Hoping Hill's Restatement Isn't Too Big a Hill to Climb $HIL

Upfront Disclaimer: Hill (HIL or HILI; disclosure: long) is on the smaller end (market cap well under $500m), was just delisted / trades OTC, and is well behind on their financials. Risks are obviously elevated here; please do your own research as nothing on this blog is a recommendation.

This is now the 3rd time I will have written about Hill (ticker HIL or HILI; disclosure: long) on the blog (see post 1 and post 2), which I believe puts it in second place behind Charter (Disclosure: long) for the company with the most "focus" articles I've written on the blog. But with shares down ~25% over the past few days in response to the NYSE delisting them this week, I felt an update was in order.

Let me start with the obvious: I love exchange delistings, particularly unexpected ones. At a high level, a delisting is an event that does not change a company's underlying value but can create huge swings in share prices as shareholders who cannot own OTC stocks are forced to sell. Hill is the same company today it was a week ago; its shares are just ~25% cheaper and its shares are going to be a bit more illiquid until they get relisted.

Ok, delisting discussion out the way, let's talk about Hill and why I think the current share price is an opportunity. A bit of background (I'd encourage you to read my prior write ups for more): Hill is a project management and construction consulting services company. A simplified way to think of Hill is to consider them a consultant on construction projects: you

hire Hill and Hill will use their expertise to identify potential sources of risk on a construction project before they turn into costly problems. Hill is the 8th largest program management firm in the U.S. (and, per the Warsaw Business Journal, the #1 firm in Poland!).

Hill was historically run and controlled by the Richter family, who founded Hill. They basically ran Hill as a personal piggybank, with egregious compensation, plenty of executive perks (including multiple cars and country club dues paid for by the company), and massive destruction of shareholder value. Everything started to change in 2015, when a private equity firm made a hostile over for Hill. Hill rejected the offer, but activists got involved in response and in 2017 the activists finally succeeded in taking over the board and fully booting the Richters. With the Richters gone and the sale of their construction claims segment closing in early 2017, Hill was left with a relatively clean balance sheet and a pretty simple path: cut a bunch of costs and then sell the newly slimmed down company to the highest strategic bidder. With activist funds controlling ~30% of shares and having multiple board seats (and the Richter family controlling another ~15%), the nice thing about Hill was management really didn't have much room to deviate from that plan.

The Hill story seemed to be progressing exactly as planned last year. With the Richters resigning, Hill named a board member as interim CEO in May 2017, and one of the interim CEO's first acts was to announce a profit improvement plan that would cut ~$30m of costs annually (not a small amount for a company with a market cap of ~$250m currently!). It seemed pretty clear that the interim CEO would fully implement the cost cutting program though the middle of 2018 and then the company could run a sales process on the new, slimmed down cost structure sometime in late 2018 or early 2019.

However, this “simple” story ran into a huge complication in September 2017, when the company announced they’d need to restate three years’ worth of financials to deal with the “accounting treatment of foreign currency translation adjustments related to intercompany balances”. The restatement has dragged on for almost a year now and ultimately led to them getting delisted this month.

It’s of course always concerning when accompany says you can’t rely on their financials, but a review of their restatement timeline raises a few more red flags:

- In December 2017, Hill gave an update that said they planned on filing all of their delayed financials by the end of Q1’18; in addition, the provided an update on guidance for 2017 and 2018 plus a current backlog update.
- In late March 2018, they gave an update that reiterated 2018 guidance and gave an update on backlog, but did not provide any updates on 2017 performance; they also pushed the bars for their refiling back, saying they’d restate their 2014-2016 financials during Q2, get their 2017 financials out by the end of Q2’18, and file their Q1’18 financials and get current on their filings by the end of Q3’18.
- In May 2018, they announced they had filed their FY14-16 financials and their Q1’17 financials, and reiterated they planned to file the rest of their 2017 financials by the end of Q2’18 and get current on their financials in Q3’18. They gave no updates on their financial performance.
- In June 2018, they announced their Q2’17 financials were filed. They pushed back the timeline for the rest of their 2017 filings to Q3’18, but reiterated they planned to be current on their filings in Q3’18. They gave no financial updates.
- In July 2018, they announced they had filed their Q3’17

financials. They gave an updated cash balance for the whole company but no other financial updates. They reiterated they planned to get current on their financials during Q3’18.
- In August 2018, they were delisted from the NYSE. They reiterated they would get current on their filings in Q3’18, but gave no financial updates.

Over time, the restatement timeline has been consistently pushed back and the company has given less and less disclosure on how the business is performing. So while the delisting probably presents opportunity, the big near term risk here is that Hill’s business is falling apart and Hill has stopped providing disclosure because they don’t want to admit their (hypothetical) poor performance to the market. There are, of course, longer term risks, several of which I’ll discuss later; the most prominent long term risk is that Hill’s business is rather cyclical and tied to the global economy, but given how tied to the near term “business is falling apart” risk it’s not worth addressing separately (though I will highlight a substantial portion of their business is tied to the Middle East).

I’ll pause here to step back and just provide an overview of the situation / everything discussed above: Hill’s shares have fallen off because of the delisting, the company remains insistent they’ll get their filings done by the end of this quarter (which, all else equal, would likely give the stock a boost simply because the wall of worry is lifted and people start anticipating a relisting), and the big risk is that the company is hiding the business falling off a cliff by giving less disclosure over time. Assuming the company can meet their Q3’18 filing guidance, this situation should resolve itself rather quickly: in the next month or two Hill will make their filings, and we’ll get a lot more details into how the business is performing. If it’s performing anywhere close to their prior projections, shares will likely go up

significantly as the valuation currently seems quite cheap.

That leaves us with two key questions to address.

1. How do we know Hill's business hasn't fallen off a cliff
2. What is Hill valued at today's share price, and what would a fair value be

The first question (has Hill's business fallen off a cliff) is a bit more complicated, and some of the results from a valuation will help inform our conclusion, so let's handle the simpler questions (Hill's valuation) first and then turn to looking at the clues on how their business is performing.

At today's share price of ~$4.20, Hill has a market cap of ~$232m and an EV of ~$250m.

The last time Hill provided 2018 guidance (in March 2018), they were targeting 10-12% EBITDA margins and revenues of $400-415m. Let's take the low end of both of those ranges and say Hill can hit 10% margins on $400m in revenue. That would give them $40m in EBITDA, and Hill today would be trading for just over 6x EBITDA.

That multiple would clearly be much too cheap. There are no perfect comps in the public markets, as most of Hill's competitors are just pieces of much larger companies, but a broad survey of related companies and industry M&A can do a decent job of guiding us to a fair multiple. I think looking at the 10 peers listed in Hill's 2016 10-k (see page 24) is a nice place to start. Of the 10, two have been taken out and the other 8 remain publicly traded. Looking at their transactions and trading multiples is instructive:

M&A:

- Peer TRC (ticker: TRR) sold to private equity firm New Mountain Capital for a 47% premium at the end of March 2017 in a deal that valued them at 13-14x EBITDA;

importantly, TRC will remain a standalone business, so New Mountain was willing to pay a significant premium despite having no potential for operating synergies (in addition, their proxy reveals there was significant competition to buy TRC).

- Peer CDI was taken out in late 2017 for >9x forward EBITDA and a 30%+ premium; like TRC, CDI's proxy reveals a ton of strategic interest in buying CDI.
- Jacobs (a Hill peer / where Hill's executive Chairman used to be CEO) bought CH2M late last year; CH2M's proxy has plenty of industry acquisition data (see ~p. 166) that further affirms 8-9x is probably the right multiple for Hill as a standalone. Like TRR and CDI, CH2M's sales process so a significant amount of strategic interest. Jacob's ended up paying a massive premium (>70%) for CH2m.
- My bottom line here is that there's huge strategic interest in these companies and that they appear to trade significantly below their strategic value on the public markets

Publicly traded comps: The other eight peers listed in the 10-K remain publicly traded and generally trade for ~8-9x EBITDA. I don't think any of the peers are perfect comps, but looking at all of them paints a broad picture that suggests Hill's share price and multiple today are well below Hill's standalone intrinsic value and significantly below their likely value to an acquirer. If Hill were to simply trade for 8x the low end of their 2018 EBITDA projections of $40m, Hill would trade for ~$5.50/share, roughly the same price they were trading for before the delist.

Ok, valuation out the way, let's turn to the more complicated (and interesting!) question: has Hill's business fallen off a cliff? Of course, we can't know for sure what exactly has happened to Hill's business until they report their results, but I think we can use some of their releases to help us

figure out how they're doing.

The first and simplest is their March 2018 release where they reiterated 2018 guidance. The hope is that if they reiterated guidance in March 2018, business was at least performing and projecting normally from when they first made the guidance in late 2017 until when they reiterated it. Could business have fallen off the cliff since then? Sure, but with the world economy generally humming over the past few months it's difficult to see what could have changed seriously for the worst since March, particularly given Hill's press releases this year seem to indicate a continued inflow of business (I count 18 press releases announcing business awards so far in 2018 versus 22 in all of 207 (~17 YTD at this time in 2017)).

A bit more complicated way of looking at Hill's business performance is to look at the company's net debt balance over time. Their March 2018 update said the company had a net debt position of $22m at March 23, 2018. The July update said their net debt was $20m at July 6, 2018. Before those two updates, the last net debt number we would have from the company comes from their September 2017 10-Q, where I calculate they had net debt of ~$19m.

At worst, this means HIL has been roughly cash flow breakeven from September 2017 through July 2018. I think the situation is actually better than that for three reasons:

1. The September 2017 10-Q reveals the company paid Kuwait $7.9m for performance guarantees in February 2018. Hill is taking legal action to recover the full amount. This is a large guarantee payout and should almost certainly be treated as a one-time item; if you ignore that payment net debt in July would have been $13m.
2. Hill has been incurring the expense of the restatements over this time period. It's difficult to estimate the amount of this expense, but it is almost certainly extremely expensive. I can think of four different major

restatements with some similarity to HIL's (AKRX, SCOR, HNGR, HAIN; I'm sure there are more but these are the only ones I can think of currently); all of them cost tens of millions to resolve. Hill is much smaller than those companies and I don't think their restatement is as severe, so I'm not trying to guide that they've spent tens of millions on the process; I'm just pointing out that the process is extremely expensive and has certainly consumed a fair bit of cash. For HIL to breakeven over the past ~year while bearing these restatement expenses suggests their underlying business is doing pretty well.

  - HAIN needed to restate their revenue recognition in FY16; they spent ~$30m on the restatement.
  - HNGR had an awful years long restatement that saw them spend ~$30m/year for multiple years on their restatement.
  - SCOR spent ~$130m over 2 years on investigation and audit related costs related to their restatement
  - AKRX (disclosure: long) spent ~$30m/year for two years (so $60m in total) on their restatement.

3. Hill has almost certainly paid taxes in 2018. Obviously taxes are a real expense, but I think their tax payments have likely been elevated this year and I think to say a business is cash flow breakeven when they are paying elevated taxes is a bit unfair to the business. Why do I think taxes are a bit elevated?
  - 17 of HIL's September 10-Q shows they had an $11.5m income tax expense associated w/ the sale of their claims business. HIL had previously guided that most of the gains would be covered by their NOLs, but I believe they still needed to pay some taxes on the sale. Tough to say an exact number here, but any taxes associated with the claims sale are a onetime drag on cash.
  - Hill is an international business, and p. 30 of

HIL’s 10-Q reveals that they would need to “pay a one-time transition tax on accumulated earnings of foreign subsidiaries” as a result of last year’s tax cut. The 10-Q also says they’re not exactly sure how much they’ll need to pay as a result of the change, but I would not be surprised if they made an estimated payment for the transition tax in early 2018.

4. I know I said three reasons, but I’ll throw a bonus reason in here: Hill is undergoing a cost cutting program. They had initially said it would cost ~$6m to implement the program, and at September 2017 it appears they had spent ~$5.8m (see p. 36 of the 10-Q). It’s possible the restructuring costs ran a bit higher than projected, so there could be a little bit of drag from the cost cutting program as well.

My bottom line here: at worst, it appears Hill’s been breakeven since last September. More likely is that a bunch of onetime items, including one-time tax payments, one-time performance guarantees, and audit costs are clouding Hill’s cash balances, and without those onetime items it appears Hill is generating a decent bit of cash.

Obviously, there’s a lot of guess work in triangulating everything here, but I think most signs point to the “delisting selloff” as being excessively harsh and presenting an opportunity to buy Hill significantly below its standalone value (which is significantly below its strategic / M&A value). I would guess in the next month or two, Hill completes their restatement and guides to performance relatively in line with what they were discussing in March 2018. After the restatement’s done and the company has produced a clean quarter or two, Hill will likely run a strategic process and be sold for a significant premium.

Other odds and ends

- A good sign that a sale is the likely end game here? Paul Evans was named interim CEO when he took over from David Richter in May 2017; he's still interim CEO today. It's certainly possible Hill hasn't been able to lure in a permanent CEO under the cloud of a restatement, but the board had ~five months in between naming Paul interim CEO and announcing the restatement in September to find a permanent CEO and they didn't do anything then. My guess is the board knows they want to sell this thing the moment the financials are clean and there's no sense in bringing in a CEO and needing to pay him a change of control when a sale is coming soon.
- Historically, Hill has done a lot of business in the Middle East, which presents unique geopolitical risks, and Hill still gets a good chunk of their revenue from the Middle East (36% through Q3'17, the last time we have stats). However, their Middle East segment has been shrinking significantly (it was <30% of total backlog at September 2017 versus 34% at YE2016). The drop in Middle East backlog has been more than offset by growth through the rest of the world, particularly Europe and Africa. Obviously you'd rather all of the segments were growing like gangbusters, but historically a ton of Hill's issues have come from the non-collectability of receivables in the Middle East so it is nice to see the rest of the world growing as a piece of their business.
- The big near term risks are obviously the restatement dragging on into next year, which the stock market would hate and would likely prove extremely expensive, or the company announcing the business has fallen off a cliff when they do report. I covered the "fall off" risk in the write up so won't address it again here. On the restatement dragging out, it's certainly a concern, particularly given management has consistently underestimated the time to get this process done (I went

over the timeline in the write up, but worth remembering they initially thought this would be done in Q1’18 and here we are in Q3’18 still waiting on resolution). However, I’ve been involved in a few of these restatements, and it’s been my experience that once the company starts actually making their financial filings the end is near (in a good way). I’ve also found that when companies start guiding towards near term end dates (as Hill did in their delisting notice when they said they planned to become current on filings this quarter), the process is very close to ending. Again, anything can happen and it’s possible something new comes up or Hill just doesn’t have a handle on what’s left to be done, but at this point I’d be very surprised if the restatement didn’t complete this quarter (or maybe a little into Q4).

- Speaking of restatement risks, I mentioned four companies that had engaged in semi-similar restatements earlier (AKRX, HAIN, SCOR, and HNGR). Obviously all of them have their restatements pretty decently in the past at this point, but it is interesting to note that all of their stocks continue to trade pretty far below where they traded prior to announcing their accounting issues and they have, in general, reported pretty disappointing results since they completed their restatement. Any restatement of this size obviously shows some pretty huge internal control defects, but perhaps the lagging share price for all of them also shows that there’s a bit of cockroach theory going on here where the poor internal controls are just one sign of larger issues. What I’m trying to drive at here is that perhaps there’s risk that Hill continues to significantly underperform even after the restatement is completed because the organization is simply fatigued or the restatement is just one sign of several larger issues.
    - This is certainly a worry, but I take comfort from two things. First, a lot of the issues at the

other restatement companies seem to come from the fact that they were big roll ups / acquisitive growth stories, and once they couldn't keep playing that game their underlying organic story really disappointed investors. Hill has generally been an organic story (I'm hesitant to use the word growth in there, so I'll just stick to calling it an organic story). Second, most of the other restatement companies started their restatement process with the same management team that had got them in trouble (often the team had to leave midway through the restatement process). Hill's in the somewhat unique situation of having already booted the old management team before the restatement process started, so the hope is most of the "cockroaches" had already been discovered. Over the years, Hill has already been forced to write of millions in uncollectable AR and went through a terribly painful process of separating and selling their claims division, so while it's possible there are still issues lurking and Hill will underperform like the other "restaters", I'm hopeful that this is the last issue and new management can start to show a clean Hill earnings story going forward.

- The valuation was very dependent on Hill's 2018 projections of $40m in EBITDA on the low end. What if the numbers were completely out of thin air? I don't think they were; I base this on two things. First, you can apply peer margins to Hill's revenue (both projected for 2018 or their historical revenue for the past few years) and come out to a similar EBITDA target (I walked through that math at the end of this post). Second, you can look at their YTD 2017 results and come out with results close to the EBITDA levels we're forecasting. P. 38 of Hill's September 2017 10-q notes YTD EBITDA was $6.1m; if you go to p. 36 the 10-Q notes that YTD SG&A

was inflated by $5.8m as the company implemented their cost cutting plan. Take out those restructuring expenses and EBITDA through three quarters in 2017 was ~$11.9m for an annualized rate of ~$16m. Hill's profit improvement plan is targeting $27m in annual cost savings on the low end; add that cost savings to the $16m run rate in EBITDA and Hill was on pace for ~$43m in EBITDA in 2017.

- As mentioned in the write ups, there are several activists involved here and they basically control the board / company. Activist involvement can be a two edged sword, but in cases where a company has strategic value that's clearly higher than its standalone value it's generally a good thing because the activist are going to make sure the company gets sold. That's clearly the case for the activists here. Bulldog is a top five holder and owns ~6.5% of Hill; here's what they had say in their March 2018 shareholder letter: 'Several large shareholders have publicly called for a sale of Hill International (HIL), another of our large holdings. We agree with them. As Barron's reported a few months ago: "With its clean balance sheet, Hill is trading at revenue and EBITDA multiples substantially below its peers. However, as the company demonstrates improved profitability, this valuation gap should close. It has been reported that the company hired a banker to explore strategic alternatives, but any sale of the company is unlikely until it completes its financial restatement. An acquisition price at one-times sales for Hill would equate to an $8-to-$9 price per share.' We have a good relationship with senior management of Hill and intend to advocate for a sale of the company sooner rather than later."
    - Speaking of activists, as I was finishing writing this Ancora filed a 13-D showing they significantly increased their stake on the heels of the delist.