286.7)
Prescience Pt Adjusted EBITDA	**$708.0**	**$844.9**	**$987.2**
EBITDA, % Overstatement Reflected by CBI Reported Financials (4)	***36%***	***34%***	***29%***
CBI Adj. EPS	$4.91	$5.07	$5.94
(-) After-Tax Benefit from Loss Reserve (3)	($1.67)	($1.79)	($1.78)
Prescience Pt Adjusted EPS	**$3.24**	**$3.28**	**$4.16**
EPS, % Overstatement Reflected by CBI Reported Financials (4)	***52%***	***54%***	***43%***
CBI Reported % Beat on 2013 Wall St Consensus Adj EPS of $4.17 (1)	***17.7%***		
PP Estimated % Miss on 2013 Wall St Consensus Adj EPS of $4.17 (4)	***(22.4)%***		
CBI Reported 2013 EPS Growth, Pro-Forma for Shaw Acquisition (5)	***47.4%***		
PP Estimated 2013 EPS Contraction, Pro-Forma for Shaw Acquisition (4)	***(10.0)%***		

(1) Street consensus data sourced from CapitalIQ
(2) Prescience Point (PP) estimate - based on company disclosures the fair value (FV) adjustment will be recognized over the life of nuclear projects, we straight-line its balance over 5-6 years. The 2013 non-cash benefit was prorated for 2/13/13 acquisition closing date. Our calc for 2013 Pro-Forma EPS growth appropriately assumes non-prorated value for non-cash benefit from loss reserve.
(3) PP estimate - assumes tax rates of 28% for 2013 and 32% for 2014E (per CBI guidance) and 2015E
(4) PP calculation
(5) Growth rate reflected by CBI 2012 & 2013 pro-forma financials (disclosed in CBI's 10-K for 2013), which assume Shaw had been consolidated as of 1/1/12
Sources: CBI filings with the SEC, Prescience Point estimates, Wall Street consensus from CapitalIQ

Background: The PPA Adjustment Process Can be Abused to Enable Earnings Manipulation

CBI's acquisition of Shaw Group was completed on February 13, 2013. As required by GAAP, CBI adjusted the acquired assets and liabilities to fair value and carried out a purchase price allocation (PPA). This preliminary PPA was disclosed in CBI's 10-Q for Q1'2013.

Under GAAP, an acquirer is allowed to make retroactive adjustments to the purchase price allocation for a period of up to 12 months following the acquisition date (i.e., the 'measurement period'). Post-acquisition PPA adjustments can, of course, be legitimate but can potentially be used as a device to enable earnings manipulations, particularly when the acquirer artificially depresses the book value of the target company by writing-down its assets and/or writing-up its liabilities; this gives the company the ability to generate 'fictional' (i.e., non-cash) earnings by later reversing the asset write-downs and/or liability write-ups.

As a result of this type of cookie jar accounting, all else equal, the acquirer will be able to go on to report margin expansion (or maintenance if costs are rising), inflated earnings, and increased book value, but with no corresponding increase in operating cash flow.

CBI Made Several Adjustments to the PPA, in Each Case Further Depressing Shaw's Book Value

Over the course of the year following its acquisition of Shaw, CBI made repeated retroactive adjustments to Shaw's assets and liabilities, in each case furthering the write-down of Shaw's book value. CBI does not provide a summary of all its post-acquisition adjustments in any of its filings. We summarize all these adjustments – compiled from four different CBI filings – in the table below, and have highlighted the most substantive changes to account values.

CBI Repeatedly Adjusted its PPA for Shaw, Each Time Depressing its Tangible Book Value

	Shaw Account	Purchase Price Allocation (PPA) for Shaw			
($ thousands)	2/13/2013 (1)	Q1 2013	Q2 2013	Q3 2013	Q4 2013
Net tangible assets:					
Unrestricted cash		1,137,927	1,137,927	1,137,927	1,137,927
Inventory		272,192	272,192	272,192	272,172
Other current assets		494,706	504,442	504,442	615,804
Property and equipment		495,837	536,563	516,407	536,888
Other non-current assets		76,249	76,258	76,258	68,881
Deferred income taxes, net		303,407	278,323	543,006	543,479
Westinghouse obligations, net		(44,793)	(44,793)	(44,793)	(44,793)
Contracts in progress, net (CIP)	**(753,786)**	**(1,117,786)**	**(1,121,164)**	**(1,779,871)**	**(2,317,471)**
Cumulative Adjustment to CIP		***(364,000)***	***(367,378)***	***(1,026,085)***	***(1,563,685)***
Accounts payable		(535,488)	(535,488)	(535,618)	(546,465)
Other current liabilities		(459,530)	(468,327)	(442,814)	(466,129)
Other non-current liabilities		(123,977)	(154,261)	(145,616)	(216,953)
Total net tangible assets		**498,744**	**481,269**	**101,520**	**(416,660)**
Intangible assets: (4)					
Backlog and customer relationships		271,000	280,800	280,800	375,200
Tradenames		120,500	121,000	121,000	73,800
Other		10,400	10,300	10,300	11,200
Total intangible assets		401,900	412,100	412,100	460,200
Goodwill		**2,449,147**	**2,446,701**	**2,826,450**	**3,296,530**
Total purchase price		3,349,791	3,340,070	3,340,070	3,340,070
Unrestricted cash acquired		(1,137,927)	(1,137,927)	(1,137,927)	(1,137,927)
Total purchase price, net of		2,211,864	2,202,143	2,202,143	2,202,143

(1) Prescience Point estimate of Shaw's acquisition closing date CIP, net; imputed based on FV adjustment disclosure in CBI's Q1'13 10-Q

Sources: CBI filings with the SEC; Prescience Point estimates

The most significant adjustments CBI made were to Shaw's Contracts in Progress, net (CIP), an account used in the accounting for construction contracts. It is the net of an asset account (unbilled receivable) and a liability account (deferred revenue). On the acquisition date (February 13, 2013), the net sum of these two for Shaw was a liability – deferred revenue – of $754m. As of Q4'2013, CBI had significantly adjusted this account higher to an ending value of $2.317B.

In sum, CBI made cumulative adjustments to Shaw's Contracts in Progress totaling **$1.56B**. Since Contracts in Progress is a net account, it would include any of the additional costs in the $1.56B CIP account adjustment. In other words, it appears CBI's PPA adjustment is essentially **100% margin revenue – a cookie jar of $1.56B of non-cash income that CBI can use to inflate its profitability and/or hide losses in the future**.

Furthermore, because the loss reserve was created via acquisition-related PPA adjustments, CBI was able to offset the cost with an increase in goodwill, preventing any signs of its creation from hitting its income statement as a charge to earnings, which likely would have drawn investor scrutiny.

And we cannot emphasize enough just how gargantuan this cookie jar reserve is in size:

- $1.56B is equal to ~90% of the market value of Shaw's equity before the CBI acquisition offer!
- $1.56B is also equal to **~3x cumulative Shaw profits** spanning the **twenty years** from 1993-2012 ($555m)!!
- The combined CBI's entire gross profit and net income (based on our adjustments) as of LTM Q1'2014 were $967m and $316m, respectively. The reserve **equates ~1.6x CBI's gross profit for an entire year, and ~5x its net income**!

Reserve Made Against Nuclear Contracts, Implies CBI Increased Shaw Nuclear Project Margin by ~3x

CBI discloses in its 2013 10-K that the Shaw CIP fair value adjustments totaling $1.56B were made to Shaw's two large nuclear project contracts – the Vogtle project in Georgia and V.C. Summer project in South Carolina:

> *The acquired Shaw operations included a net contracts in progress liability of $2.3 billion, primarily related to upfront payments received on our two large nuclear power projects prior to the Acquisition Closing Date and fair value adjustments associated with the contracts.*

We note that in CBI's 'Shaw acquisition presentations' (dated August 2012 and November 2012), CBI discloses information revealing the total margin it expected from the two nuclear projects to be ~$782m (refer to extract below).[1] Comparing this with the $1.56B of cumulative margin fair value adjustment indicates that CBI is doing the equivalent of raising its margin on these two projects by ~3x!

Power
- Backlog $9.2 billion; 52% of total; 10 material contracts; gas, coal , nuclear and retrofit
- Vogtle and Summer projects represent approximately 85% of Power sector backlog; expected gross margin is in excess of 10%
- Problem coal projects nearing completion, appropriately reserved

Adjustments Indicate Shaw Acquisition at Best a Failure, at Worst Driven to Obfuscate Decline

We believe both the existence and size of the fair value adjustment indicate that either,

- The Shaw acquisition is a CBI failure: Management either misjudged the quality of Shaw's assets prior to the acquisition or Shaw has turned for the worst, substantially deteriorating under CBI's ownership, or,
- The Shaw acquisition was made to obfuscate what was bad: In other words, the Shaw assets are performing as CBI had anticipated in its pre-acquisition due diligence, and the loss reserve was created solely as a device to cover up a precipitous decline in the rest of its business.

[1] CB&I and the Shaw Acquisition presentation November 2012, slide 11

Either way, as we will demonstrate extensively in this report, we believe CBI has not been honest in informing shareholders of these realities.

PPA Adjustments Result in Earnings Mirage

CBI notes that a large part of these adjustments will be included in revenue over the next five or six years. Per the 10-K for 2013:

> *Contracts in Progress — Included in contracts in progress is a **margin fair value adjustment** of approximately **<u>$745,500</u>** associated with **<u>acquired long-term contracts that were less than fair value</u>** at the Acquisition Closing Date. This margin fair value adjustment will be **<u>included in revenue on a POC basis</u>** as the applicable projects progress **<u>over approximately five to six years</u>**.*

The note above states that $746m will be recognized over the next five to six years; however, the total adjustment was $1.56B, which leaves the treatment of the remaining $744m undisclosed. CBI has not disclosed how this remainder will be recognized in revenue, but we would expect for it also to be recognized in the time it takes to complete the nuclear projects – over 5-6 years – and, this was corroborated on our recent call with management.

Assuming recognition of the $1.56B total adjustment on a straight-line basis, we estimate that <u>on average $286.7m of non-cash income will be released into gross profit each year for 5.5 years</u>.

In the table below, we demonstrate the impact of an adjustment of this size on CBI's LTM Q1'2014 reported financials. We estimate CBI's **<u>net income was inflated by 53% – 72%!</u>**

Estimating the Non-Cash Boost to Gross Profit and Net Income, Per Year

($ thousands)	Recognition of FV Adjustment	
Total PPA Adjustment	$ 1,563,685	$ 1,563,685
Period of recognition (Years)	6	5
Non-cash Benefit to Gross Profit Per Year	**$ 260,614**	**$ 312,737**
After-tax Boost to Net Income Per Year (1)	**$ 177,218**	**$ 212,661**

(1) Assumes 32% tax rate, in accordance with CBI Q4'2013 earnings call
Sources: CBI filings with the SEC; Prescience Point estimates

Our Estimate Implies CBI's LTM Q1'14 Net Income was Inflated by 53-72%!

($ thousands)	Recognition of FV Adjustment	
CBI Reported LTM Q1'2014 Net Income	$ 509,460	$ 509,460
Prescience Pt Adj LTM Q1'2014 Net Income	**$ 332,242**	**$ 296,799**
% Net Income Overstatement	***53%***	***72%***

(Note that in our summary adjusted financial statements in the intro to this section we assume a point estimate for the PPA FV Adjustment of $286m, the average of the two 'Benefit to Revenue per Year' figures derived in the above table.)

Mysterious Inflation of Acquired Backlog Coincides with PPA Adjustments

CBI also retroactively adjusted backlog acquired from Shaw over the course of 2013, mysteriously <u>increasing it by $1.8B</u>! In Q4 alone CBI inflated this backlog by $1.2B!

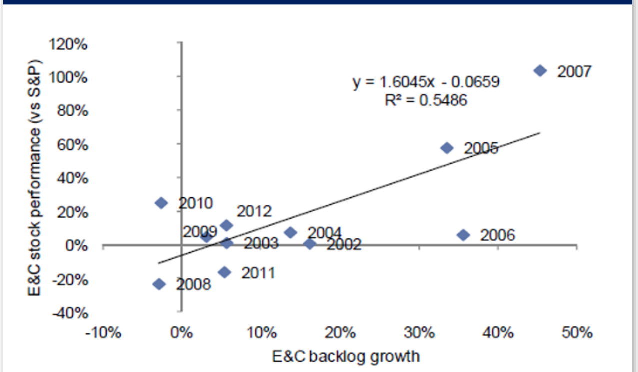
Retroactive Adjustments Made to Acquired Shaw Backlog Coincide with PPA Adjustments

	Q1 2013	Q2 2013	Q3 2013	Q4 2013
Acquired Backlog	**15.0**	**15.0**	**15.6**	**16.8**
Change, QoQ		0.0	0.6	1.2
Cumulative Change, Q4 vs Q1				1.8

Sources: CBI filings with the SEC

This is very important, as **backlog growth is a principal driver of valuation in the space**. Backlog translates to visibility and is used by investors as a gauge of future profitability.

Backlog Growth has been a Significant Driver of Relative Stock Performance



Source: Company data, Goldman Sachs Research.

**Source of Chart: Goldman Sachs, *Engineering & Construction: End market selectivity key in late stages of E&C cycle.* April 2013

PPA Adjustment Results in Understated Credit Risk

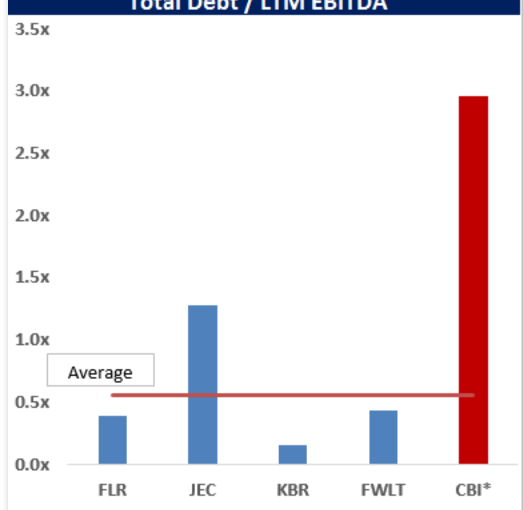
In reflection of overstated profitability, we believe CBI's credit risk is understated by its reported financial statements.

Among E&C's, which tend to keep funded debt balances low because of generally highly volatile cash flows, CBI stands as a high-leverage outlier, the result of using debt-financing to acquire Shaw.

As of Q1'2014, its debt balance was $2.035B. Based on its reported financials for CBI's leverage ratio was 2.1x; but based on our adjustments, its leverage climbs to 3.0x, ~50% higher than the level indicated by its financial statements. And as we discuss in the section detailing CBI's Q1'2014 results, our estimate of 3.0x more likely understates rather than overstates CBI's reality.

Furthermore, CBI has only $420m of cash on its balance sheet, and will likely have to spend a significant amount of that cash, if not all of it, to actually "earn" the deferred revenue sitting on its balance sheet and fund unexpected losses from its nuclear contract – we believe it has an already small margin for error, which may be narrowing. As we will discuss, we believe CBI will be forced to write-down its goodwill (or restate its financials), triggering a debt default; if this were to take place as bookings were to decline, CBI would be at heightened risk of a liquidity

CBI is Far More Leveraged than it Appears
Total Debt / LTM EBITDA[1]



(1) Based on Prescience Point's Adj EBITDA – Excludes estimated PPA adjustment impact on EBITDA
Note: Group average excludes CBI

crisis. While we have no edge in making such a prediction, we believe the risk exists based on CBI's financial position and that it is not priced into the stock at current levels.

Bizarre Pattern of FV Adjustments Raises Red Flags; May Point to GAAP Violation

It is surprising that CBI needed to make any post-acquisition fair value adjustment in the first place given both its incessant pre-acquisition assurances of having thoroughly vetted the Shaw nuclear projects over a 3 month period and the projects' high level of transparency as being public works projects.

Per the extract below, taken from a presentation CBI gave in November 2012 to explain the merits of the Shaw acquisition, specifically assured investors that, based on its 3 month long analysis and that of external counsel, the "*risk profile and expected profit of the nuclear projects is consistent with Shaw public statements*".[2]

Power Projects	Contract	% of Total Backlog	Gross Margin	% Completed	Completion
Vogtle Units 3 & 4	Hybrid with overrun protection (becomes reimbursable)			$\leq$ 30%	2017
Summer EPC Unit 2	Hybrid (field construction labor becomes reimbursable)			$\leq$ 20%	2018
DC Cook LCM	Cost plus			$\leq$ 10%	NA
Entergy Nine Mile	Lump sum			$\leq$ 10%	2015
China SNPTC AP1000	Hybrid with lump sum EP and escalation; CM on day rate			$\geq$ 80%	2015
AEP Turk	Lump sum; converted to cost plus as of August 2012			$\geq$ 90%	2012
Duke Dan River	Hybrid fixed price			$\geq$ 80%	2013
Duke Cliffside	Hybrid fixed price			$\geq$ 90%	2012
Dominion Virginia	Hybrid fixed price; reached substantial completion July 2012			$\geq$ 90%	2013
Grand Gulf Nuclear	Target price / reimbursable; now complete			$\geq$ 90%	2012
Others	Miscellaneous < 10 million contracts generally low risk				
Total ($ millions)		**$9.2 billion**			

On track | At risk | Reduced profit | Loss project

Results as of May 31, 2012

Due Diligence:

- Team of 24 employees, with external support, conducted thorough due diligence over three month period
- Process consistent with past successful due diligence efforts (Howe-Baker, John Brown, ABB Lummus)
- Shaw provided data room with more than 3,500 documents; on-site analysis of U.S. nuclear projects
- Analysis by CB&I leadership and external counsel indicate that risk profile and expected profit is consistent with Shaw public statements

CBI's S-4 filing, dated November 13, 2012, contains many similar assurances, for example stating that the "*nuclear contracts were well-structured from the perspective of protecting Shaw (and thus CB&I post-Transaction) in the event of overruns, increased input costs, or performance delays or customer dissatisfaction".*

We would expect that CBI should, indeed, have been able to complete a thorough pre-acquisition due diligence process, given the high level of transparency into Shaw's nuclear projects: As public works projects, nuclear project progress reports are required to be filed with public service commissions on regular basis and are then made publicly available. These reports extensively detail project progress and challenges being dealt with. Progress reports for the Plant Vogtle construction are filed with the Georgia Public Service Commission and those for VC Summer are filed with the South Carolina Public Service Authority. Project progress is also widely reported on by the mainstream press. Based on our review of the public disclosures and press accounts (for example, here, here, here), Shaw's specific projects were widely known before the acquisition to have been marred by delays and problems that were resulting in cost overruns.[3]

Furthermore, months after the acquisition, CBI maintained its confidence in its pre-acquisition due diligence. For example, at a Credit Suisse conference on June 6, 2013, CBI's CEO stated, "*…we don't feel that there's anything different than what we talked about when we looked at the original project during the diligence, so we feel pretty comfortable…if anything, we were fairly conservative in our original outlook."*

[2] CB&I and the Shaw Acquisition presentation November 2012, slide 11

[3] Goldman Sachs. *Engineering & Construction: End market selectivity key in late stages of E&C cycle.* April 2013

This is why the pattern of CBI's fair value adjustments appears downright bizarre. As the table below demonstrates, CBI made $1.2B of the total ~$1.56B **(>75%)** fair value adjustment in Q3 and Q4 alone, 8 to 11 months after the deal was completed and nearly 18 months after CBI and Shaw entered into a definitive agreement in July 2012.

Pattern of Fair Value Adjustments Made to Nuclear Contracts is Bizarre

($ thousands)	Shaw Account 2/13/2013 (1)	Purchase Price Allocation (PPA) for Shaw Q1 2013	Q2 2013	Q3 2013	Q4 2013
Contracts in progress, net (CIP)	(753,786)	(1,117,786)	(1,121,164)	(1,779,871)	(2,317,471)
QoQ Adjustment to CIP, net		*(364,000)*	*(3,378)*	*(658,707)*	*(537,600)*

(1) Prescience Point estimate of Shaw's acquisition closing date CIP, net; imputed based on FV adjustment disclosure in CBI's Q1'13 10-Q
Sources: CBI filings with the SEC; Prescience Point estimates

We believe that in light of having stood by its due diligence for many months following the acquisition, that CBI had indeed completed its due diligence of Shaw's nuclear projects, and that because the PPA adjustments were made later, CBI may have violated GAAP. The basis for our assessment is grounded wholly in management comments, and taking management at its word.

Fact Pattern Consistent w/ CBI Having Made the Adjustments in Response to Post-Acquisition Events

Were they made in response to unanticipated losses resulting from post-acquisition events?

Based on our review of the public service filings and press accounts, the post-acquisition period has been littered with events we would expect to have resulted in losses CBI would not have been able to anticipate in its pre-acquisition due diligence, especially given that its contracts are heavy on fixed price components. (For more examples, please refer to the Appendix, which contains an exhaustive analysis of nuclear project challenges arising post-acquisition that could be expected to negatively impact CBI's financials.)

For example, CBI is so far behind schedule on the fabrication and delivery of certain components for Plant Vogtle construction that the work has been reassigned to 3rd party fabricators. Use of 3rd party contractors is typically thought to be a major source of cost overruns. Mackson, for instance, as of 9/3/2013 has taken over the CA03 module fabrication. We would expect that transferring fabrication to a third party would result in previously unanticipated costs, thereby reducing CBI's nuclear contract margin and impacting its income statement.

In another example, on June 5, 2013, Scana, CBI's client for nuclear plant construction at VC Summer, announced that completion of its Unit 2 reactor would be delayed by ~1 year. Delays are a major cause for unanticipated losses. CBI gave a presentation at the Credit Suisse conference the following day (June 6, 2013), during which analysts expressed great concern about the implications of the delay on CBI's financials. CEO Philip Asherman assured them the delays would have no impact on guidance or CBI's financials going forward, meaning CBI would not be responsible for any of the additional costs on the nuclear cost overruns.

Source of Discussion	CBI Tells Investors Overruns Have No Impact on Guidance or Go-Forward Financials
Credit Suisse conference, 6/6/ 2013	**Jamie Cook** *… Phil, why don't you just address the inevitable, which everyone is worried (about)… the news that came out of Scana with regards to Unit 2 and the delay that they talked about. Did you expect it? … What does it mean to you?* **Phil Asherman** *…No, I think Scana gave a very balanced view of the project… They gave a broad estimate in terms of potential cost impact. But I think it's important to remember about these nuclear jobs -- it's fundamentally different than other large capital projects. These are not necessarily cost- and schedule-driven, per se; but they are quality and safety. Not in the sense of industrial safety, but nuclear safety; nuclear safety and nuclear quality.* *That's a completely different set of drivers on these type of projects, and it's what we all want, right? We want these nuclear jobs to be filled as safely and as reliable as possible. And that's what drives -- that's what drives these, and that's not a bad thing. So as we look for other opportunities to make these jobs more safe, more reliable, certainly the licensees are going to take an opportunity to invest in that…* *…So were making progress. The milestones that we talked about I think were great milestones on these projects. So we have most of that backlog still in front of us.* ***So, we'll be analyzing the impacts as we go forward.*** *And I apologize, I'm losing my voice a little bit today. But that's all right, that's all right, that's not a problem. A lot of people see that as a benefit….* *As far as exposure to the Company -- very minimal, that we see. When they talk about cost and schedule, it's not necessarily defined itself in the contract or issues. And we're in a consortium, so there is a lot of ways to look at that. <u>But we don't feel that there's anything different than what we talked about when we looked at the original project during the diligence, so we feel pretty comfortable</u>.* **Jamie Cook:** *So no impact on guidance?* **Phil Asherman:** ***<u>No impact on guidance</u>***. *I guess if that's what the question was, yes. I should've just started there -- no impact on guidance. You could've saved me a lot of breath there; <u>no impact on guidance and our financials going forward</u>.*

However, we believe CBI is likely on the hook: A recent report to the South Carolina office of regulatory staff indicates, the delay was in part due to CBI's failure to deliver modules on time and to quality from is Lake Charles, LA facility, which would indicate CBI should be on the hook for some of these costs.

Of course, if CBI is on the hook, as we suspect, but it made PPA adjustments in response to post-acquisition events such as the one above, then indeed, it would be enable it to demonstrate <u>no impact on guidance or go-forward financials, given that the reserve would allow it to avert the reporting of contract losses</u>.

In our view, the fact pattern appears to be consistent with CBI having made PPA adjustments in response to unanticipated costs arising from post-acquisition events.

PPA Adjustments Made in Response to Post-Acquisition Events Violate GAAP

If it did, the PPA adjustments are <u>not legitimate</u> and <u>CBI has violated GAAP</u>. As previously stated, GAAP allows an acquirer to make retroactive adjustments to its purchase price allocation for a period of up to 12 months post-acquisition. But it also stipulates that such adjustments must be based on information "known to be available or obtainable" as of the acquisition date. In other words, to be legitimate, adjustments cannot me made in response to post-acquisition events; <u>asset write-downs necessitated by post-acquisition events must be charged against earnings.</u>

In sum, in light of the pre-acquisition level of due diligence CBI conducted, made possible by a high level of transparency for project progress, and CBI's reassurance in its due diligence process months after the acquisition, the pattern of CBI's fair value adjustments – with the lion share of the total adjustment being made in Q3 and Q4, <u>8 to 11 months after the deal was completed</u> – appears to indicate they were made in response to post-acquisition events. Our assessment is supported by the existence of a litany of post-acquisition events we would think should negatively impact CBI's guidance and financial statements, but that never did – which would be consistent with CBI having made the adjustments in response to post-acquisition events.

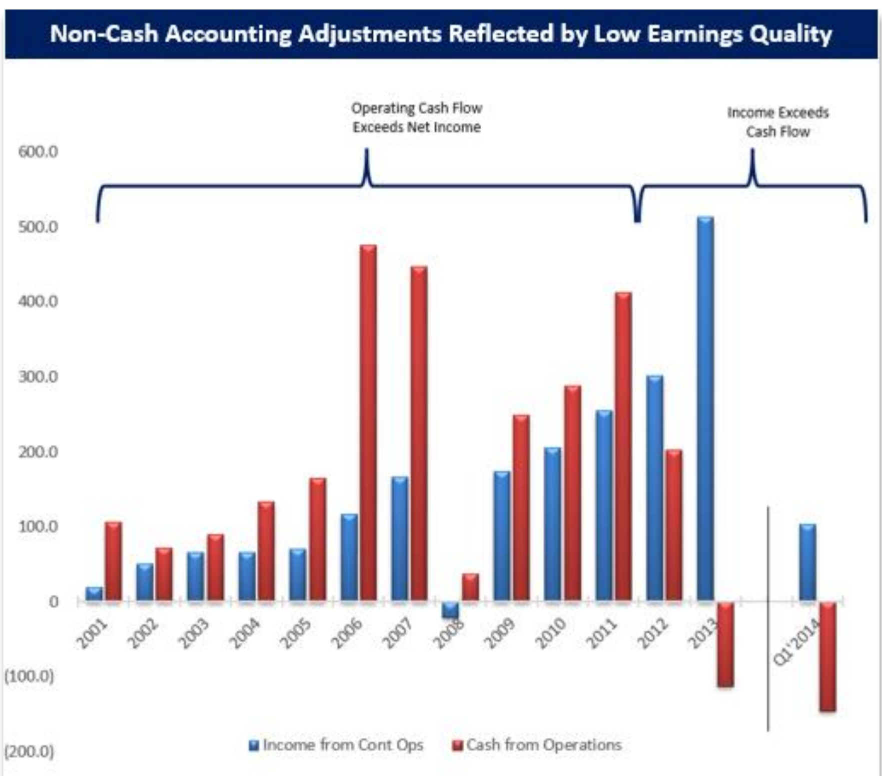
CBI Appears Deceptive in Informing Shareholders of its Realities

Regardless of the legitimacy of its acquisition accounting, we believe CBI is knowingly or recklessly failing to disclose that its underlying financial performance is dramatically different from what it reports to the investing public. Based on our review, outside the confusing disclosures located primarily in the Acquisitions footnote of its 2013 financial statements, there is a pervasive omission of any discussion about the PPA fair value adjustments: CBI does not disclose by exactly how much income is inflated by its release of the reserve or why the reserve was created. Worse, management can be observed, we believe, to actively mislead investors to prevent the discovery of its accounting shenanigans: Despite financial statements showing that the Shaw acquisition is a failure, management touts the success of the transaction on conference calls, which we believe is misleading.

CBI is Taking Losses, as Reflected by CFFO; Shenanigans Cause Earnings Quality Decline

CBI is taking cash losses, and we believe those losses are being concealed from shareholders.

In 2013, CBI reported the highest earnings in its history as a public company; this was accompanied by the lowest level of reported Cash from Operations in its history. 2013 was the first year in CBI's history that it reported negative cash from operations.



The wealth-generation historically represented by CBI's GAAP profits is no longer observable in the company's cash flows – it now appears to be 'paper' wealth generated by accounting entries.

CBI does not disclose by exactly how much income is inflated by its release of the reserve.

Investors Misled by Touts of Success of Shaw Integration & Nuclear Projects; No Mention of Losses

If the disclosures in CBI's SEC filings are to be believed, management seems to have been deceptive with investors. Based on our review of public disclosures, management never discusses losses CBI is taking, and has only good things to say about the Shaw acquisition – continually touting the success of the Shaw integration and noting positive progress in the nuclear projects. Furthermore, we should mention that in spite of the cash-basis shareholder losses and a dramatic miss of CBI's 2013 internal free cash flow targets (see section on management comp), CBI's CEO was paid a $2m bonus for the successful integration of Shaw!

The below display management commentary across time. In taking it in, keep in mind that CBI took additional write-downs against the Shaw CIP account of $658.7m in Q3'2013 and $537.6m in Q4'2013.

Source of Discussion	CBI Touts Success of the Shaw Transaction, No Mention of Losses or PPA Adjustments
Credit Suisse conference, 6/6/ 2013	**Phil Asherman …** *I know that several of you, because of the timing, probably have a couple of Scana questions, but we'll hold those for the end. I've been hearing them all morning, so it's okay. But, no, we're really pleased in terms of the performance of the assets that we acquired, and certainly the performance in our own end markets, as you'll hear about in just a minute.* *Philip Asherman, CS conference June 2013* **Unidentified Audience Member***: It appears in the integration of Shaw was swift and efficient, with the overhead projection. Is that the case?* **Phil Asherman:** *That's the case. We talked about $30 million of cost synergies right off the bat. And of course a lot of that had to do with duplication of corporate activities and so forth. We didn't buy it for the synergies; we were very conservative, I think, on our synergy projections, both on the cost and the revenue side. But, clearly, we see opportunities on both to continue. We're working hard on this year to get most of those identified and addressed this year. There is some consolidation; there is some other things that we can do. We're looking at possible -- parts of the combined companies that may even lend itself to divestiture, if that's necessary to just work on making sure the portfolio is as efficient as possible.*
Q3'2013 Earnings Call (10/29/2013)	**Phil Asherman …** *Now a word on the integration since the close of the transaction in February. I'm very pleased with the progress we've made on many fronts. For example, applying CB&I's best practices, our safety performance on nearly 100 million manhours worked year-to-date around the world remains one of the best records in the industry.* *We achieved several important milestones in both V.C. Summer and Vogtle Nuclear projects this year. And Lasse and Luke will report, our pace of modular delivery, which is critical to achieving the schedule of both sites, has improved significantly since we assumed control of the operations. We've also announced a new benefit program beginning January 1 for all of our employees, which will keep us in the top tier as an employer of choice in our industry.* *Cost synergies should exceed $50 million this year, and we expect to drive additional efficiencies in 2014 for another $50 million. We see tremendous synergy opportunities with our expanded fabrication capabilities for capturing more of the wallet on CB&I's backlog, while benefiting as a preferred supplier for capital work on much of the new energy infrastructure around the world.*
Q4'2013 Earnings Call (2/25/2014)	**Phil Asherman …** We've just passed the 1-year mark since the financial close of the Shaw acquisition. And as I've told you before, our employees worked extremely hard to ensure that we became one CB&I last February and made the transition virtually seamless. Their commitment to the integration continued throughout the year, as reflected in our strong results and success in building a world-class, highly competitive company.

Source of Discussion	CBI Touts Progress of Nuclear Projects, No Mention of Losses or PPA Adjustments
Q3'2013 Earnings Call (10/29/2013)	**Andy Kaplowitz:** *...Can you talk about so sequentially in your (inaudible) business, margins were down. And I know you gave some reasons for margins what they are, but revenues were up pretty decently, so we would expect utilization to help a bit. We know the nuclear projects are in there.... Was there any more noise in the nuclear project in terms of cost ...? What happened in that quarter?* **Ron Ballschmiede:** *Sure, no, the nuclear projects continue to perform as in the past. Our revenues from those nuclear projects were just under $0.25 billion, which is consistent with our run rate in the second quarter and the first half of the -- no, last half of the first quarter...* **Andy Kaplowitz:** *Okay, Ron, so similar margins for the nuclear projects between 2Q and 3Q, right? That's what you're saying?* **Ron Ballschmiede:** *Yes, and similar revenue burn.*
Q4'2013 Earnings Call (2/25/2014)	**Steven Fisher:** *Hi, good afternoon. On the nuclear projects in the US, to what extent are you starting to pick up some speed and gain efficiencies as you go along there? ...* **Philip Asherman:** ***...[in terms of] the progress on the existing work. We're pretty pleased*** *and probably want you to get comments from the licensees to confirm this, but we picked up the pace significantly in our Lake Charles and other plants. We've subcontracted some of the fabrication or modularization work outside of Lake Charles and that program is proceeding very well. We're busily erecting the work over on the side. More and more of this work is moving to the side. I think all concerned including the licensees on both projects as well as Westinghouse and our Company are very encouraged by the progress being made. Again, let me just say, everything that's being done additionally to that project points to the safety and reliability of these projects. We're all on the same page and wanting the same thing about having the safest, most reliable nuclear projects anywhere in the world. We're all working towards that end in a very, very stringent regulatory environment. We're pretty encouraged about the way it's going.*

Investors Misled by Incomplete Explanation for Declining Cash Flow Conversion

We believe that, when asked to explain the disconnect between CBI's net income and cash flow on the Q4'2013 earnings call, CFO Ballschmiede again appears to mislead investors in a way that might prevent discovery of the reserve and/or its financial impacts. He cites upfront payments received on the nuclear projects as the cause of the divergence, stating they will be worked off over the life of the pertinent nuclear projects, at a rate of $200-300m per year for 4-5 years. He completely ignores mention of the fair value adjustments, which we believe to be the **primary** driver! The $1.56B cumulative fair value adjustment is the largest component of Shaw's net CIP liability, by our estimates making up ~67.5% of the $2.32B account per CBI's final purchase price allocation.

He then continues to apparently stretching the truth, telling investors the source of the income-to-cash flow discrepancy is money "*essentially sitting on our balance sheet somewhere"*, a comment which cannot, in our view, be more misleading. He appears to be making it seem to investors that the Shaw CIP liability is deferred revenue that resulted entirely from the acceptance of upfront cash payments: In essence, he seems to be trying to leave investors with an impression that can be summarized as follows: 'Yes, while the account has caused income and cash to diverge, it is not all bad news. The flipside is that the cash has helped to fortify our balance sheet'. Get real. As previously stated, by our estimates ~67.5% of that account can be attributed to the PPA fair value adjustment, which is an accounting entry that involves no intake of cash; it is essentially created with the strike of a pen.

Discussion	What CBI Tells Investors ≠	What CBI Says in its SEC Filings
Discrepancy b/w CF and NI	<u>**Source: Q4'2013 conference call Q&A on 2/25/2014**</u> – **Andrew Kaplowitz** *And, Ron, could I just ask you to clarify something quickly, like around free cash flow in '14? Should you start to see the benefit from the nuclear projects stopping bleeding cash, I guess, if you may, and start to actually hit milestones there so you should see better free cash flow in '14? If there's any color there, it will be great.* **Ronald A. Ballschmiede** *Sure. We certainly expect some improvement in '14. But when -- just from a macro standpoint on the nuclear projects -- and this is not bad -- we still have, give or take, $1 billion of advances, net advances, on those projects. And of course, like all advances, they get worked off over time. And if you just did the simple math, we have 4-plus years of heavy going to grow on those. So you could probably do that math and say, "Okay, we're going to unwind those advances on that kind of rate in the next many years." ...* **Jamie L. Cook** *... Ron, just on the free cash flow. I know Andy asked the question, and there were puts and takes. But in general, this year, do you expect free cash flow to be more comparable to your net income number? If you could just -- because it felt like, I don't know, that we've really got an answer.* **Ronald A. Ballschmiede** *Sure. Yes, I think over a cycle, we would continue to tell you that operating income is a pretty good surrogate for what we would expect our cash flow to be... there's some unique pieces of that certainly in '14 and the future.* ***I mentioned the <u>nuclear advances</u>.*** *So if you just do that easy math, it's* ***<u>$200 million to $300 million</u>*** *of the nuclear side being essentially worked off over --* ***<u>per year for the next 4 or 5</u>*** *as we finish those projects. Like I said, while that might be viewed as a negative,* ***it's -- <u>we have the money in our -- essentially on our balance sheet somewhere at this point in time</u>****. ...*	<u>**Source: CBI 10-K for 2013**</u> – *The acquired Shaw operations included a net contracts in progress liability of $2.3 billion, primarily related to <u>upfront payments received</u> on our two large nuclear power projects prior to the Acquisition Closing Date* ***<u>and fair value adjustments</u>*** *associated with the contracts*

Investors Misled by Explanation for Mysterious Increase in Backlog

As previously discussed, CBI retroactively adjusted backlog "acquired in connection with the Shaw acquisition" from $15bn in Q1'213 to $15.6B in Q3'2013 and then to $16.8B in Q4'2013, seemingly adding $1.8B to its backlog with a simple accounting entry, **<u>and with no explanation</u>**.

When asked by an analyst on the Q4'2013 earnings call as to what he was missing in not being able to reconcile CBI's reported Q4 backlog number based on its driving factors, CFO Ronald Ballschmiede <u>again</u> appears to mislead investors in a way that would prevent the identification of potential shenanigans. Specifically, he not only makes <u>no mention</u> of the retroactive write-up of backlog acquired from Shaw but appears to mislead the analyst, attributing the discrepancy primarily to hundreds of millions is from currency movements.

Discussion	What CBI Tells Investors ≠	What CBI Says in its SEC Filings
Unexplained Backlog Growth	<u>**Source: Q4'2013 conference call Q&A on 2/25/2014**</u> – **Brian Konigsberg** *...Just more clarity just on the backlog balance... doing the basic math, and I think you kind of pointed to this but it wasn't exactly clear, if you just take the Q3 ending backlog, you add the orders, subtract out the revenue, you get about $1 billion less in backlog balance than you reported. <u>Was that all?</u> I mean, you said FX was a headwind, but were there other change orders? Or are there things that will explain that differential?* **Ronald A. Ballschmiede** *It was primarily currency. So it's $800 million for the full year. I don't have the third -- the fourth quarter number right in front of me, but there were significant movements in the fourth quarter of currency. And moving it by hundreds -- high hundreds of millions would not be a surprise. We haven't had any cancellations out of backlog of any magnitude at all.*	<u>**Source: CBI 10-Q for Q3'2013**</u> – *Backlog as of September 30, 2013 was approximately $24.5 billion compared to $10.9 billion at December 31, 2012, with the increase primarily reflecting the impact of the backlog acquired in connection with the Shaw Acquisition (approximately* ***<u>$15.6 billion</u>*** *at the Acquisition Closing Date)...* <u>**Source: CBI 10-K for 2013**</u> – *Backlog at December 31, 2013 was approximately $27.8 billion compared to $10.9 billion at December 31, 2012, with the increase primarily reflecting the impact of the backlog acquired in connection with the Shaw Acquisition (approximately* ***<u>$16.8 billion</u>*** *at the Acquisition Closing Date)...*

In light of this and other misleading comments discussed, we are left to conclude that CBI management is engaged in a coordinated effort to avert scrutiny of its aggressive accounting practices.

Q1'14 Results May Indicate Increasing Losses & Income-to-Cash Flow Divergence:

Q1'2014 results indicate CBI is currently even more dependent on masking losses than our estimates, based on straight-lining the reserve suggest. We believe Q1 is a harbinger of accelerating losses and income-to-cash flow divergence, raising the specter for a liquidity crisis, a risk previously discussed.

CBI reported Q1 net income of $89m and EPS of $0.82, missing consensus of $1.11 by -26%. We estimate the results were boosted by reserve release of $134m, far greater than we would have expected based on our straight line estimates (i.e. $286m per year, or $71.5m per quarter). Excluding the non-cash income boost, we estimate CBI would have reported a net loss of -$46m, or -$0.43 per share. Our calculation of a quarterly loss is reflected by CBI reported negative quarterly CFFO of -$145.7m. We note that CBI's cash balance, $420m, was stable from Q4'13 to Q1'14, made possible having drawn from its revolving credit line, with total debt rising $1.84B to $2.034B over the same period.

Our assessment of CBI's Q1'2014 results follows:

- **PPA Fair Value adjustments contributed $134m to net earnings**
- CBI reported EPS of $0.82 missing consensus of $1.11 by -26%. Without the benefit of the FV adjustment, EPS would have been a loss of $(0.43)! We believe that Q1 2014 shows just how material the FV adjustment is to results.
- Cash flow from operations was negative, with cash out flow of –$145.7m. This was mainly driven by a $422.5m decrease in the CIP
- Future losses may be even higher than reserved for in the PPA, meaning that that once the reserve has been used up, the losses will flow to the bottom line.

How we derived our conclusions:

- CBI states in its Q1 2014 10-Q, p.31, that, "*The $300.5 million net change in our Contract Capital balances was due primarily to progress on our two large nuclear power projects (approximately $295.0 million).*" Per the data in the table below, it is clear that the $295m is related to the change in CIP. Additionally the FV has been identified as being for the nuclear projects.

CBI Q1'2014 Drivers of Contract Capital

($ millions)	Q1'2014
Account Receivables	111.9
Inventory	11
Accounts Payable	-0.8
CIP	-422.5
Contract Capital	**-300.5**

Source: CBI 10-Q for Q1'2014

- The FV adjustment was 67.5% of total Shaw CIP (all related to Nuclear Projects); assuming recognition in the same proportion, we calculate that CBI used a massive $199m of the FV adjustment in Q1 2014, equating to $135.4m after-tax.

- We adjust net income to remove the non-cash boost; we estimate that without the adjustment CBI would have reported a - –$46.4 **LOSS** vs the reported $89m gain.

CBI Q1'2014 EPS, Excluding Non-Cash Benefit from PPA	
($ millions)	**Q1'2014**
Total Shaw CIP - PPA	$2,317.5
FV adjustment - as calculated	$1,563.7
FV adjustment % of CIP	*67.5%*
Contract Capital for Nuclear Projects in Q1 2014	$295.0
Q1 FV adjustment used	**$199.0**
Tax rate	*32%*
After tax effect on net income	**$135.4**
CBI net income after noncontrolling interests	$89.0
Net income adjusted for FV adjustment	**($46.4)**
Diluted shares (m)	109.1
EPS, ex PPA adjustment	**($0.43)**

Note: Prescience Point estimate
Source: CBI 10-Q for Q1'2014

Goodwill Grossly Overstated; a Write-down Would Trigger Debt Default

We believe CBI will be forced to write-down its goodwill balance, which will result in a default on its debt covenants. The company's balance sheet is bloated by a grossly overstated goodwill balance, the direct result of CBI's PPA fair value adjustments.

As of Q1'2014, CBI had amassed $4.2 billion of goodwill, relative to a book equity totaling $2.6 billion (i.e., goodwill is 162% of CBI's book value). $3.3 billion of that goodwill balance, or 126% of the consolidated company's book value, is attributed to Shaw. This means that the company's shareholder equity would be negative without the Shaw goodwill and, generally, that any substantial write-down in goodwill would send shareholder equity plunging. Moreover, CBI's Revolving Credit Facilities have a financial covenant that as of March 31, 2014 requires it to maintain a minimum net worth of $1.762B. CBI's current net worth is $2.441B, meaning that a goodwill write-down of only $679m would result in a debt default.

- Even if we take CBI at its word by assuming the reserve it created is based on a legitimate estimate of future losses that were not expected when the deal was agreed upon, then by definition the Shaw goodwill on CBI's balance sheet is overstated, necessitating a write down; because Shaw is expected to be making significant losses, there should be an impairment.
- CBI management, when they were courting Shaw from May – June 2012, set forth their expectation that Shaw would generate revenue in 2013 of $6.3B. Based on CBI's post-acquisition financials, Shaw actually generated revenue of $4.5B in 2013, falling short of their projections by 40%!! Shaw's business seems to be much weaker than CBI had expected when they purchased it, which indicates that a goodwill write-down is necessary, especially given that its balance was increased ~33% over the course of the year CBI was carrying out its PPA adjustments – a time frame in which its value was declining!
- Comparing Shaw's performance in 2013 to its performance in 2012 offers further evidence that its business has deteriorated under CBI's ownership. Based on the pro-forma financials located in CBI's 2013 10-K, Shaw generated revenue of $5.373B in 2012 vs $4.5B in 2013, down -16% in one year! Again, Shaw's business has weakened substantially since being acquired, and yet over the same timeframe its goodwill balance was increased >33%.
- Lastly, the amount of goodwill CBI has allocated to Shaw, ~$3.3B, has grown to 1.5x the value placed on the entire entity ($2.2B) at acquisition!

All roads lead to the same destination. We are confident CBI will soon have to take a crippling write-down to its goodwill.

Successive PPA Adjustments Made to Shaw's Contracts in Progress (CIP) Account, Offset by Adjustments to Goodwill & Intangibles

($ thousands)	Shaw Account 2/13/2013 (1)	CBI Purchase Price Allocation Q1 2013	Q2 2013	Q3 2013	Q4 2013
Allocation of Price to Construction in Progress, Net	(753,786)	(1,117,786)	(1,121,164)	(1,779,871)	(2,317,471)
PPA Adjustment to CIP, Quarter on Quarter (2)		**(364,000)**	**(3,378)**	**(658,707)**	**(537,600)**
Cumulative PPA Adjustment from Shaw Closing Balance Sheet		**(364,000)**	**(367,378)**	**(1,026,085)**	**(1,563,685)**
Allocation of Price to Goodwill		2,449,147	2,446,701	2,826,450	3,296,530
Allocation of Price to Intangibles		401,900	412,100	412,100	460,200
Allocation of Price to Goodwill & Intangibles		2,851,047	2,858,801	3,238,550	3,756,730
Total Purchase Price, Net of Cash Acquired		2,211,864	2,202,143	2,202,143	2,202,143
Goodwill, % of Purchase Price		***111%***	***111%***	***128%***	***150%***
Goodwill & Intangibles, % of Purchase Price		***129%***	***130%***	***147%***	***171%***

(1) Prescience Point estimate of acquisition closing date Shaw CIP balance, imputed based on CBI Q1'13 fair value adjustment disclosure

(2) Q2'2013 CBI PPA adjustment calculated as difference between Q1 and Q2 PPA to Shaw CIP

Sources: CBI filings with the SEC; Prescience Point estimates

Flawed Corporate Governance May Encourage Earnings Manipulation

> ***"It pays to do it, it's easy to do, and it's unlikely that you'll get caught."***
>
> **Howard Schilit**

The PPA adjustment feeds right into the core driver of CBI's incentive structures – Adjusted EPS. As this measure rose sharply in 2013, management realized both, 1) a large payout of annual incentive – 3x what they would have been paid absent the acquisition accounting adjustment – and 2) an acceleration in the vesting of CBI shares doled out as part of CBI's long-term incentives plan. With the bulk of cash incentive compensation tied to Adjusted EPS targets, management's accounting for the Shaw acquisition translates to a tool that can be used toward assuring lavish annual cash bonuses, resulting in little long-lasting accountability for shareholders and incentivizing more empire-building at the expense of long term cash on cash returns for shareholders.

Decisions made by CBI's board also seem to evidence a tacit acknowledgement that they have all but given up on CBI's ability to generate cash earnings. In 2013 the board made a change to the management annual incentive structure, reducing the weighting of Free Cash Flow as a determinant of bonuses, indicating a reorientation toward lower quality earnings vs. higher quality, cash-based earnings. The board's position can also be gleaned from its decision to award CBI's CEO with a $2m discretionary bonus for the 'successful integration' of Shaw in 2013, the same year the company generated the lowest level of free cash flow in its history.

Management Incentives Based on Adjusted EPS, a Primary Beneficiary of PPA Adjustments

Adjusted EPS is the primary determinant of CBI management's annual, and the only determinant of its long-term, incentives structure. In congruence with what we'd expect of this company, CBI of course defines Adjusted EPS as "EPS excluding merger and acquisition costs," but does not appear to exclude the non-cash benefit from recognition of the PPA fair value adjustment. This translates to a management capability to artificially inflate CBI's underlying earnings, meet EPS bonus targets, and get paid out of shareholders' pocket books; from a moral standpoint, this is akin to a theft. We cannot even fathom that CBI's board would vote and agree to implement this and some of the other policies soon to be discussed.

For annual incentives, the Adjusted EPS target comprises 40% of the weighting, and offers a 250% payout if Adjusted EPS meets or exceeds the maximum target set by the board, giving it the highest max payout rate among the performance measures considered. Because it bears the greatest influence on bonus payouts, managers are likely to focus on maximizing Adjusted EPS even as the company maybe underperforming, as related by other measures taken into account.

Per the table below, CBI missed dramatically on its target for free cash flow and barely achieved the minimum target for New Orders in 2013, even after slashing the FCF minimum by approximately 50% compared to 2012. As such, the relative contribution of adjusted EPS to the calculation of the cash incentive was 66% of the total. Fortunately for management, the bonus system has been structured such that it still was able to achieve a bonus of 152% of base salary. We estimate that by releasing non-cash income from the reserve, management was able to "earn" 3x the cash bonus (as a % of salary) that would have been paid absent this accounting adjustment!

Annual Incentive Compensation for 2013 (i.e., Determination of Cash Bonus, as a % of Salary)
($ millions)

Measure	Weighting, % of Bonus	Minimum	Target	Maximum	Actual	Cash Bonus, % of Salary	Relative Contribution
Adjusted EPS	40%	3.35 (0%)	3.85 (100%)	4.34 (250%)	$4.91	100%	66%
New Awards	20%	$12b (0%)	$14.5b (100%)	$16.0b (200%)	$12.3b	2%	1%
Free cash flow	10%	$500m (0%)	$600m (100%)	$700m (200%)	-$203.3m	0%	0%
Ethics	10%	Any Unresolved (0%)		No Unresolved (100%)	No Unresolved	10%	7%
Acquisition Integration	10%	Variable	Variable	Variable	31 / 4.16	20%	13%
Safety	10%	Variable	Variable	Variable	0.05 / 0.29	20%	13%
Total	**100%**					**152%**	**100%**

Source: CBI Proxy filed on 3/21/2014

Long term incentives consist of restricted stock and performance shares. The restricted stock vests 25% per year over a 4 year period and performance shares vest 33.3% over a 3 year period. Performance targets – entirely determined by Adjusted EPS – need to be met each year in order for vesting to occur, as follows: at minimum performance (50% vest), at target performance (100% vest), and at maximum performance (200% vest). CBI's 2013 reported Adjusted EPS of $4.91 exceeded the maximum performance levels of $2.48, $3.30, $4.35, as set in 2011, 2012, and 2013, respectively, at the 200% of target level. This amounted to an acceleration of management pay, yet another gift management doled out as the result of a most giving soul – acquisition accounting.

Compensation for Named Executive Officers for 2013

Name	Base Salary	Bonus	Stock Awards	Cash Incentive	Other Comp	2013 Total	2012 Total	Change
Philip K. Asherman, CEO	$1,208,269	$2,000,000	$8,438,590	$2,528,064	$530,335	$14,705,258	$9,224,778	$5,480,480
Ronald A. Ballschmiede, CFO	$576,916		$1,976,989	$818,938	$133,352	$3,506,195	$3,033,400	$472,795
Daniel M. McCarthy, Pres Technology	$601,100		$1,534,056	$775,200	$151,234	$3,061,590	$2,894,964	$166,626
Lasse J. Petterson* (Retired COO, as of Dec 2013)	$710,043		$8,459,910	$0	$162,595	$9,332,548	$3,311,132	$6,021,416
Edgar C. Ray, Pres Govt Solutions	$607,403		$1,184,737	$745,104	$149,693	$2,686,937	$2,030,431	$656,506
Luke V. Scorsone, Pres Fabrication	$659,011		$1,188,298	$824,980	$213,198	$2,885,487	n/a	n/a
Total	**$ 4,362,742**	**$2,000,000**	**$22,782,580**	**$ 5,692,286**	**$ 1,340,407**	**$ 36,178,015**		

* - all shares vested due to retirement
Source: CBI Proxy filed on 3/21/2014

Board Awards CEO $2m Bonus for 'Successful Shaw Integration' as FCF Falls to Lowest Level in History

It is notable that on February 20, 2014, just past the one year anniversary of CBI's Shaw acquisition, CEO Asherman was granted a $2m discretionary bonus, payable in restricted stock units vesting 33⅓% per year based on the closing price of the stock on February 20, 2014. CBI's Compensation Committee attributed the payout to the CEO's "exceptional performance and the successful integration of the Shaw acquisition in 2013."

The payout of Mr. Asherman's bonus coincides with CBI having generated the lowest level of free cash flow in its history as a public company and creating a reserve for future losses that it appears to hide from investors, calling to question the board's standard in representing shareholder interests. Moreover, as discussed in our section no Goodwill, Shaw appears to have deteriorated significantly in 2013 under CBI's ownership, with revenues collapsing by -16% YoY!

Who knows what the board is really rewarding management on? Whatever it is, it seems to at the expense of long-term shareholder interests.

Who Exactly is the Board Representing?! CBI Misses its Own FCF Targets; Board Cuts FCF Weighting

As the ability to manipulate Adj EPS to achieve higher bonus payouts were not bad enough... CBI's board now seems to be giving up on the company's ability to generate free cash flow; and, rather than increase incentives for management to turn the ship around, it appears to be pacifying management at shareholders' expense. It has taken measures to reduce damage to management compensation packages should free cash flow remain elusive.

In 2013, it reduced the weighting for the Free Cash Flow target for annual incentives from 20%, where it was set in 2011 and 2012, to 10%, and established a new target measure for Acquisition Integration.

Annual Incentive Compensation Weightings by Measure

	% of Bonus at Target Threshold		
Measure	**2013**	**2012**	**2011**
Adjusted EPS	40%	40%	40%
New awards	20%	20%	20%
Free Cash Flow	**10%**	**20%**	**20%**
Ethics	10%	10%	10%
Safety	10%	10%	10%
Acquisition integration	10%	-	-
Total	100%	100%	100%

Source: CBI Proxy for 2011, 2012, 2013

We note that CBI had not achieved the minimum FCF target requirement in either 2012 or 2013; further, CBI was so far off from its minimum FCF target in 2012 that the miss raises serious questions as to the health of the underlying business. In 2013, CBI reduced its FCF target levels by almost 50%, but still came nowhere close to achieving the minimum threshold set, even though the company seemed to be expecting additional cash flow from the Shaw acquisition:

Annual Incentive Compensation Free Cash Flow Targets
($ millions)

Year	Minimum 0%	Target 100%	Maximum 200%	Actual
2013	$ 500.0	$ 600.0	$ 700.0	$ (203.3)
2012	$ 987.0	$ 1,087.0	$ 1,187.0	$ 130.2
2011	$ 165.0	$ 265.0	$ 365.0	$ 372.7

Source: CBI Proxy for 2011, 2012, 2013

Fortunately for management, CBI's board has structured its bonus pool to minimize the impact from failures to generate cash flow. The dominance in weighting of Adjusted EPS, in conjunction with the ability to manufacture it courtesy of acquisition accounting, is sure to result in hefty bonus payouts for years to come.

In studying CBI's proxy statements, we come away with the sense of an almost tangible absence of shareholder representation by CBI's board.

PP Talks to Management – Confirmed: the Reserve is Used Primarily to Offset Costs

Given the gravity of our findings, we arranged calls with CBI Investor Relations (IR), and tried arranging calls with CFO Ballschmiede, for more clarity. We spoke with a CBI IR contact on 2 occasions (3/26/14 and 5/14/14). He was helpful in answering questions and had a working knowledge of the PPA adjustments and how they are used, although we asked several questions he either did not know the answer to or just did not want to answer, asking that we follow-up by emailing him a written list of these and other questions we might have. We found it interesting that, even though we contacted the company anonymously, without prompt they asked to review anything we might plan to publish. We requested two different times to have a follow-up call with the CFO but these requests were never met. Following our 5/14/14 call, we emailed IR with our follow-up questions, which dove deeper into the financial statement impacts of the PPA adjustments. We have followed with multiple calls and emails, yet – now over 30 days later – have received no follow-up.

Regardless, the conversation that did take place, we believe, served to confirm our core thesis – that CBI is inflating its profitability as a result of CBI's post-acquisition adjustments to the Shaw PPA.

Highlights from management commentary on the 5/14/14 call (a segment from our call is displayed below):

- The PPA adjustments basically relate to changes in the fair values of project assets. They should be thought of as an impairment, and are amortized over the life of the projects that were affected as a function of the percent of completion on these projects.
- The adjustments should not be thought of as implying a re-recognition of revenue. They are primarily an impairment of an asset that will be reflected in CBI's financials on a percent of completion basis.
- They primarily serve as a ***cost offset***.
- Backlog is not affected by (the adjustments). It is not an adjustment to contract price. It is an adjustment to the assets of the project.
- Management refuses to talk about what drove the adjustments, which we find very strange. Furthermore, in an interesting flip, CBI seems to go back on its incessant pronouncements of the quality, depth, and completeness of its pre-acquisition Shaw due diligence:

> CBI: *That I think we have not clearly laid out in our financials as to why we say there was a change in the fair value of the assets that we acquired. We have not pinpointed a specific cause for these adjustments beyond the change in value. As you know when you go through an acquisition you don't have 100% visibility as to the quality of the assets. We have not specifically discussed the cost and drivers for that adjustments.*

Prescience Point Takeaways:

- The fair value adjustment is not a re-recognition of revenue but an off-set to costs (either in the revenue line or as a deduction to COGS).
- Seems confused but, per our assessment in the preceding sections, it appears they go straight through to the bottom line
- After so much due diligence and public information – shocking that they have had to make such large adjustments
- It was more shocking they wouldn't disclose what drove the adjustments; however, based on having taken asset impairments we assume cost overruns are to blame, highlighting that the downside scenario for these projects appears to be in play
- Concern that reserve was created for post-acquisition events
- IR says the adjustments do not affect backlog but its SEC filings indicate something has driven acquired backlog from Shaw, which was marked up from $15bn in Q1'13 to $16.8b as of Q4

The below is an excerpt from our call (with emphasis added to highlight key points):

PP - The first questions have to relate to reconciling net income to FCF in terms of future periods. Can you explain the basis of the Shaw fair value adjustment, how does that work generally and why the purchase price allocation was modified over the course of the year. What was the basis for that?

CBI – The fair value adjustments are basically changes to the project assets that we have a change in terms of what was considered the fair value at the time of acquisition from the actual fair value. The way to think about them is as an impairment. As you know that is allowed in terms of when you have an acquisition you have 12 months to make those adjustments to the fair value of the assets that were acquired. This would basically serves as an impairment this amortized over the life of the projects that were affected and it would be a function of the percent of completion of the progress on these projects. The effects of revenue would primarily depend upon the progress of the projects and the cost to cost accounting.

If you are targeting the root cause of the adjustments or the reasons for the adjustments basically changes in the fair value of the assets. As we get further visibility into this we primarily will adjust the value of the asset accordingly to what the real value was.

PP- How does that impact the expected margins on the contracts?

CBI – The impact will be a headwind for the margin of the projects and it is primarily worked off or discounted depending on the percent of completion. So it affects revenue and proportionally margin.

PP – Is the fair value adjustment the expected margin on the contract?

CBI – No, I don't think that is the case. It is discounted on revenues alone, not margin alone.

PP – How do these adjustments flow through to revenue, is that on POC basis?

CBI – Yes, that is entirely on a percentage of completion basis.

PP – Is it an offset to cost? Like a reduction in COGS? Do I think about it more as a re-recognition of revenue that had been recognized by Shaw or an offset to COGS?

CBI – I don't think a re-recognition would be accurate. It is primarily an impairment of an asset that will be reflected on a percent of completion basis. So, to your question it might be a function of a cost offset.

PP – Say that again, it is more of a cost offset.

CBI – Yes.

PP – More than a re-recognition of revenue.

PP – How did this adjustment impact backlog? Does the backlog benefit when the fair value adjustment is made? Is there an offset to backlog?

CBI – No, backlog is not affected by this. It is not an adjustment to contract price. It is an adjustment to the assets of the project.

PP – In balance, is it both a revenue benefit and a COGS reduction in terms of the income statement?

CBI – It is primarily a function of the percentage of completion basis. You can think of it offsetting COGS and also having an impact of revenue. The impairment would impact both lines and to a certain degree margin.

PP – What exactly was the reserve established for? What it is specifically related to the project or anticipation of what the future costs might be? What was learned during the period where these adjustments were made?

CBI – That I think we have not clearly laid out in our financials as to why we say there was a change in the fair value of the assets that we acquired. We have not pinpointed a specific cause for these adjustments beyond the change in value. As you know when you go through an acquisition you don't have 100% visibility as to the quality of the assets. We have not specifically discussed the cost and drivers for that adjustments.

Valuation and Price Target

The market was initially skeptical of CBI's decision to acquire Shaw, which was widely thought of as the much riskier company; CBI's stock fell -14% and was downgraded by several analysts the day after CBI announced the transaction (i.e., July 20, 2012). Credit Suisse, for example, downgraded CBI stock, stating, "*we remain cautious on the deal… We think SHAW's power (fossil and nuclear business) introduces risk to CBI's business model, evident by historic financial performance… We believe investor concern will remain centered on the risk associated with acquiring SHAW and we reduce our rating to Neutral from Outperform.*" [4]

Since that time, analysts and investors have changed their tunes in response to CBI's strong reported financial results, and the stock price has doubled. CBI's accounting-created earnings mirage is effectively concealing that the downside risks the market originally feared are materializing as CBI's reality. By our estimates the stock price remains inflated beyond reasonable measure, representing 49% downside from current levels.

Distorted Financials Lead to Disconnected Wall St Estimates & Unjustifiably High Target Valuations

The consensus stock price target of $92.97 per CBI share is founded on both artificially juiced financials and unjustifiably high valuation multiples that fail to reflect the risks of CBI's nuclear contracts – risks that have been concealed by creative accounting.

The vast majority of sell-side analysts who cover CBI anchor their projections to CBI management's guidance, without knowledge that CBI is using cookie jar accounting that enables it to achieve or 'close the gap on achieving' this guidance. For example, the Wall St consensus 2014 Adj EPS estimate of $5.17 compares to CBI guidance of $5.23, at the midpoint of the range, indicating analysts are being misled into issuing financial projections that overstate CBI's true earnings potential.

Analysts' Valuations for CBI Stock Based on Inflated Earnings Estimates

Analyst	Price Target	Valuation Multiple(s)	Rating
Barclays	$93.00	16X 2015E EPS $5.80	Overweight
Deutsche Bank	$93.00	~15X 2015 EPS $6.34	Buy
Jefferies	-	15.6X 2015E EPS $6.10	Buy
Stephens	$100.00	20X 2014 Adj EPS $4.96	Overweight
Sterne Agee	$100.00	17X 2015E EPS $5.88	Buy
Stifel	$92.00	18X 2014 EPS $5.29; EV/Backlog 0.4X; 3.5X P/B 2014 BVPS $29/sh; 9X EV/EBITDA 2014 $1.23b	Buy
UBS	$89.00	15.5-16X 2015E EPS $5.65	Buy
William Blair	$92.00	17.5X 2014 EPS $5.25	Outperform
Credit Suisse	$90.00	17X 2014 EPS $5.25	Neutral
Goldman Sachs	$90.00	16X 2014 EPS $5.60	Neutral
KeyBanc	NA	2015 GAAP EPS $5.87	Hold
Macquarie	$56.00	2014 EPS $4.72	Underperform

Analysts compound their mistakes by attributing unjustifiably high multiples to value CBI stock, an indication that CBI's substantial risk exposures are not being accounted for. As previously discussed, CBI is effectively masking the financial impacts of its nuclear contracts, which may prove severely loss-making. The resultant smoothed and 'growing' earnings are reflected by the analyst consensus target

[4] Credit Suisse Research. *CB&I: Chicago SGR Daddy.* July 2012

multiples implied by the $92.97 price target – 10.1x forward EBITDA and 17x forward Adj EPS! These valuations are preposterously high and defy logic for a company with elevated financial and operational risk exposures.

Although we believe analysts have been misled, given the plethora of red flags we are shocked in how completely they have missed and continue to miss the forest for the trees; several warning signals were shot off by CBI's 2013 reported CFFO alone. When CBI was marketing the Shaw acquisition to investors in 2012, management guided for 'significant combined free cash flow', indicating they expected additional cash flow from the Shaw acquisition.[5] This would not materialize; CBI ended up reporting CFFO of -$112.8, marking its lowest reported CFFO and first year of negative CFFO **ever**! The message was loud and clear: The Shaw acquisition had gone very wrong, an assertion supported by CBI's severe miss on its own internal 2013 FCF targets (as discussed in the section on Corporate Governance). In the table below we have compiled forecasts for analysts who had published estimates for 2013 CFFO. CBI's dramatic miss on each one's expectations alone should have been a wake-up call; that CBI at the same time reported Adj EPS which greatly exceeded their estimates should have set off alarms. In 2013, CBI reported its highest ever net income and, again, its lowest ever reported CFFO. It is hard to believe the innumerable warnings were never heeded.

CBI Reported a Dramatic Miss on 2013 Analyst CFFO Estimates, But a Big Upside Surprise on Adj EPS Estimates

($ in millions)

Source	2013 EPS Estimate	Variance From Actual = $4.91	2013 CFFO Estimate	Variance From Actual = ($112.8)
Citi (1)	$4.11	*19%*	$613.0	($726)
Baird (2)	$4.09	*20%*	$564.1	($677)
Barclays (3)	$3.85	*28%*	$480.0	($593)
Credit Suisse (4)	$3.90	*26%*	$505.9	($619)
Goldman Sachs (5)	$3.45	*42%*	$309.2	($422)

(1) Citi. *CBI SHAW Acquisition Pro Forma Model.* Sept 6, 2012
(2) Baird Equity Research. *CBI: Initiating Coverage at Neutral.* May 28, 2013
(3) Barclays. *CB&I : EPS Accretion Still Looks Significant*. Feb 19, 2013
(4) Credit Suisse. *CB&I: A Fly-By Quarter*. Feb 28, 2013
(5) Goldman Sachs. *Americas: Engineering & Construction*. April 8, 2013.

We Believe Warren Buffett Would Agree w/ Our Conclusions if Made Aware of the Highlighted Issues

Berkshire Hathaway is the largest holder of CBI stock, owning 8.8% of the company. As (grateful) students of Warren Buffett's teachings, we are confident that if he were made aware of CBI's use of accounting entries that inflate earnings, as highlighted in this report, he would be agreeable with our primary conclusion – that for valuation purposes, CBI's reported earnings need to be adjusted to exclude the non-cash income boost from purchase price accounting adjustments.

Mr. Buffett covers this very topic in the appendix to Berkshire's 1986 Chairman's Letter to Shareholders, entitled ***Purchase-Price Accounting Adjustments and the "Cash Flow" Fallacy***." In explaining his philosophy, he begins by demonstrating that, because of the mechanics of acquisition accounting, it is possible for identical businesses that generate the same amount of cash for owners to report substantially different GAAP earnings.

In his example, he compares the post-acquisition income statement of Scott Fetzer – a business Berkshire acquired in 1986 – to the 'cleaner' income statement Scott Fetzer would have reported had Berkshire not acquired it. Although in either case, Scott Fetzer has identical economic characteristics, the two income statements are substantially different – the cause relates to simple accounting distortions that result from purchase price accounting.

Because of the presence of such distortions, Mr. Buffett suggests that when conducting a business valuation, investors should begin by making adjustments to the company's reported financials toward calculating a more sustainable measure of profitability, which he refers to as "owner earnings" and defines as follows:

[5] CBI's Shaw Acquisition presentation August 2012, slide 32

These represent (a) reported earnings plus (b) depreciation, depletion, amortization, and certain other non-cash charges such as (purchase price adjustments) less (c) the average annual amount of capitalized expenditures for plant and equipment, etc. that the business requires to fully maintain its long-term competitive position and its unit volume. (If the business requires additional working capital to maintain its competitive position and unit volume, the increment also should be included in (c) …)

Mr. Buffett states that reported earnings should be adjusted for certain non-cash items, specifically mentioning purchase price adjustments. Accordingly, we believe that if CBI had more thoroughly disclosed its post-acquisition purchase price adjustments, Mr. Buffett would likely adjust CBI's financials for the resultant noncash gains. Furthermore, given his openness with his own shareholders, he may look with disapproval at CBI's lack of transparency with its shareholders and indications it may have misled them.

In closing, we leave you with another quote from Mr. Buffett, extracted from Berkshire's 1998 Chairman's Letter to Shareholders, in which he describes a situation we believe to be relatable to CBI's.

In the acquisition arena, restructuring has been raised to an art form: Managements now frequently use mergers to dishonestly rearrange the value of assets and liabilities in ways that will allow them to both smooth and swell future earnings.

An example from the property-casualty insurance industry will illuminate the possibilities. When a p-c company is acquired, the buyer sometimes simultaneously increases its loss reserves, often substantially. This boost may merely reflect the previous inadequacy of reserves -- though it is uncanny how often an actuarial "revelation" of this kind coincides with the inking of a deal. In any case, the move sets up the possibility of 'earnings" flowing into income at some later date, as reserves are released.

Berkshire has kept entirely clear of these practices: If we are to disappoint you, we would rather it be with our earnings than with our accounting. In all of our acquisitions, we have left the loss reserve figures exactly as we found them. After all, we have consistently joined with insurance managers knowledgeable about their business and honest in their financial reporting. When deals occur in which liabilities are increased immediately and substantially, simple logic says that at least one of those virtues must have been lacking -- or, alternatively, that the acquirer is laying the groundwork for future infusions of "earnings".

Warren Buffett, 1998 Chairman's Letter to Shareholders

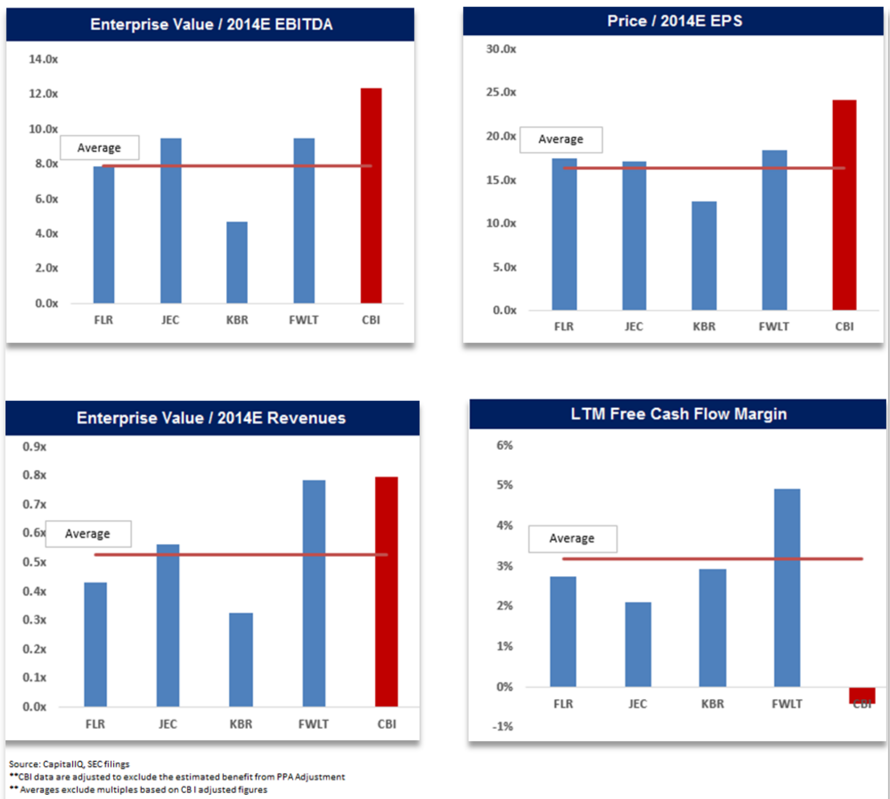
Price Target and Conclusion

The mirage of CBI's reported gross margin, EBITDA, and EPS, has existed for long enough to result in the levitation of its stock price to a valuation that defies reasonable measure.

On the surface, CBI appears to be trading at moderate valuations -- 8.7x and 14.5x 2014E EBITDA and reported Adj. EPS, respectively However, both EBITDA and EPS fail to reflect the true costs of CBI's business. By adjusting these metrics accordingly (as previously detailed), we calculate CBI is selling at 'true' 11.6x 2014E EBITDA and 22.4x EPS, meaning that CBI is the most expensive (and in our view the highest risk) E&C in its sector and yet is in our opinion the absolute riskiest.

CBI's comps trade at average multiples of 8.3x and 17.3x 2014E EBITDA and EPS, respectively - much cheaper valuations than our estimates for CBI. CBI, however should trade at a significant discount to these peers, primarily because it is the most highly exposed to nuclear projects, which entail substantial tail risk (refer to the Appendix for more information).

We note that just prior to CBI having announced its intent to acquire Shaw Group (at July 27, 2012), Shaw traded at 5.1x and 8.5x forward EBITDA and EPS, respectively, on the basis of higher risk exposures - exposures CBI now carries. Moreover, it appears Shaw's risk exposures have risen under CBI's ownership, ramping up alongside nuclear plant construction in early 2013.



Engineering & Construction Comps

($ in millions, except per share figures)

					'14E-'15E		LTM			P / E			Enterprise Value / EBITDA			Enterprise Value / Revenue		
Name	Ticker	Stock Price	Equity Value	Ent. Value	Revenue Growth	EPS Growth	Gross Margin	EBITDA Margin	FCF Margin	LTM	2014E	2015E	LTM	2014E	2015E	LTM	2014E	2015E
Fluor Corporation	FLR	$76.98	$12,617	$11,144	12%	21%	5.2%	5.3%	2.7%	19.4x	18.2x	15.0x	8.2x	8.2x	7.2x	0.4x	0.4x	0.4x
Jacobs Engineering Group	JEC	$54.65	$7,214	$7,563	11%	31%	15.3%	5.9%	2.1%	18.2x	17.7x	13.5x	10.3x	9.6x	7.6x	0.6x	0.6x	0.5x
KBR, Inc.	KBR	$26.06	$3,883	$2,840	7%	22%	8.0%	5.5%	2.9%	16.9x	14.4x	11.8x	7.1x	5.6x	4.7x	0.4x	0.4x	0.4x
Foster Wheeler AG	FWLT	$34.51	$3,461	$3,093	17%	28%	17.4%	7.3%	4.9%	35.6x	19.1x	14.9x	13.0x	9.8x	8.4x	1.0x	0.8x	0.7x
URS Corporation	URS	$44.86	$3,351	$5,383	2%	10%	7.4%	6.5%	3.4%	16.4x	14.1x	12.8x	7.8x	7.0x	7.2x	0.5x	0.5x	0.5x
				Max	17.2%	31.5%	17.4%	7.3%	4.9%	35.6x	19.1x	15.0x	13.0x	9.8x	8.4x	1.0x	0.8x	0.7x
				Average	11.7%	25.4%	11.5%	6.0%	3.2%	22.5x	17.3x	13.8x	9.7x	8.3x	7.0x	0.6x	0.6x	0.5x
				Min	6.6%	20.8%	5.2%	5.3%	2.1%	16.9x	14.4x	11.8x	7.1x	5.6x	4.7x	0.4x	0.4x	0.4x
Prescience Point Adjusted Financials for CB&I																		
Chicago Bridge & Iron	**CBI**	**$73.58**	**$ 8,028**	**$ 9,817**	**9.3%**	**26.6%**	**8.2%**	**5.8%**	**-0.4%**	**25.4x**	**22.4x**	**17.7x**	**14.3x**	**11.6x**	**10.0x**	**0.8x**	**0.7x**	**0.7x**

Sources: Company financials, Wall St. estimates, CapIQ.
**CBI data are adjusted to exclude the estimated benefit from PPA Adjustment

We believe CBI's stock is at risk of significant downside from its current price of $73.58. Based on our analysis,

1) CBI used creative acquisition accounting to conceal ongoing operating losses from its nuclear contracts, resulting in financial statements that dramatically overstate its underlying earnings potential. Backlog appears to have been manipulated with no explanation. Credit risk is substantially understated and the company is overleveraged.
2) CBI's realities are better reflected by our estimates, which demonstrate that absent creative accounting, CBI would have reported a 2013 earnings miss relative to Wall St estimates and its own guidance, and a contraction in 2013 pro-forma earnings.
3) CBI is knowingly or recklessly failing to disclose that its underlying financial performance is dramatically different from what it reports to the investing public. <u>CBI does not disclose by exactly how much income is inflated</u> by its release of the reserve or why the reserve was created. Worse, despite financial statements showing that the Shaw acquisition is a failure, CBI touts the success of the transaction, which we believe is misleading. Management also appear to actively mislead analysts in several instances to prevent the discovery of the reserve and its impacts on CBI's financials.
4) CBI is struggling with certain contracts that may prove to be severely loss making, and PP believes the reserve is being used to mask the effect of those contracts. CBI's Q1'2014 results confirm our expectations and signal continued losses and income-to- cash flow divergence. The Q1'2014 results indicate an increased reliance on debt to cover cash losses, with CBI drawing on its revolver, taking total debt from $1.84B in the previous quarter to $2.034B and enabling it to maintain a flat cash balance.
5) CBI is at high risk of a liquidity crisis or dilutive equity raise. CBI's $420m net cash position is misleading, in that the company is likely to have <u>no excess cash</u>. CBI will have to spend a significant amount of that cash, if not all of it, to actually "earn" the deferred revenue balance sitting on its balance sheet. Continued cash losses or a decline in bookings would necessitate CBI increase its dependency on its revolver. While the company has $1.36B of available capacity under its revolving credit facilities, we believe CBI will be forced to write-down its bloated goodwill balance, triggering a default on its minimum net worth covenant and heightening the risk of a liquidity crisis.
6) The bizarre pattern of PPA fair value adjustments may point to a GAAP violation. CBI made <u>$1.2B</u> of the total ~<u>$1.56B</u> (>75%) fair value adjustment in Q3 and Q4 alone, 8 to 11 months after the deal was completed and nearly 18 months after CBI and Shaw entered into a definitive agreement in July 2012. In light of the completeness of CBI's pre-acquisition due diligence and its reassurances in its due diligence process months after the acquisition, the pattern appears to indicate the adjustments were made in response to post-acquisition events. If so, the PPA adjustments are <u>not legitimate</u> and <u>CBI has violated GAAP</u> by not taking charges against its earnings.
7) CBI's has a flawed corporate governance structure that may encourage earnings manipulation. Adjusted EPS is the primary determinant of management incentives. CBI of course defines Adjusted EPS as "EPS <u>excluding</u> merger and acquisition costs," but its calculation does not appear to exclude <u>the non-cash benefit from recognition of the PPA fair value adjustment</u>. This translates to a management capability to artificially inflate CBI's underlying earnings, meet EPS bonus targets, and get paid out of shareholders' pocket books; from a moral standpoint, it is akin to a theft.
8) CBI's board's actions signal FCF to remain elusive: Had CBI not reduced the weighting of FCF in determining executive compensation, we might entertain that there in fact was a strategic path towards generating free cash flow. We believe that doing so signals that CBI itself – with its board's stamp of approval – has written off the possibility of any <u>sustainable</u> FCF generation in the foreseeable future.
9) The equity has been the beneficiary of a Wall St consensus that values CBI on both inflated profit forecasts and inflated multiples. Analysts are being <u>misled</u> into issuing financial projections that <u>overstate</u> CBI's <u>true earnings potential</u>; they <u>anchor their projections to CBI management's guidance</u>, without knowledge that CBI is using cookie jar accounting that enables it to achieve or '<u>close the gap on achieving'</u> this guidance. Analysts compound their mistakes by attributing unjustifiably high multiples to value CBI stock, an indication that CBI is doing a good job in concealing the substantial risks of its nuclear contracts.

Given our belief that CBI's goodwill is grossly overstated and that it may have violated GAAP, CBI will likely be forced into a goodwill write-down or a financials restatement. Either scenario would result in a debt default, potentially resulting in its lenders limiting or withdrawing CBI's access to credit, and at a time in which CBI appears to be growing more debt-dependent to fund cash losses. CBI likely has no excess cash as a cushion to fall back on. As a result, we believe CBI is at growing risk of a liquidity crisis or a dilutive equity raise to prevent one. We value CBI at 6.5x – 7.5x our forward Adj EBITDA (i.e., 9.1x – 11.3x our forward Adj EPS), implying an intrinsic value in the range of $33.26 - $41.49 per share and reflecting *44% – 55%* downside from the current price.

($ millions)	EBITDA Multiple Range 6.5x	--	7.5x
Forward EBITDA (1)	$898.1	--	$898.1
Enterprise Value	$5,837.7	--	$6,735.8
Less: Minority Interest	($173.8)	--	($173.8)
Less: Debt	($2,034.8)	--	($2,034.8)
Equity Value	$3,629	--	$4,527
Fully Dil. Shares	109.1	--	109.1
Price Target	**$33.26**	--	**$41.49**
Current Price	$ 73.58	--	$ 73.58
% Downside	***(54.8)%***	--	***(43.6)%***

(1) PP estimate – derived by adjusting the Wall St consensus forward EBITDA estimate, $1185, to exclude our estimate for the annual noncash income benefit, $286.7m, related CBI's PPA Adjustment

Note: Our valuation assumes CBI has no excess cash, as discussed in this report. As such, its $420m cash balance as of Q1'14 is excluded from this calculation. Including it would have resulted in a price target in the range of $37.11 – $45.34, reflecting 38% – 50% downside from the current price

Appendix – An Analysis of Shaw Nuclear Projects and Inherent Risks

Nuclear Projects Notoriously Risky – Downside Scenario Appears to be in Play

As history demonstrates, nuclear projects are often marred by unforeseen delays that extend project lives out by years, making them notoriously risky endeavors. Unlike standard fossil fuel projects, nuclear projects are also licensed and overseen by the U.S. Nuclear Regulatory Commission (NRC) and add a new layer of complex regulatory compliance. While costs for large projects are never static, nuclear projects are subject to extensive reworking and/or redesigning that can meaningfully increase cost – costs that become burdensome to the contractor participating in fixed-price contracts. During the prior cycle in the 1970s and 1980s, nuclear construction projects went over budget by 2-3x.[6] In the current cycle, nuclear builds cost 2-3x what they did in the past cycle. Because of this and the current low price of natural gas, nuclear economics are disfavored today with only 5 new reactors under construction.

Historical Nuclear Project Cost Overruns

Construction Starts: Year Initiated	Construction Starts: Number of Plants	Utilities estimate ('000 of dollars per MW)	Actual ('000 of dollars per MW)	Overrun (%)
1966-1967	11	612	1,279	109
1968-1969	26	741	2,180	194
1970-1971	12	829	2,889	248
1972-1973	7	1,220	3,882	218
1974-1975	14	1,263	4,817	281
1976-1977	5	1,630	4,377	169
Average		**938**	**2,959**	**207**
2007*	1	2,119	3,390-3,814	60-80

*Watts Bar 2, being constructed by Tennessee Valley Authority

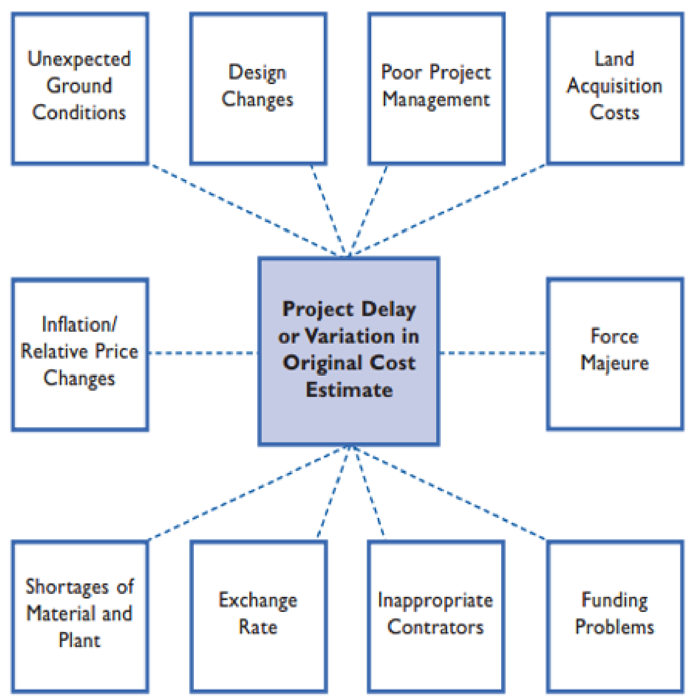
Upward revisions of cost estimates by Industry experts

Forecasts	Timeline	Overnight Cost ($/kW)
DOE	2002	$1200-$1500
MIT	2003	$2,000
Keystone Centre	2007	$2,950
Moody	2007	$2,950
EIA	2007	$5,335
MIT	2008	$4,000
Vogtle 3 and 4		$3,886
Summer 2 and 3		$3,617
Levy 1 & 2*		$4,668
Turkey Point 6 and 7*		$4,669

* not being constructed

Source: Company documents, Congressional Budget Office, Goldman Sachs Research.
*Source of Chart: Engineering & Construction: *End market selectivity key in late stages of E&C cycle.* April 2013

Cost Changing Factors



**Source: European Commission – *Understanding and Monitoring the Cost-Determining Factors of Infrastructure Projects: A User's Guide*

By acquiring Shaw, CBI assumed the buildout of 4 of them – 2 reactors each at plants Vogtle in Georgia and V.C. Summer in South Carolina. These contracts were signed by Shaw in 2008. The Vogtle project is monitored by Georgia Power (Southern Company subsidiary), and the V.C. Summer project is being monitored by South Carolina Electric & Gas Company. These reactors are the same commercially untested Westinghouse AP1000 reactor design, purportedly quicker to build and more safe than previous plants.
CBI is very highly exposed to the risk of loss that might result from delays and other factors causing budget overruns. Although CBI represents these nuclear contracts as hybrid-type projects (include fixed-priced and cost-plus components), our research indicates the

[6] Goldman Sachs. *Engineering & Construction: End market selectivity key in late stages of E&C cycle.* April 2013

Vogtle projects are heavily tilted to fixed-price and that V.C. Summer is two-thirds fixed-cost with escalation. Fixed-price (a.k.a. lump-sum) contracts shift more of the risk of project execution to the EPC contractor, such that project cost overruns result in reduced project margins. From our conversations with project managers for fixed-price EPC contracts, even for run of the mill power plants, the risk management process for fixed-price contracts can be extremely challenging.

The underlying risk from fixed price contracts is disclosed by CBI as follows:

> *"Under fixed-price contracts, we perform our services and execute our projects at an established price and, as a result, benefit from cost savings, but may be unable to recover any cost overruns. If we do not execute a contract within our cost estimates, we may incur losses or the project may be less profitable than we expected. The revenue, cost and gross profit realized on such contracts can vary, sometimes substantially, from the original projections due to a variety of factors"*

CBI is highly exposed to substantial losses in the event of major budget overruns.

As these projects are public works projects, the Owners are required to file regular progress reports with the Georgia Public Service Commission (for Vogtle) and the South Carolina Public Service Authority (for V.C. Summer) for the purpose of assuring project costs are prudent and to protect the interests of all electricity ratepayers. We have reviewed the public filings and spoke with former project participants to describe the financial risks embedded in these projects. In this report, we provide insights that better explain the aggressive accounting stance taken by CBI that is not providing details about these large EPC contracts and generally sidestepping analysts questions on these issues.

CBI Awarded Shaw a Clean Bill of Health – Analysts Thought Otherwise

While mainstream press accounts (here, here, here) detailed delays and problems with Shaw's nuclear projects, CBI failed to discuss these issues in its due diligence section of the Shaw acquisition slide deck as shown below:

Due Diligence:

- Team of 24 employees, with external support, conducted thorough due diligence over three month period
- Process consistent with past successful due diligence efforts (Howe-Baker, John Brown, ABB Lummus)
- Shaw provided data room with more than 3,500 documents; on-site analysis of U.S. nuclear projects
- Analysis by CB&I leadership and external counsel indicate that risk profile and expected profit is consistent with Shaw public statements

However, these risk were not unknown to analysts and CBI faced several downgrades and some questions from analysts.

From the period 2008-2012, prior to Shaw's acquisition by CBI, we identified several aspects of the Vogtle projects that were likely to pose future risks to CBI. For example, the earliest delays with the project concerned approvals required for the Design Control Document (DCD) by the Nuclear Regulatory Commission (NRC) and combined construction and operating licenses (COLs). The COL was applied for in March 2008 and it was issued Feb 2012 with only a 6 month delay relative to expectations. The red tape challenges to this type nuclear project were alluded to in the 2009 construction monitoring report: *"The Company [Georgia Power] has responded to over 1,600 requests for additional information from the NRC"* and *"The Company is watching and managing several areas of exposure to the schedule and cost, but as of now it believes the Project will stay on budget and on schedule from a licensing perspective."*

In 2010 and 2011, the Vogtle project was reported to be largely on-budget and on-schedule according to Georgia Power's public report. In reality, Shaw was already experiencing major issues. Shortly after Shaw Modular Systems (SMS) started work on the CA20 module (a major component of the reactor), several short stop work orders were issued by the NRC "due to inadequate procedures and failure to comply with existing procedures." Only 13 out of 26 planned fabrication starts had been commenced on schedule. Other internal audits showed that Shaw was not following procedures for background checks, a requirement for the NRC Fitness For Duty program. In 2H of 2011, although GA Power cited these increased costs, they reiterated the higher costs will be borne by the contractors per the EPC agreement and not ratepayers.

In early 2012, the problems were becoming incrementally worse. The 7th Semi-Annual Construction Monitoring Report (VCM) represented a shift to a more cautious tone and the acknowledgement by Georgia Power that cost increases were forthcoming and completion dates were being moved back by 8 months for both reactors to November 2017 and 2018, respectively. Georgia Power disclosed cost disputes of $425m that ended in litigation which commenced 11/1/12 and has since provided CBI an excuse not to discuss the cost overruns as it is now an active legal matter. To summarize the litigation, GA Power alleges that in 2010 and 2011, Shaw (a.k.a. Stone & Webster) asserted entitlement to Change Orders concerning 1) AP1000 Shield Building (May 27, 2010); 2) Structural Modules (November 23rd, 2010); and 3) delays concerning Limited Work Authorization (LWA) (March 1, 2011). According to statements filed by both GA Power and CBI, they still intend to solve this dispute outside of court. We believe this is increasingly unlikely.

In the 8th VCM for 2H 2012 (released 2/28/13 – just 2 weeks after the Shaw acquisition), a bombshell was dropped indicating an additional 1 year delay with 4Q 2017 and Q4 2018 as the new completion dates or approximately 19-21 month delay from the original completion dates. GA Power also requested an increase to capital costs of $381m to over GA Power's increased costs of oversight of the project and for project delays.

CBI Has Been Challenged to Fix the Nuclear Projects – Delays & Cost Overruns Persist

Even after CBI acquired Shaw in 2013, problems have persisted. Here we discuss aspects of these projects that illustrate higher than expected project costs likely offset by the CIP liability cookie-jar and thus have avoided the income statement.

The 8th VCM , in particular, created substantial concern for the Georgia Public Service Commission with several hearings and events evolving from that filing, particularly with regard to the issue of cost contingencies. The project was budgeted with a 3-5% contingency but then as costs escalations continued, GA Power indicated a 20-25% contingency was more typical of this type of EPC project, particularly a project of this magnitude. The GA PSC was incredulous as to why the original contingency was so low. A stipulation reached for the 8th VCM was required after GA Power had acknowledged that costs were going to exceed the approved costs by 5%. As the contingency threshold was set at 5%, this meant that all additional costs must instead be specifically approved if shown to meet the "prudence" legal standard and then approved. However, due to the ongoing litigation and inability to ascertain future costs, it was jointly decided that "any further requests to increase the certified cost should be held in abeyance until the completion of Vogtle 3", now estimated to be Q4 2017. In effect, this delays the decision as to which costs are "reasonable and prudent" until at least 3.5 years from today – a discount factor likely not recognized by most investors.

GA Power did indicate a higher confidence that CBI was more competent than Shaw to complete the project. From the 8th VCM Testimony 6/28/13: *"And again, the reason that we believe that is we have seen CB&I Services successfully -- very successfully -- procure and put together the modules for the containment vessel. They've now taken over the [Shaw] facility and taken over the running of not only the Lake Charles facility but they're responsible for all module fabrication."* In the interim report filed for 1H 2013, it was indicated that 50% of the EPC contract was completed based on milestones.

However, problems have persisted. From January 2013 through March 2013, CBI received a stop work order to prevent delivery of materials with deficiencies. This restriction continued past March for Lake Charles. These challenges were summarized as follows in the interim report: "*The Contractor has established more rigorous review processes that include CB&I, Westinghouse, and Lake Charles personnel, with SNC oversight, to ensure that sub-modules meet licensing and quality requirements and project schedule needs. This area continues to be a challenge and focus for the project, and process improvements have resulted in nine structural sub-modules being released in the last four months*."

In the combined VCM report for FY 2013 released 2/28/14, which is also the most recent semiannual report, Georgia Power commented on the impact for the CBI takeover of Shaw: *"This change resulted in key leadership changes and the Company has seen overall improvement in the Contractor's transparency, cooperation and communication as well as execution with a focus on quality and schedule."* The major structural module CA20 was set to be placed May 2013, but was then projected for November 2013. During this time, CBI established an extension site of Lake Charles now referred to as Lake Charles-Vogtle to create "parallel work paths to mitigate schedule impacts of delayed sub-module deliveries". However, CA20 was actually placed March 2014 – 4 months later than the last expected date.

CBI is so far behind schedule on some components they have been reassigned construction to other 3rd party fabricators. For example, Mackson has taken over the CA03 fabrication as of 9/3/13. Additional evidence CBI is not self-performing other work is discussed below in the section regarding V.C. Summer. We do not know the cost differences of CBI using a 3rd party for worked originally intended to be done by themselves.

Southern Company commented in its 2013 10-K, that claims from the contractor have continued to increase from the initial claim of $300m. According to 2013 Georgia Power parent Southern Company (SO) 10-K, these costs have since escalated to from the $300m as identified in the lawsuit to $425m – *"The portion of the additional costs claimed by the Contractor that would be attributable to Georgia Power with respect to these issues is approximately $425 million (in 2008 dollars). Georgia Power has not agreed with either the proposed cost or schedule adjustments or that the Owners have any responsibility for costs related to these issues."* As Georgia Power is a 45.7% owner of the project, this implies the total claim by CBI to all project owners is $930m.

To close, Commissioner Echols of the Georgia Public Service Commission expressed candid concerns about the open ended nature of the cost escalations – *"I mean we'll be over and done with this whole hearing in one day and this code interpretation could cost our ratepayers $100 million. And the paperwork incident at Lake Charles that we talked about in the last hearing could cost our ratepayers $100 million. And this is really serious that we are -- you know, that we're going down this road. And that the contractors and their errors are having such an impact on our ratepayers." "And it's concerning and I -- you know, to think that we're going to delay making a prudency decision until 2017 or 2018, I don't know how much I'll remember then. That's a long time."* We agree wholeheartedly with this sentiment.

Problems at V.C. Summer Reflect Those at Vogtle

CBI is also building 2 additional and identical AP1000 reactors at V.C. Summer under the direction of South Carolina Electric & Gas Company. Like Vogtle, the project has been marred by delays and unexpected costs, as widely reported in the press here, here, here. Currently, V.C. Summer Unit 2 is delayed by 9 months to December 15th 2017 and Unit 3 is also delayed by 7 months to December 15th 2018.

Although CBI has generally referenced Vogtle with respect to possible financial impacts, a recent US Department of Energy presentation (pg. 14) cites $200m in increased and unallocated costs at V.C. Summer with a different presentation (pg. 18) indicates SCE&G will contest these costs while a new project schedule and cost estimates won't be available until Q3 2014. The placement of the large CA-20 module at V.C. Summer Unit 2 on 5/9/2014 indicates similar progress compared to Vogtle which placed a CA-20 in March 2014.

According to public filings with the South Carolina Office of Regulatory Staff (SC-ORS) and interviews with former project managers, the primary issue at V.C. Summer is the delayed delivery of structural sub-modules.

Relevant quotes from SC-ORS public filings include the following:

- *"The most significant currently identified challenge to the project is the continued inability of CB&I to reliably meet the quality and schedule requirements of the project."* *(pg. 21)*
- *"The most significant issue is the continued delay in the delivery of the structural sub-modules"* *(pg. 1)*
- *"Although some progress has been demonstrated, fabrication of modules CA20 and CA01 remains the most significant challenge to meeting the project construction schedule."* *(pg. 2)*
- *"Since assuming responsibility for the facility from Shaw in late 2012, CB&I has made several management changes; increased the staff from 700 in February 2013 to 1,205 as of September 25, 2013"* *(pg. 20)*

Coincident with the announced takeover of Shaw by CBI, it was first noted in Q3 2012 SC-ORS that some Unit 2 modules were going to be reassigned to another fabricator. This issue was further elaborated upon in the Q4 2012 SC-ORS report as follows *"Because of the production and quality issues associated with SMS (Shaw), fabrication of the Shield Building modules has been reassigned to Newport News Industries ("NNI"). However, NNI's sustained, reliable performance has not yet been demonstrated, and a delivery schedule had not yet been provided as of December 31, 2013.* A presentation from NNI indicates they are responsible for "Dry shield modules for both sites at Vogtle and V.C. Summer (~670 modules)". A non-conformance report from the NRC directed at NNI indicated that "*Chicago Bridge & Iron contracted NNI in Newport News, VA, to fabricate, assemble, inspect, transport, and deliver shield building structural modules to the Vogtle & V.C. Summer new construction sites."*

The inability of CBI to self-perform module construction has persisted after the acquisition of Shaw and is a probable factor that has eroded project margins. Beginning in Q2 2013, there was ample evidence that additional Unit 2 modules that were previously the responsibility of CBI are now being completed by other vendors.

- "The sub-modules for CA03 were originally scheduled to be manufactured by Chicago Bridge & Iron's module fabrication facility, known as CB&I Lake Charles ("CB&I-LC"), but in order to expedite the work on other modules, the fabrication of these sub-modules was transferred to Pegasus Steel, LLC earlier this year." (pg. 5)
- From the Q2 2013 SC-ORS filing "In an effort to improve delivery times, CB&I shifted work from CB&I-LC to other fabricators, including the CA04 module, the CA03 module, and Shield Building modules."
- For Unit 3, the use of additional 3rd parties is also expanding as included in the most recent report in Q4 2013 SC-ORS - "*With regard to Unit 3 sub-modules, SCE&G advised ORS that the Consortium plans to transfer responsibilities from CB&I-LC to additional fabrication vendors and will finalize these plans soon."* This language suggests the Consortium has latitude within the terms of the EPC agreement to take away sub-module construction rights or force the contractor to use a 3rd party.

The incremental costs to outsource key modules is not being discussed by management or analysts and we are doubtful that CBI is able to realize the project margins that were anticipated when the EPC contract was bid.