

STERLING CONSTRUCTION CO INC  
Form 10-Q  
November 10, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark one)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: September 30, 2014

Or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_ to \_\_\_

Commission file number 1-31993

STERLING CONSTRUCTION COMPANY, INC.  
(Exact name of registrant as specified in its charter)

DELAWARE  
State or other jurisdiction of incorporation  
or organization

25-1655321  
(I.R.S. Employer  
Identification No.)

1800 Hughes Landing Blvd.  
The Woodlands, Texas  
(Address of principal executive office)

77380  
(Zip Code)

Registrant's telephone number, including area code (281) 214-0800

(Former name, former address and former fiscal year, if changed from last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Edgar Filing: STERLING CONSTRUCTION CO INC - Form 10-Q

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
[ ] Yes [x] No

At October 31, 2014, there were 18,802,779 shares outstanding of the issuer's common stock, par value \$0.01 per share.

1

---

STERLING CONSTRUCTION COMPANY, INC.  
QUARTERLY REPORT ON FORM 10-Q  
TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

|  |           |
|--|-----------|
| <u>Item 1. Financial Statements</u>  | <u>3</u>  |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>21</u> |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>                            | <u>28</u> |
| <u>Item 4. Controls and Procedures</u>   | <u>29</u> |

PART II. OTHER INFORMATION

|  |           |
|--|-----------|
| <u>Item 1. Legal Proceedings</u>   | <u>29</u> |
| <u>Item 1A. Risk Factors</u>   | <u>30</u> |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | <u>30</u> |
| <u>Item 3. Defaults upon Senior Securities</u>                             | <u>30</u> |
| <u>Item 4. Mine Safety Disclosures</u>                                     | <u>30</u> |
| <u>Item 5. Other Information</u>   | <u>30</u> |
| <u>Item 6. Exhibits</u>  | <u>31</u> |
| <u>SIGNATURES</u>  | <u>32</u> |

## PART I

## Item 1. Financial Statements

STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(Amounts in thousands, except share and per share data)

|   | September<br>30,<br>2014<br>(Unaudited) | December 31,<br>2013 |
|---|---|----------------------|
| <b>ASSETS</b>   |   |                      |
| Current assets:   |   |                      |
| Cash and cash equivalents   | \$ 17,000                               | \$ 1,872             |
| Contracts receivable, including retainage   | 105,302                                 | 77,245               |
| Costs and estimated earnings in excess of billings on uncompleted contracts                                     | 31,745                                  | 11,684               |
| Inventories   | 6,618                                   | 6,189                |
| Receivables from and equity in construction joint ventures  | 10,621                                  | 6,118                |
| Other current assets  | 10,153                                  | 11,377               |
| Total current assets  | 181,439                                 | 114,485              |
| Property and equipment, net   | 90,453                                  | 93,683               |
| Goodwill  | 54,820                                  | 54,820               |
| Other assets, net   | 8,356                                   | 10,030               |
| Total assets  | \$ 335,068                              | \$ 273,018           |
| <b>LIABILITIES AND EQUITY</b>   |   |                      |
| Current liabilities:  |   |                      |
| Accounts payable  | \$ 81,097                               | \$ 61,599            |
| Billings in excess of costs and estimated earnings on uncompleted contracts                                     | 28,521                                  | 31,576               |
| Current maturities of long-term debt  | 964                                     | 134                  |
| Income taxes payable  | 1,868                                   | 2,035                |
| Accrued compensation  | 10,985                                  | 5,755                |
| Current obligation for noncontrolling owners' interest in subsidiaries and joint ventures                       | -                                       | 196                  |
| Other current liabilities   | 4,304                                   | 4,504                |
| Total current liabilities   | 127,739                                 | 105,799              |
| Long-term liabilities:  |   |                      |
| Long-term debt, net of current maturities   | 36,810                                  | 8,331                |
| Member's interest subject to mandatory redemption and undistributed earnings                                    | 22,837                                  | 23,989               |
| Other long-term liabilities   | 734                                     | 2,105                |
| Total long-term liabilities   | 60,381                                  | 34,425               |
| Commitments and contingencies (Note 8)  |   |                      |
| Equity:   |   |                      |
| Sterling stockholders' equity:  |   |                      |
| Preferred stock, par value \$0.01 per share; 1,000,000 shares authorized, none issued                           | -                                       | -                    |
| Common stock, par value \$0.01 per share; 28,000,000 shares authorized, 18,802,879 and 16,657,754 shares issued | 188                                     | 167                  |
| Additional paid in capital  | 205,534                                 | 190,926              |
| Retained deficit  | (64,846 )                               | (62,317 )            |
| Accumulated other comprehensive income (loss)   | (73 )                                   | 117                  |
| Total Sterling common stockholders' equity  | 140,803                                 | 128,893              |

|                              |            |            |
|------------------------------|------------|------------|
| Noncontrolling interests     | 6,145      | 3,901      |
| Total equity                 | 146,948    | 132,794    |
| Total liabilities and equity | \$ 335,068 | \$ 273,018 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Amounts in thousands, except share and per share data)  
(Unaudited)

|  | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |             |
|--|-------------------------------------|------------|------------------------------------|-------------|
|  | 2014                                | 2013       | 2014                               | 2013        |
| Revenues   | \$ 189,275                          | \$ 185,935 | \$ 518,618                         | \$ 430,320  |
| Cost of revenues   | (180,919 )                          | (177,576 ) | (489,894 )                         | (437,211 )  |
| Gross profit (loss)  | 8,356                               | 8,359      | 28,724                             | (6,891 )    |
| General and administrative expenses  | (9,326 )                            | (8,176 )   | (27,316 )                          | (27,273 )   |
| Other operating income (expense), net  | (603 )                              | 1,514      | (4 )                               | 1,965       |
| Operating income (loss)  | (1,573 )                            | 1,697      | 1,404                              | (32,199 )   |
| Gain (loss) on sale of securities  | -                                   | (11 )      | -                                  | 472         |
| Interest income  | 113                                 | 335        | 644                                | 871         |
| Interest expense   | (211 )                              | (306 )     | (766 )                             | (614 )      |
| Income (loss) before income taxes and earnings<br>attributable to noncontrolling interests   | (1,671 )                            | 1,715      | 1,282                              | (31,470 )   |
| Income tax (expense) benefit   | (546 )                              | 380        | (573 )                             | 12,928      |
| Net income (loss)  | (2,217 )                            | 2,095      | 709                                | (18,542 )   |
| Noncontrolling owners' interests in earnings of<br>subsidiaries and joint ventures           | (1,718 )                            | (2,284 )   | (3,238 )                           | (3,250 )    |
| Net loss attributable to Sterling common stockholders  | \$(3,935 )                          | \$(189 )   | \$(2,529 )                         | \$(21,792 ) |
| Net loss per share attributable to Sterling common<br>stockholders:                          |                                     |            |                                    |             |
| Basic  | \$(0.21 )                           | \$(0.06 )  | \$(0.14 )                          | \$(1.38 )   |
| Diluted  | \$(0.21 )                           | \$(0.06 )  | \$(0.14 )                          | \$(1.38 )   |
| Weighted average number of common shares<br>outstanding used in computing per share amounts: |                                     |            |                                    |             |
| Basic  | 18,809,401                          | 16,652,074 | 17,814,332                         | 16,626,118  |
| Diluted  | 18,809,401                          | 16,652,074 | 17,814,332                         | 16,626,118  |

The accompanying notes are an integral part of these condensed consolidated financial statements.

STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
 (Amounts in thousands)  
 (Unaudited)

|   | Nine Months Ended<br>September 30, |             |
|---|------------------------------------|-------------|
|   | 2014                               | 2013        |
| Net loss attributable to Sterling common stockholders   | \$(2,529 )                         | \$(21,792 ) |
| Net income attributable to noncontrolling owners' interests included in equity                | 3,238                              | 1,563       |
| Net income attributable to noncontrolling owners' interests included in liabilities           | -                                  | 1,687       |
| Add /(deduct) other comprehensive income, net of tax:   |                                    |             |
| Realized gain from sale of available-for-sale securities                                      | -                                  | (300 )      |
| Change in unrealized holding loss on available-for-sale securities                            | -                                  | (588 )      |
| Realized gain from settlement of derivatives  | (15 )                              | (30 )       |
| Change in the effective portion of unrealized gain (loss) in fair market value of derivatives | (175 )                             | 31          |
| Comprehensive income (loss)   | \$519                              | \$(19,429 ) |

The accompanying notes are an integral part of these condensed consolidated financial statements.

STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2014  
(Amounts in thousands)  
(Unaudited)

STERLING CONSTRUCTION COMPANY, INC.  
STOCKHOLDERS

|   | Common Stock |        | Addi-<br>tional<br>Paid in<br>Capital | Retained<br>(Deficit) | Accu-<br>mulated<br>Other<br>Compre-<br>hensive<br>Income<br>(loss) | Noncon-<br>trolling<br>Interests | Total      |
|---|--------------|--------|---------------------------------------|-----------------------|---|----------------------------------|------------|
|   | Shares       | Amount |                                       |                       |   |                                  |            |
| Balance at January 1,<br>2014                       | 16,658       | \$ 167 | \$ 190,926                            | \$ (62,317)           | \$ 117  | \$ 3,901                         | \$ 132,794 |
| Net income (loss)                                   | -            | -      | -                                     | (2,529 )              | -   | 3,238                            | 709        |
| Other comprehensive<br>loss                         | -            | -      | -                                     | -                     | (190 )  | -                                | (190 )     |
| Stock issued upon<br>option exercises               | 4            | -      | 12                                    | -                     | -   | -                                | 12         |
| Issuance and<br>amortization of restricted<br>stock | 41           | -      | 592                                   | -                     | -   | -                                | 592        |
| Distribution to owners                              | -            | -      | -                                     | -                     | -   | (994 )                           | (994 )     |
| Stock issued in equity<br>offering, net of expenses | 2,100        | 21     | 14,057                                | -                     | -   | -                                | 14,078     |
| Other   | -            | -      | (53 )                                 | -                     | -   | -                                | (53 )      |
| Balance at September<br>30, 2014                    | 18,803       | \$ 188 | \$ 205,534                            | \$ (64,846)           | \$ (73 )  | \$ 6,145                         | \$ 146,948 |

The accompanying notes are an integral part of these condensed consolidated financial statements.



STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)

(Unaudited)

|   | Nine Months Ended<br>September 30, |             |
|---|------------------------------------|-------------|
|   | 2014                               | 2013        |
| Cash flows from operating activities:   |                                    |             |
| Net loss attributable to Sterling common stockholders                                 | \$(2,529 )                         | \$(21,792 ) |
| Plus: Noncontrolling owners' interests in earnings of subsidiaries and joint ventures | 3,238                              | 3,250       |
| Net income (loss)   | 709                                | (18,542 )   |
| Adjustments to reconcile net income (loss) to net cash used in operating activities:  |                                    |             |
| Depreciation and amortization   | 13,809                             | 14,020      |
| Gain on disposal of property and equipment  | (905 )                             | (765 )      |
| Deferred tax benefit  | -                                  | (10,174 )   |
| Stock-based compensation expense  | 592                                | 739         |
| Gain on sale of securities  | -                                  | (472 )      |
| Tax impact from exercise of stock options   | -                                  | 17          |
| Changes in operating assets and liabilities:  |                                    |             |
| Contracts receivable  | (28,057 )                          | (19,848 )   |
| Costs and estimated earnings in excess of billings on uncompleted contracts           | (20,061 )                          | (10,889 )   |
| Receivables from and equity in construction joint ventures                            | (4,503 )                           | (1,255 )    |
| Income tax receivable   | 650                                | (2,714 )    |
| Inventories, deposits and other current assets  | 1,759                              | (9,292 )    |
| Accounts payable  | 19,497                             | 31,314      |
| Billings in excess of costs and estimated earnings on uncompleted contracts           | (3,055 )                           | 12,152      |
| Accrued compensation and other liabilities  | 6,599                              | 3,871       |
| Member's interest subject to mandatory redemption and undistributed earnings          | (1,152 )                           | -           |
| Net cash used in operating activities   | (14,118 )                          | (11,838 )   |
| Cash flows from investing activities:   |                                    |             |
| Additions to property and equipment   | (14,404 )                          | (11,333 )   |
| Proceeds from sales of property and equipment   | 4,874                              | 4,517       |
| Purchases of short-term securities, available-for-sale                                | -                                  | (1,638 )    |
| Sales of short-term securities, available-for-sale                                    | -                                  | 28,929      |
| Net cash provided by (used in) investing activities                                   | (9,530 )                           | 20,475      |
| Cash flows from financing activities:   |                                    |             |
| Cumulative daily drawdowns – Credit Facility  | 237,577                            | 152,798     |
| Cumulative daily repayments – Credit Facility   | (211,242)                          | (156,376)   |
| Distributions to noncontrolling interest owners                                       | (1,190 )                           | (3,244 )    |
| Net proceeds from stock issued  | 14,078                             | -           |
| Tax impact from exercise of stock options   | -                                  | (17 )       |
| Other   | (447 )                             | 74          |
| Net cash provided by (used in) in financing activities                                | 38,776                             | (6,765 )    |
| Net increase in cash and cash equivalents   | 15,128                             | 1,872       |
| Cash and cash equivalents at beginning of period                                      | 1,872                              | 3,142       |
| Cash and cash equivalents at end of period  | \$17,000                           | \$5,014     |
| Supplemental disclosures of cash flow information:                                    |                                    |             |
| Cash paid during the period for interest  | \$760                              | \$540       |
| Cash paid during the period for income taxes  | \$28                               | \$170       |

Non-cash items:

|  |     |            |
|--|-----|------------|
| Revaluation of noncontrolling interest obligations, net of tax | \$- | \$(1,100 ) |
|--|-----|------------|

The accompanying notes are an integral part of these condensed consolidated financial statements.

7

---

STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. Summary of Business and Significant Accounting Policies

Basis of Presentation

Sterling Construction Company, Inc. (“Sterling” or “the Company”), a Delaware corporation, is a leading heavy civil construction company that specializes in the building and reconstruction of transportation and water infrastructure projects in Texas, Utah, Nevada, Arizona, California, Hawaii and other states in which there are construction opportunities. The Company’s transportation infrastructure projects include highways, roads, bridges and light rail, and the Company’s water infrastructure projects include water, wastewater and storm drainage systems.

The accompanying condensed consolidated financial statements include the accounts of subsidiaries and construction joint ventures in which the Company has a greater than 50% ownership interest or otherwise controls such entities, and all significant intercompany accounts and transactions have been eliminated in consolidation. For all periods presented, the Company had no subsidiaries where its ownership interests were less than 50%.

Under accounting principles generally accepted in the United States (“GAAP”), the Company must determine whether each entity, including joint ventures in which it participates, is a variable interest entity. This determination focuses on identifying which owner or joint venture partner, if any, has the power to direct the activities of the entity and the obligation to absorb losses of the entity or the right to receive benefits from the entity disproportionate to its interest in the entity, which could have the effect of requiring the Company to consolidate the entity in which we have a non-majority variable interest.

The Company determined that Myers & Sons Construction, L.P., a Company in which we have a 50% limited partner interest (“Myers”), is a variable interest entity. As discussed further in Note 3 of the Notes to Consolidated Financial Statements included in the annual report on Form 10-K for the year ended December 31, 2013 (“2013 Form 10-K”), the Company determined that it exercises primary control over activities of the partnership and it is exposed to more than 50% of potential losses from the partnership. Therefore, the Company consolidates this partnership in the condensed consolidated financial statements and includes the other partners’ interests in the equity and net income of the partnership in the balance sheet line item “Noncontrolling interests” in “Equity” and the condensed statement of operations line item “Noncontrolling owners’ interests in earnings of subsidiaries and joint ventures,” respectively.

Where the Company is a noncontrolling joint venture partner, its share of the operations of such construction joint venture is accounted for on a pro rata basis in the condensed consolidated statements of operations and as a single line item (“Receivables from and equity in construction joint ventures”) in the condensed consolidated balance sheets. Refer to Note 3 for further information regarding the Company’s construction joint ventures, including those where the Company does not have a controlling ownership interest.

The condensed consolidated financial statements included herein have been prepared by Sterling, without audit, in accordance with the rules and regulations of the Securities and Exchange Commission (“SEC”) and should be read in conjunction with the 2013 Form 10-K. Certain information and note disclosures prepared in accordance with GAAP have been either condensed or omitted pursuant to SEC rules and regulations. The condensed consolidated financial statements reflect, in the opinion of management, all normal recurring adjustments necessary to present fairly the Company’s financial position at September 30, 2014 and the results of operations and cash flows for the periods presented. The December 31, 2013 condensed consolidated balance sheet data was derived from audited financial statements, but as discussed above, does not include all disclosures required by GAAP. Interim results may be subject to significant seasonal variations, and the results of operations for the three and nine months ended September 30,

2014 are not necessarily indicative of the results to be expected for the full year or subsequent quarters.

#### Significant Accounting Policies

The Company's significant accounting policies are more fully described in Note 1 of the Notes to Consolidated Financial Statements in the 2013 Form 10-K. These accounting policies include, but are not limited to, those related to:

8

---

contracts receivable, including retainage  
revenue recognition  
valuation of property and equipment, goodwill and other long-lived assets  
construction joint ventures  
income taxes  
segment reporting

There have been no material changes to significant accounting policies since December 31, 2013.

#### Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Certain of the Company's accounting policies require higher degrees of judgment than others in their application. These include the recognition of revenue and earnings from construction contracts under the percentage-of-completion method, the valuation of long-term assets (including goodwill), and income taxes. Management continually evaluates all of its estimates and judgments based on available information and experience; however, actual amounts could differ from those estimates.

#### Construction Revenue Recognition

The Company is a general contractor which engages in various types of heavy civil construction projects principally for public (government) owners. Credit risk is minimal with public owners since the Company ascertains that funds have been appropriated by the governmental project owner prior to commencing work on such projects. While most public contracts are subject to termination at the election of the government entity, in the event of termination, the Company is entitled to receive the contract price for completed work and reimbursement of termination-related costs. Credit risk with private owners is minimized because of statutory mechanics liens, which give the Company high priority in the event of lien foreclosures following financial difficulties of private owners.

Revenues are recognized on the percentage-of-completion method, measured by the ratio of costs incurred up to a given date to estimated total costs for each contract. The Company's contracts generally take 12 to 36 months to complete.

Contract costs include all direct material, labor, subcontract and other costs and those indirect costs related to contract performance, such as indirect salaries and wages, equipment repairs and depreciation, insurance and payroll taxes. Administrative and general expenses are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions and estimated profitability, including those changes arising from contract penalty provisions and final contract settlements may result in revisions to estimated costs, costs and income and are recognized in the period in which the revisions are determined. Changes in estimated revenues and gross margin during the three and nine months ended September 30, 2014 resulted in a net loss of \$4.5 million and a net gain of \$0.4 million, respectively, included in the operating results, or a loss of \$0.24 and a gain of \$0.02, respectively, per diluted share attributable to Sterling common stockholders.

#### Financial Instruments

The fair value of financial instruments is the amount at which the instrument could be exchanged in a current transaction between willing parties. The Company's financial instruments are cash and cash equivalents, short-term

investments, short-term and long-term contracts receivable, derivatives, accounts payable, mortgage and notes payable, a credit facility with Comerica Bank (“Credit Facility”), the buy/sell agreement related to certain noncontrolling owners’ interests in subsidiaries which was converted to a mandatorily redeemable long-term liability on December 30, 2013 and an earn-out liability related to the acquisition of J. Banicki Construction, Inc. (“JBC”).

The recorded values of cash and cash equivalents, short-term investments, short-term contracts receivable and accounts payable approximate their fair values based on their short-term nature. The Company currently has one long-term contract receivable which is discounted at 4.25% and recorded at fair value. Interest earned related to the long-term contract receivable was \$0.1 and \$0.3 million for the three and nine months ended September 30, 2014, respectively. We consider the credit quality of the borrower to assess the appropriate discount rate to apply and continuously monitor the borrower’s credit quality.

The recorded value of the Credit Facility debt approximates its fair value, as interest approximates market rates. Refer to Note 5 regarding the fair value of derivatives and Note 9 regarding the fair value of the earn-out liability, the change to the mandatorily redeemable long-term liability and the change in noncontrolling owners' interests in subsidiaries. The Company had one mortgage outstanding at September 30, 2014 and December 31, 2013 with a remaining balance of \$0.1 million and \$0.2 million, respectively, for the periods. The mortgage was accruing interest at 3.50% at both September 30, 2014 and December 31, 2013 and contains pre-payment penalties. At September 30, 2014 and December 31, 2013, the fair value of the mortgage approximated book value. The Company also has long-term notes payable of \$2.6 million related to machinery and equipment purchased which have payment terms ranging from 3 to 5 years and associated interest rates ranging from 3.12% to 6.29%. The fair value of the notes payable approximates their book value. The Company does not have any off-balance sheet financial instruments other than operating leases (refer to Note 14 of the Notes to Consolidated Financial Statements in the 2013 Form 10-K).

In order to assess the fair value of the Company's financial instruments, the Company uses the fair value hierarchy established by GAAP which prioritizes the inputs used in valuation techniques into the following three levels:

Level 1 Inputs – Based upon quoted prices for identical assets in active markets that the Company has the ability to access at the measurement date.

Level 2 Inputs – Based upon quoted prices (other than Level 1) in active markets for similar assets, quoted prices for identical or similar assets in markets that are not active, inputs other than quoted prices that are observable for the asset such as interest rates, yield curves, volatilities and default rates and inputs that are derived principally from or corroborated by observable market data.

Level 3 Inputs – Based on unobservable inputs reflecting the Company's own assumptions about the assumptions that market participants would use in pricing the asset based on the best information available.

For each financial instrument, the Company uses the highest priority level input that is available in order to appropriately value that particular instrument. In certain instances, Level 1 inputs are not available and the Company must use Level 2 or Level 3 inputs. In these cases, the Company provides a description of the valuation techniques used and the inputs used in the fair value measurement.

#### Recent Accounting Pronouncements

In August 2014, the Financial Accounting Standards Board issued ASU 2014-14, "Presentation of Financial Statement – Going Concern." The guidance, which is effective for annual reporting periods ending after December 15, 2016 and interim periods within annual periods beginning after December 15, 2016, requires management to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern and to provide related footnote disclosures. Early adoption is permitted. Although early adoption is permitted, the Company expects to adopt this guidance as required and does not expect a material impact to our financial statements.

In May 2014, the Financial Accounting Standards Board issued ASU 2014-09, "Revenue from Contracts with Customers." The guidance, which is effective for annual reporting periods beginning after December 15, 2016, defines the steps to recognize revenue for entities that have contracts with customers. Early adoption is not permitted. The Company has not determined the effect of this new guidance.

#### 2. Cash and Cash Equivalents and Short-term Investments

The Company considers all highly liquid investments with original or remaining maturities of three months or less at the time of purchase to be cash equivalents. Cash and cash equivalents include cash balances held by our wholly-owned subsidiaries as well as the Company's variable interest entity (VIE). Refer to Note 11 for more

information regarding the Company's consolidated VIE.

At September 30, 2014 and December 31, 2013, the Company had no short-term investments.

At September 30, 2013, gains and losses realized on short-term investment securities were included in "Gain on sale of securities" in the accompanying condensed consolidated statements of operations. Unrealized gains (losses) on short-term investments were included in accumulated other comprehensive income in stockholders' equity, net of tax, as the gains and losses were considered temporary. For the three and nine months ended September 30, 2013, total proceeds from sales of short-term investments were \$0.3 million and \$28.9 million, respectively, with no gross realized gains and \$0.5 million gross realized gains for the three and nine month period, respectively. There were immaterial gross realized losses during both periods. Accumulated other comprehensive income (loss) at September 30, 2013 included unrealized losses on short-term investments of \$0.3 million less the associated tax benefit of less than \$0.1 million.



Upon the sale of short-term investments, the cost basis used to determine the gain or loss is based on the specific security sold. All items included in accumulated other comprehensive income are at the corporate level, and no portion is attributable to noncontrolling interests.

The Company earned interest income of \$0.2 million and \$0.7 million for the three and nine months ended September 30, 2013, respectively, on its cash, cash equivalents and short-term investments. These amounts were included in interest income in the Company's condensed consolidated statement of operations.

### 3. Construction Joint Ventures

The Company participates in various construction joint venture partnerships. Generally, each construction joint venture is formed to construct a specific project and is jointly controlled by the joint venture partners. Refer to Note 6 of the Notes to Consolidated Financial Statements in the 2013 Form 10-K for further information about our joint ventures. Condensed combined financial amounts of joint ventures in which the Company has a noncontrolling interest and the Company's share of such amounts which are included in the Company's condensed consolidated financial statements are shown below (amounts in thousands):

|   | September<br>30,<br>2014 | December<br>31,<br>2013 |
|---|--------------------------|-------------------------|
| <b>Total combined:</b>  |                          |                         |
| Current assets  | \$ 30,360                | \$ 51,329               |
| Less current liabilities  | (50,834 )                | (64,531 )               |
| Net assets  | \$ (20,474 )             | \$ (13,202 )            |
| Backlog   | \$ 60,999                | \$ 101,014              |
| <br>  |                          |                         |
| Sterling's noncontrolling interest in backlog                         | \$ 17,679                | \$ 30,652               |
| Sterling's receivables from and equity in construction joint ventures | \$ 10,621                | \$ 6,118                |

|  | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|--|-------------------------------------|----------|------------------------------------|----------|
|  | 2014                                | 2013     | 2014                               | 2013     |
| <b>Total combined:</b>                 |                                     |          |                                    |          |
| Revenues                               | \$7,734                             | \$39,085 | \$44,959                           | \$97,961 |
| Income (loss) before tax               | 922                                 | (175 )   | 3,047                              | (8,578 ) |
| <br>                                   |                                     |          |                                    |          |
| <b>Sterling's proportionate share:</b> |                                     |          |                                    |          |
| Revenues                               | \$2,747                             | \$16,447 | \$18,371                           | \$39,842 |
| Income (loss) before tax               | 453                                 | (23 )    | 1,885                              | (4,116 ) |

Approximately \$18 million of the Company's backlog at September 30, 2014 was attributable to projects performed by joint ventures. The majority of this amount is attributable to the Company's joint venture with Shimmick Construction Company, where the Company has a 30% interest.

### 4. Property and Equipment

Property and equipment are summarized as follows (amounts in thousands):

| September<br>30, | December<br>31, |
|------------------|-----------------|
|------------------|-----------------|

Edgar Filing: STERLING CONSTRUCTION CO INC - Form 10-Q

|                               | 2014       | 2013       |
|-------------------------------|------------|------------|
| Construction equipment        | \$ 130,412 | \$ 127,199 |
| Transportation equipment      | 18,461     | 19,132     |
| Buildings                     | 10,512     | 10,512     |
| Office equipment              | 2,780      | 2,025      |
| Leasehold improvement         | 867        | 816        |
| Construction in progress      | 424        | -          |
| Land                          | 5,517      | 5,309      |
| Water rights                  | 200        | 200        |
|                               | 169,173    | 165,193    |
| Less accumulated depreciation | (78,720 )  | (71,510 )  |
|                               | \$ 90,453  | \$ 93,683  |

5.

## Derivative Financial Instruments

The Company enters into various fixed rate commodity swap contracts in an effort to manage its exposure to price volatility of diesel fuel. Historically, fuel prices have been volatile because of supply and demand factors, worldwide political factors and general economic conditions. The objective of the Company in executing the hedge is to mitigate the fuel price volatility that could adversely affect forecasted cash flows and earnings related to construction contracts. Swaps are designed so that the Company receives or makes payments based on a differential between fixed and variable prices for off-road ultra-low sulfur diesel (“ULSD”). The Company has designated its commodity derivative contracts as cash flow hedges designed to achieve more predictable cash flows, as well as to reduce its exposure to price volatility. While the use of derivative instruments limits the downside risk of adverse price movements, they also limit future benefits from reductions in costs as a result of favorable market price movements.

All of the Company’s outstanding derivative financial instruments are recognized on the balance sheet at their fair values. The Company has a master netting arrangement with the counterparty; however, the gross amounts are recorded on the balance sheet. All changes in the fair value of outstanding derivatives, except any ineffective portion, are included in accumulated other comprehensive income until earnings are impacted by the hedged transaction. Amounts in accumulated other comprehensive income are reclassified to earnings when the related hedged items affect earnings or the anticipated transactions are no longer probable. All items included in accumulated other comprehensive income are at the corporate level, and no portion is attributable to noncontrolling interests.

At September 30, 2014, accumulated other comprehensive income included unrecognized losses of \$73,000, representing the unrealized change in fair value of the effective portion of the Company’s commodity contracts, designated as cash flow hedges, as of the balance sheet date. For the nine months ended September 30, 2014, the Company recognized a pre-tax net realized cash settlement gain on commodity contracts of \$15,000.

At September 30, 2014, the Company had hedged its exposure to the variability in future cash flows from forecasted diesel fuel purchases totaling 0.3 million gallons. The swap monthly volumes hedged range from 10,000 gallons to 50,000 gallons over the period from October 2014 to August 2015 at fixed prices per gallon ranging from \$2.75 to \$2.88.

The derivative instruments are included on the condensed consolidated balance sheet at fair value as follows (amounts in thousands):

| Balance Sheet Location      | September<br>30,<br>2014 | December<br>31,<br>2013 |
|-----------------------------|--------------------------|-------------------------|
| Derivative assets:          |                          |                         |
| Other current assets        | \$ -                     | \$ 109                  |
| Other assets, net           | -                        | 8                       |
|                             | \$ -                     | \$ 117                  |
| Derivative liabilities:     |                          |                         |
| Other current liabilities   | \$ 73                    | \$ -                    |
| Other long-term liabilities | -                        | -                       |
|                             | \$ 73                    | \$ -                    |

The following table summarizes the effects of commodity derivative instruments on the condensed consolidated statements of operations and comprehensive income for the nine months ended September 30, 2014 and 2013 (amounts in thousands):

|   | September 30,<br>2014 | September 30,<br>2013 |
|---|-----------------------|-----------------------|
| Increase (decrease) in fair value of derivatives included in other comprehensive income - effective portion | \$ (190 )             | \$ 1                  |
| Realized gain included in cost of revenues - effective portion  | 15                    | 47                    |
| Increase (decrease) in fair value of derivatives included in cost of revenues - ineffective portion         | -                     | -                     |

The Company's derivative instruments contain certain credit-risk-related contingent features which apply both to the Company and to the counterparties. The counterparty to the Company's derivative contracts is a high credit quality financial institution.

#### Fair Value

The Company's swaps are valued based on a discounted future cash flow model. The primary input for the model is the forecasted prices for ULSD. The Company's model is validated by the counterparty's mark-to-market statements. The swaps are designated as Level 2 within the valuation hierarchy. Refer to Note 1 for a description of the inputs used to value the information shown above.

At September 30, 2014 and December 31, 2013, the Company did not have any derivative assets or liabilities measured at fair value on a recurring basis that meet the definition of Level 1 or Level 3.

#### 6. Changes in Accumulated Other Comprehensive Income (loss) by Component

The changes in the balances of each component of accumulated other comprehensive income (loss), net of tax, which is included as a component of stockholders' equity, are as follows (amounts in thousands):

|   | Nine Months<br>Ended<br>September 30,<br>2014 (*)<br>Unrealized<br>Gain and Loss<br>on Cash Flow<br>Hedges |
|---|--|
| Beginning Balance   | \$ 117   |
| Other comprehensive loss before reclassification                        | (175 )   |
| Amounts reclassified from accumulated other comprehensive income (loss) | (15 )  |
| Net current-period other comprehensive loss                             | (190 )   |
| Ending Balance  | \$ (73 )   |

(\*) Amounts in parentheses represent reductions to accumulated other comprehensive income (loss).

The significant amounts reclassified out of each component of accumulated other comprehensive income (loss) are as follows (amounts in thousands):

| Details About Accumulated Other Comprehensive<br>Income (loss) Components | Amount Reclassified From Accumulated<br>Other Comprehensive Income (loss) (*) |         |                                    |        | Statement of<br>Operations<br>Classification |
|---|---|---------|------------------------------------|--------|--|
|   | Three Months Ended<br>September 30,   |         | Nine Months Ended<br>September 30, |        |  |
|   | 2014  | 2013    | 2014                               | 2013   |  |
| Realized gains (losses) on available-for sale securities                  | \$ -  | \$ (11) | \$ -                               | \$ 472 | Gain on sale<br>of securities                |
| Less: Income tax (expense) benefit  | -   | 4       | -                                  | (172)  | Income tax<br>(expense)<br>benefit           |

Edgar Filing: STERLING CONSTRUCTION CO INC - Form 10-Q

|   |    |      |    |      |    |    |    |      |                              |
|---|----|------|----|------|----|----|----|------|------------------------------|
| Total reclassification related to available-for-sale securities | \$ | -    | \$ | (7)  | \$ | -  | \$ | 300  | Net income (loss)            |
| Realized gains and (losses) on cash flow hedges                 | \$ | (14) | \$ | 44   | \$ | 15 | \$ | 47   | Cost of revenues             |
| Less: Income tax expense  |    | -    |    | (16) |    | -  |    | (17) | Income tax (expense) benefit |
| Total reclassification related to cash flow hedges              | \$ | (14) | \$ | 28   | \$ | 15 | \$ | 30   | Net income (loss)            |

(\* ) Amounts in parentheses represent reductions to earnings in the statement of operations.

7.

## Income Taxes

The Company and its subsidiaries file U.S. federal and various U.S. state income tax returns. Current income tax expense or benefit represents federal and state taxes based on tax paid or expected to be payable or receivable for the periods shown in the condensed consolidated statement of operations. The income tax expense (benefit) in the accompanying condensed consolidated financial statements consists of the following (amounts in thousands):

|                               | Three Months Ended |          | Nine Months Ended |             |
|-------------------------------|--------------------|----------|-------------------|-------------|
|                               | September 30,      |          | September 30,     |             |
|                               | 2014               | 2013     | 2014              | 2013        |
| Current tax expense (benefit) | \$546              | \$513    | \$573             | \$(2,754 )  |
| Deferred tax benefit          | -                  | (893 )   | -                 | (10,174 )   |
| Total tax expense (benefit)   | \$546              | \$(380 ) | \$573             | \$(12,928 ) |

The Company is not expecting a federal current tax liability for 2014. The Company does expect a state tax liability for 2014. Therefore, a current tax expense has been recorded for those states for the three and nine months ended September 30, 2014. Additionally, the Company has recorded a current tax expense for the reduction of its net tax receivable.

The Company's deferred tax expense or benefit reflects the change in deferred tax assets or liabilities. The Company performs an analysis at the end of each reporting period to determine whether it is more likely than not the deferred tax asset is expected to be realized in future years. Based upon this analysis, a valuation allowance has been applied to our net deferred tax assets as of September 30, 2014 and December 31, 2013. Therefore, there has been no change in net deferred taxes for the three and nine months ended September 30, 2014.

The deferred tax benefit in the three and nine months ended September 30, 2013 reflects, among other temporary timing differences, the impact of the current quarter job charges from revisions to estimated profitability on construction projects which resulted in a net operating loss.

On September 13, 2013, the U.S. Treasury Department and the I.R.S. issued the final regulations that address costs incurred in acquiring, producing, or improving tangible property (the "tangible property regulations"). The tangible property regulations are generally effective for tax years beginning on or after January 1, 2014. The Company intends to adopt the tax treatment of expenditures to improve tangible property and the capitalization of inherently facilitative costs to acquire tangible property for tax years on or after January 1, 2014. The tangible property regulations may require the Company to make additional tax accounting method changes for tax years beginning on or after January 1, 2014; however, management does not anticipate the impact of these changes to be material to the Company's consolidated financial position, its results of operations, or both.

The income tax expense (benefit) differs from the amounts using the statutory federal income tax rate of 35% for the following reasons (amounts in thousands, except for percentages):

|   | Nine Months Ended September 30, |          |             |      |
|---|---------------------------------|----------|-------------|------|
|   | 2014                            |          | 2013        |      |
|   | Amount                          | %        | Amount      | %    |
| Tax expense (benefit) at the U.S. federal statutory rate  | \$449                           | 35.0     | \$(11,014 ) | 35.0 |
| State franchise and income tax based on income, net of refunds and federal benefits                 | (53 )                           | (4.1 )   | (625 )      | 2.0  |
| Taxes on subsidiaries' and joint ventures' earnings allocated to noncontrolling ownership interests | (1,906 )                        | (148.8 ) | (1,187 )    | 3.8  |
| Valuation allowance   | 1,529                           | 119.4    | -           | -    |

Edgar Filing: STERLING CONSTRUCTION CO INC - Form 10-Q

|                              |       |      |               |        |
|------------------------------|-------|------|---------------|--------|
| Reduction of tax receivable  | 524   | 40.9 | -             | -      |
| Non-taxable interest income  | -     | -    | (231 )        | 0.7    |
| Other permanent differences  | 30    | 2.4  | 129           | (0.4 ) |
| Income tax expense (benefit) | \$573 | 44.7 | % \$(12,928 ) | 41.1 % |

As a result of the Company's analysis, management has determined that the Company does not have any material, uncertain tax positions.



8. Contingencies Related to Litigation

The Company is the subject of certain claims and lawsuits occurring in the normal course of business. Management, after consultation with legal counsel, does not believe that the outcome of these actions will have a material impact on the financial statements of the Company.

The Company typically indemnifies contract owners for claims arising during the construction process and carries insurance coverage for such claims, which in the past have not been material.

The Company's Certificate of Incorporation provides for indemnification of its officers and directors. The Company has a directors and officers liability insurance policy that limits their exposure to litigation against them in their capacities as such.

9. Acquisitions and Subsidiaries and Joint Ventures with Noncontrolling Owners' Interests

In January 2012, Road and Highway Builders, LLC ("RHB"), a wholly-owned subsidiary, assumed six construction contracts with \$25.0 million of unearned revenues from Aggregate Industries – SWR, Inc. ("AI"), an unrelated third party. In addition, Aggregate South West Holdings, LLC ("ASWH") and RHB Properties, LLC ("RHBP"), newly formed entities owned by Richard Buenting, the President and Chief Executive Officer of RHB, acquired construction related machinery and equipment and land with quarries from AI. AI entered into a two-year non-compete agreement with respect to Utah, Idaho and Montana as well as certain areas of Nevada. On April 27, 2012, RHB merged with ASWH and acquired RHBP. In exchange, RHB granted Mr. Buenting a 50% membership interest in RHB. These transactions allowed RHB to expand its operations in Nevada.

On February 1, 2012, the Company also agreed with Mr. Buenting to amend and restate the operating and management agreement for RHB. The amended agreement provides that the Company is the Manager of RHB and retains full, exclusive and complete power, authority and discretion to manage, supervise, operate and control RHB; therefore, the Company consolidates RHB with its other subsidiaries. Under the amendments, the Company will provide RHB with access to a \$5 million line of credit. The Company also entered into a buy/sell and management agreement with Mr. Buenting. Under this agreement, the Company or Mr. Buenting may annually elect to make offers to buy the other owner's 50% interest in RHB and sell their 50% interest in RHB at a price which they specify. Upon receipt of the offers, the other owner must elect either to sell their interest or purchase the interest from the owner making the offers. The agreement also requires that the Company acquire Mr. Buenting's interest in the event of his termination without cause, death, or disability. To the extent that the redemption value under the buy/sell and management agreement exceeds the initial valuation of Mr. Buenting's noncontrolling interest, the Company records a charge to retained earnings, or in the absence of retained earnings, additional paid-in capital ("APIC"). Any related benefit as a result of a lower valuation of Mr. Buenting's noncontrolling interest compared to previous valuations will be offset to retained earnings up to the amounts previously charged to retained earnings. The calculation used in the buy/sell and management agreement is the higher of the trailing twelve months of earnings before interest, taxes and depreciation and amortization ("EBITDA") times a multiple of 4.5 or the orderly liquidation value of RHB. The valuation of the orderly liquidation value is classified as a Level 2 fair value measurement. These values have been updated based on recent sales and dispositions of assets and liabilities to obtain a current estimate of the orderly liquidation value at September 30, 2013. Based on the Company's calculation, the trailing twelve months EBITDA times the multiple of 4.5 provided the higher result of the two methods. As such, a pre-tax charge of \$1.2 million, \$0.8 million net of tax, was recorded for the periodic revaluation of Mr. Buenting's noncontrolling interest during the three months ended September 30, 2013. The total charge resulted in a net pre-tax charge of \$1.9 million, \$1.2 million net of tax, for the nine months ended September 30, 2013.

On December 30, 2013, the Company and Mr. Buenting revised the Second Amended and Restated Operating Agreement entered into on April 27, 2012 and their Management Agreement entered into on February 1, 2012. The

Third Amended and Restated Operating Agreement and the amended Management Agreement eliminated the buy/sell option and instead included the obligation for the Company to purchase Mr. Buenting's interest upon his death or permanent disability for \$20 million or \$18 million, respectively. In the event of Mr. Buenting's death or permanent disability, his estate representative, trustee or designee will become the selling representative and sell his 50% interest to the Company. In order to fund the purchase of Mr. Buenting's interest, the Company has purchased term life insurance with a payout of \$20 million in the event of Mr. Buenting's death. The Company will be the beneficiary and will also pay the premiums related to this life insurance contract. The life insurance proceeds of \$20 million will be used as full payment for Mr. Buenting's interest in the occurrence of his death. In the event of Mr. Buenting's permanent disability, the \$18 million payment will be made by using the Company's available cash on hand, and/or to the extent necessary, the Company's line of credit. No other transfer of a member's interest is permitted other than to the selling representative in the event of Mr. Buenting's death or permanent disability. In the event that Mr. Buenting resigns or is terminated without cause (i.e., termination other than through permanent disability or death), RHB will be dissolved unless both members agree otherwise. The amended agreements were entered into in order to eliminate the earnings-per-share volatility caused by the buy/sell option.

Because the amended agreements result in an obligation to acquire Mr. Buenting's 50% member's interest that the Company is certain to incur, either through Mr. Buenting's permanent disability or death, the Company has classified the noncontrolling interest as mandatorily redeemable and has recorded a liability in "Member's interest subject to mandatory redemption and undistributed earnings" on the condensed consolidated balance sheet. The liability consists of the following (in thousands):

|  | September<br>30,<br>2014 | December<br>31,<br>2013 |
|--|--------------------------|-------------------------|
| Member's interest subject to mandatory redemption    | \$ 20,000                | \$ 20,000               |
| Undistributed earnings attributable to this interest | 6,037                    | 3,989                   |
| Earnings distributed                                 | (3,200 )                 | -                       |
| Total liability                                      | \$ 22,837                | \$ 23,989               |

Undistributed earnings increased by \$0.5 million and \$2.0 million for the three and nine months ended September 30, 2014, respectively, and were included in "Other operating income (expense), net" on the Company's condensed consolidated statement of operations. Distributions for the three and nine months ended September 30, 2014 were \$2.0 million and \$3.2 million, respectively.

On June 20, 2014, the Company sold to Mr. Buenting a 50% interest in RHB Inc. RHB Inc. is currently an ancillary company that provides certain services for RHB LLC. RHB Inc. is run as a cost center with a financial goal to break-even, and has an immaterial amount of assets. The purchase price and the accounting effects of the total transaction were immaterial to the Company.

In connection with the August 1, 2011, acquisition of J. Banicki Construction, Inc. ("JBC") by Ralph L. Wadsworth Construction Company, LLC ("RLW"), RLW agreed to additional purchase price payments of up to \$5 million to be paid over a five-year period. The additional purchase price is in the form of an earn-out which is classified as a Level 3 fair value measurement. In making this valuation, the unobservable input consisted of forecasted EBITDA for the periods after the period being reported on through July 31, 2016. The additional purchase price is calculated generally as 50% of the amount by which EBITDA exceeds \$2.0 million for each of the calendar years 2011 through 2015 and exceeds \$1.2 million for the seven months ended July 31, 2016.

On January 23, 2014, RLW, the former owner of JBC and the Company agreed to amend the above-mentioned earn-out agreement in order to reduce the Company's currently recorded liability while providing the former owner, who at the time was the chief executive officer of JBC, a greater incentive to meet earnings benchmarks. The amendment resulted in a reduction of \$0.6 million in the Company's earn-out liability, thereby reducing the total earn-out liability to \$1.4 million on December 31, 2013. As part of the amendment, a payment of \$0.8 million was made during the first quarter of 2014. The amendment increases the total available earn-out from \$5.0 million to \$10.0 million if certain EBITDA benchmarks are met. The amendment extends the earn-out period through December 31, 2017 and reduces the benchmark EBITDA for 2014 and 2015 to \$1.5 million and increases it to \$2.0 million in 2016 and 2017. This earn-out liability continues to be classified as a Level 3 fair value measurement and the unobservable inputs continue to be the forecasted EBITDA for the periods after the period being reported on through December 31, 2017. The yearly excess forecasted EBITDA in our calculation at September 30, 2014 ranged from 0% to 22% of the minimum EBITDA benchmarks for the years 2014 through 2017. The discounted present value of the additional purchase price was estimated to be \$0.3 million as of September 30, 2014 which included a revaluation benefit of \$0.3 million that was included in interest income on the condensed consolidated statement of operations. The undiscounted earn-out liability at September 30, 2014 is estimated at \$0.3 million and could increase by \$9.0 million if EBITDA during the earn-out period increases \$17.9 million or more, and could decrease by the full amount of the liability for the year if EBITDA does not exceed the minimum threshold for that year. Each year is considered a discrete earnings period, and future losses by JBC, if any, would not reduce the Company's liability in years in which JBC has exceeded

its earnings benchmark. Any significant increase or decrease in actual EBITDA compared to the forecasted amounts would result in a significantly higher or lower fair value measurement of the additional purchase price. This liability is included in other long-term liabilities on the accompanying condensed consolidated balance sheets.

## Changes in Noncontrolling Interests

The following table summarizes the changes in the obligation for noncontrolling owners' interests in subsidiaries and joint ventures (amounts in thousands):

|  | Nine Months Ended<br>September 30, |          |
|--|------------------------------------|----------|
|  | 2014                               | 2013     |
| Balance, beginning of period   | \$4,097                            | \$20,046 |
| Net income attributable to noncontrolling interest included in liabilities | -                                  | 1,687    |
| Net income attributable to noncontrolling interest included in equity      | 3,238                              | 1,563    |
| Change in fair value of RLW put/call                                       | -                                  | (59 )    |
| Change in fair value of RHB obligation                                     | -                                  | 1,875    |
| Distributions to noncontrolling interest owners                            | (1,190 )                           | (2,735 ) |
| RLW Put/Call Payout  | -                                  | (509 )   |
| Balance, end of period   | \$6,145                            | \$21,868 |

The "noncontrolling owners' interest in earnings of subsidiaries and joint ventures" for the nine months ended September 30, 2014, shown in the accompanying condensed consolidated statement of operations, was \$3.2 million, which the Company includes in "Equity", "Noncontrolling interests" in the accompanying condensed consolidated balance sheet. There were no distributions and distributions of \$1.2 million to certain noncontrolling interest members during the three and nine months ended September 30, 2014, respectively.

## 10. Stockholders' Equity

## Stock-Based Compensation Plan and Warrants

The Company has a stock-based incentive plan which is administered by the Compensation Committee of the Board of Directors. Refer to Note 15 of the Notes to Consolidated Financial Statements included in the 2013 Form 10-K for further information. The Company recorded stock-based compensation expense of \$0.2 million and \$0.6 million for the three and nine months ended September 30, 2014, respectively, and \$0.3 million and \$0.7 million for the three and nine months ended September 30, 2013, respectively.

In addition, the Company has shares outstanding that are subject to the completion of certain performance conditions. In order to recognize the compensation expense related to these shares, the Company must assess at each reporting period whether it is probable that the performance conditions will be met. These shares must also be re-valued at each reporting period until they vest. At September 30, 2014, the Company determined that it would not be probable that the performance conditions would be met for these shares and has not recorded any expense for the three and nine months ended September 30, 2014.

The Company issued 600 and 69,457 shares of unvested common stock during the three and nine months ended September 30, 2014, respectively. Of this amount, 43,421 shares of unvested common stock were issued in May 2014 to the non-employee members of the Company's Board of Directors in accordance with the Company's standard compensation arrangements for non-employee directors.

At September 30, 2014, total unrecognized compensation cost related to unvested common stock awards was \$0.7 million. This cost is expected to be recognized over a weighted average period of 1.2 years. There was no unrecognized compensation expense related to stock options at September 30, 2014 and 2013. Proceeds received by the Company from the exercise of stock options for the three and nine months ended September 30, 2014 and 2013 were immaterial for both periods. No stock options were granted in the three or nine months ended September 30,

2014 or 2013. At September 30, 2014, there were 257,171 shares of common stock covered by outstanding unvested common stock.

#### Stock Offering

On April 29, 2014, an amended “shelf” registration statement filed by the Company with the SEC became effective. Under the amended shelf registration statement, the Company may offer from time to time any combination of securities described in the prospectus in one or more offerings up to a total of \$80 million. The securities described in the prospectus include common and preferred stock, depository shares, debt securities, warrants entitling the holders to purchase one or more classes or series of these securities or units consisting of two or more of these issuances, classes or series of securities. Net proceeds from the sales of the offered securities may be used for working capital needs, capital expenditures and other expenditures related to general corporate purposes, including future acquisitions.

On May 6, 2014, the Company closed a public offering with D.A. Davidson & Co. as sole underwriter (the “Underwriter”), pursuant to which the Underwriter purchased from the Company 2,100,000 shares of the Company’s common stock at a price of \$6.90 per share. The net proceeds of \$14.1 million from the offering, after deducting underwriting discounts and offering expenses, was used to repay a portion of the indebtedness outstanding under our \$40 million revolving credit facility in accordance with the Fifth Amendment mentioned in Note 13.

#### 11. Variable Interest Entities

The Company owns a 50% interest in Myers of which it is the primary beneficiary and has consolidated Myers into the Company’s financial statements. Because the Company exercises primary control over activities of the partnership and it is exposed to the majority of potential losses of the partnership, the Company has consolidated Myers within the Company’s financial statements since August 1, 2011, the date of acquisition. Refer to Note 3 of the Notes to Consolidated Financial Statements included in the 2013 Form 10-K for additional information on the acquisition of this limited partnership.

The condensed financial information of Myers which is reflected in the Company’s condensed consolidated balance sheets and statements of operations is as follows (amounts in thousands):

|   | September<br>30,<br>2014 | December<br>31,<br>2013 |
|---|--------------------------|-------------------------|
| <b>Assets:</b>                            |                          |                         |
| <b>Current assets:</b>                    |                          |                         |
| Cash and cash equivalents                 | \$ 283                   | \$ 566                  |
| Contracts receivable, including retainage | 25,808                   | 6,475                   |
| Other current assets                      | 3,865                    | 7,964                   |
| Total current assets                      | 29,956                   | 15,005                  |
| Property and equipment, net               | 8,985                    | 6,869                   |
| Other assets, net                         | -                        | 5                       |
| Goodwill                                  | 1,501                    | 1,501                   |
| Total assets                              | \$ 40,442                | \$ 23,380               |
| <b>Liabilities:</b>                       |                          |                         |
| <b>Current liabilities:</b>               |                          |                         |
| Accounts payable                          | \$ 14,777                | \$ 8,361                |
| Other current liabilities                 | 13,061                   | 7,080                   |
| Total current liabilities                 | 27,838                   | 15,441                  |
| <b>Long-term liabilities:</b>             |                          |                         |
| Other long-term liabilities               | 38                       | 137                     |
| Total liabilities                         | \$ 27,876                | \$ 15,578               |

|   | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|---|-------------------------------------|----------|------------------------------------|----------|
|   | 2014                                | 2013     | 2014                               | 2013     |
| Revenues  | \$40,159                            | \$23,240 | \$101,953                          | \$59,377 |
| Operating income  | 3,461                               | 1,772    | 6,760                              | 3,130    |
| Net income attributable to Sterling common stockholders | 1,728                               | 575      | 3,376                              | 1,016    |

#### 12. Net Loss per Share Attributable to Sterling Common Stockholders

Basic net loss per share attributable to Sterling common stockholders is computed by dividing net loss attributable to Sterling common stockholders by the weighted average number of common shares outstanding during the period. Diluted net loss per common share attributable to Sterling common stockholders is the same as basic net loss per share attributable to Sterling common stockholders but includes dilutive unvested common stock and stock options using the treasury stock method. The following table reconciles the numerators and denominators of the basic and diluted per common share computations for the net loss attributable to Sterling common stockholders (amounts in thousands, except per share data):



|   | Three Months<br>Ended<br>September 30,<br>2014 |           | Nine Months<br>Ended<br>September 30,<br>2014 |             |
|---|--|-----------|---|-------------|
|   | 2013   | 2013      | 2013  | 2013        |
| <b>Numerator:</b>   |  |           |   |             |
| Net loss attributable to Sterling common stockholders   | \$(3,935 )                                     | \$(189 )  | \$(2,529 )                                    | \$(21,792 ) |
| Revaluation of the noncontrolling interest obligations reflected in retained earnings, net of tax | -  | (766 )    | -   | (1,100 )    |
|   | \$(3,935 )                                     | \$(955 )  | \$(2,529 )                                    | \$(22,892 ) |
| <b>Denominator:</b>   |  |           |   |             |
| Weighted average common shares outstanding — basic  | 18,809   | 16,652    | 17,814  | 16,626      |
| Shares for dilutive unvested common stock and stock options                                       | -  | -         | -   | -           |
| Weighted average common shares outstanding and assumed conversions — diluted                      | 18,809   | 16,652    | 17,814  | 16,626      |
| Basic loss per share attributable to Sterling common stockholders                                 | \$(0.21 )                                      | \$(0.06 ) | \$(0.14 )                                     | \$(1.38 )   |
| Diluted loss per share attributable to Sterling common stockholders                               | \$(0.21 )                                      | \$(0.06 ) | \$(0.14 )                                     | \$(1.38 )   |

In accordance with the treasury stock method, 143,761 and 145,940 shares of unvested common stock and stock options were excluded from the diluted weighted average common shares outstanding for the three and nine months ended September 30, 2014, respectively, and 63,457 and 113,913 shares of unvested common stock and stock options were excluded for the three and nine months ended September 30, 2013, respectively, as the Company incurred a loss during these periods and the impact of such shares would have been antidilutive.

### 13. Credit Facility and Covenant Compliance

The Company's Credit Facility is subject to compliance with certain covenants, including financial covenants at quarter-end relating to leverage, tangible net worth and asset coverage. The Credit Facility also contains restrictions on the Company's ability to:

- Make distributions or pay dividends;
- Incur liens and encumbrances;
- Incur further indebtedness;
- Guarantee obligations;
- Dispose of a material portion of assets or merge with a third party;
- Make acquisitions; and
- Make investments in securities.

At the end of the fourth quarter of 2013, the Company was not in compliance with the minimum tangible net worth and the leverage ratio financial covenants. As a result, subsequent to year end, the Company obtained a Waiver and Fourth Amendment to Credit Agreement (the "Fourth Amendment") with its lender which waived the noncompliance with the financial covenants as of December 31, 2013 and provided less restrictive covenant requirements. The Fourth Amendment also imposed liquidity thresholds that the Company is required to meet in 2014. The Company believes that it will be able to maintain compliance with all covenants required under the Fourth Amendment through at least the next twelve months. Refer to the discussion below regarding a revised amendment which eased our required liquidity thresholds.

Among other things, the Fourth Amendment reduced the borrowings available to \$40 million from the previously available \$50 million and eliminated the option to increase the Credit Facility by an additional \$50 million. The Fourth Amendment also modified the existing borrowing interest fee schedule and increased borrowing rates by 50 basis points to 4.75% effective December 31, 2013. In addition, if certain liquidity thresholds are not met in 2014 the

interest rate may increase 200 basis points and continue to increase 100 basis points every quarter after 2015 until such thresholds are met. Furthermore, the Fourth Amendment requires the payment of a quarterly commitment fee of 0.75% per annum on unused availability.

On April 29, 2014, the Company and its lender amended the Credit Facility (the "Fifth Amendment") which removed a requirement that the Company raise \$20 million of new equity capital by September 30, 2014, in addition to raising \$10 million of other liquidity by June 30, 2014, provided that the Company raise \$10 million of new equity capital by May 30, 2014. As discussed in Note 10, the Company raised \$14.1 million and the cash was used to repay a portion of our outstanding indebtedness under the Credit Facility. The equity raise did not reduce the Company's borrowing capacity.

On September 5, 2014, the Company and its lender amended the Credit Facility (the “Sixth Amendment”) which accomplished the following:

- Removed the prohibition against acquisitions and amended the definition of Permitted Acquisition in the Credit Agreement to provide that the Company may, without the lender's consent, but subject to certain restrictions, acquire another entity or its assets for a price of up to \$8 million payable in shares of the Company's common stock.
- Modified the Company’s Tangible Net Worth requirement.
- Eliminated the covenant which capped losses per quarter.
- Changed the monthly Covenant Compliance Reports to quarterly reports.

The foregoing summary description of the Sixth Amendment is not complete and is qualified in its entirety by reference to the full text of the Sixth Amendment, which has been filed with the SEC on Form 8-K.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Comment Regarding Forward-Looking Statements

This Report includes statements that are, or may be considered to be, “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These forward-looking statements are included throughout this Report, including in this section, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and relate to matters such as our industry, business strategy, goals and expectations concerning our market position, future operations, margins, profitability, capital expenditures, liquidity and capital resources and other financial and operating information. We have used the words “anticipate,” “assume,” “believe,” “budget,” “continue,” “co-estimate,” “expect,” “forecast,” “future,” “intend,” “may,” “plan,” “potential,” “predict,” “project,” “should,” “will,” “would” and phrases to identify forward-looking statements in this Report.

Forward-looking statements reflect our current expectations as of the date of this Report regarding future events, results or outcomes. These expectations may or may not be realized. Some of these expectations may be based upon assumptions or judgments that prove to be incorrect. In addition, our business and operations involve numerous risks and uncertainties, many of which are beyond our control, that could result in our expectations not being realized or otherwise could materially affect our financial condition, results of operations and cash flows.

Actual events, results and outcomes may differ materially from our expectations due to a variety of factors. Although it is not possible to identify all of these factors, they include, among others, the following:

- changes in general economic conditions, including recessions, reductions in federal, state and local government funding for infrastructure services and changes in those governments’ budgets, practices, laws and regulations;
- delays or difficulties related to the completion of our projects, including additional costs, reductions in revenues or the payment of liquidated damages, or delays or difficulties related to obtaining required governmental permits and approvals;
- actions of suppliers, subcontractors, design engineers, joint venture partners, customers, competitors, banks, surety companies and others which are beyond our control, including suppliers’, subcontractors’, and joint venture partners’ failure to perform;
- factors that affect the accuracy of estimates inherent in our bidding for contracts, estimates of backlog, percentage-of-completion accounting policies, including onsite conditions that differ materially from those assumed in our original bid, contract modifications, mechanical problems with our machinery or equipment and effects of other risks discussed in this document;
  - design/build contracts which subject us to the risk of design errors and omissions;
- cost escalations associated with our contracts, including changes in availability, proximity and cost of materials such as steel, cement, concrete, aggregates, oil, fuel and other construction materials, and cost escalations associated with subcontractors and labor;
  - our dependence on a limited number of significant customers;
- adverse weather conditions; although we prepare our budgets and bid contracts based on historical rain and snowfall patterns, the incidence of rain, snow, hurricanes, etc., may differ materially from these expectations;
- the presence of competitors with greater financial resources or lower margin requirements than ours, and the impact of competitive bidders on our ability to obtain new backlog at reasonable margins acceptable to us;
  - our ability to successfully identify, finance, complete and integrate acquisitions;
  - citations issued by any governmental authority, including the Occupational Safety and Health Administration;
- federal, state and local environmental laws and regulations where non-compliance can result in penalties and/or termination of contracts as well as civil and criminal liability;
  - adverse economic conditions in our markets; and
-

the other factors discussed in more detail in our Annual Report on Form 10-K for the year ended December 31, 2013 (“2013 Form 10-K”) under “Item 1A. — Risk Factors.”

In reading this Report, you should consider these factors carefully in evaluating any forward-looking statements and you are cautioned not to place undue reliance on any forward-looking statements. Although we believe that our plans, intentions and expectations reflected in, or suggested by, the forward-looking statements that we make in this Report are reasonable, we can provide no assurance that they will be achieved.

The forward-looking statements included in this Report are made only as of the date of this Report, and we undertake no obligation to update any information contained in this Report or to publicly release the results of any revisions to any forward-looking statements to reflect events or circumstances that occur, or that we become aware of after the date of this Report, except as may be required by applicable securities laws.

## Overview

Sterling is a leading heavy civil construction company that specializes in the building and reconstruction of transportation and water infrastructure projects in Texas, Utah, Nevada, Arizona, California, Hawaii and other states where there are construction opportunities. Its transportation infrastructure projects include highways, roads, bridges and light rail and its water infrastructure projects include water, wastewater and storm drainage systems. Sterling performs the majority of the work required by its contracts with its own crews and equipment.

Although we describe our business in this report in terms of the services we provide, our base of customers and the geographic areas in which we operate, we have concluded that our operations comprise one reportable segment and one reporting unit component: heavy civil infrastructure construction. In making this determination, we considered that each project has similar characteristics, includes similar services and similar types of customers and is subject to similar regulatory and economic environments. We organize, evaluate and manage our financial information around each project when making operating decisions and assessing our overall performance.

Sterling has grown its service profile and geographic reach both organically and through acquisitions. Expansions into Utah, Arizona and California were achieved with the 2009 acquisition of RLW and the 2011 acquisitions of JBC and Myers. These acquisitions also extended Sterling's service profiles. For a more detailed discussion of the Company's business, readers of this report are advised to review "Item 1, Business," of the 2013 Form 10-K.

For purposes of the discussions which follow, "Current Quarter" refers to the three-month period ended September 30, 2014 and "Prior Quarter" refers to the three-month period ended September 30, 2013, "Current Period" refers to the nine-month period ended September 30, 2014 and "Prior Period" refers to the nine-month period ended September 30, 2013.

## Financial Results for the Current Quarter and Current Period, Operational Issues and Outlook for 2014 Financial Results

In the Current Quarter and Current Period, we had an operating loss of \$1.6 million and operating income of \$1.4 million, respectively, loss before income taxes and earnings attributable to noncontrolling interest owners of \$1.7 million and income before income taxes and earnings attributable to noncontrolling interest owners of \$1.3 million, respectively, net loss attributable to Sterling common stockholders of \$3.9 million and \$2.5 million, respectively, and net loss per diluted share attributable to Sterling common stockholders of \$0.21 and \$0.14, respectively.

Revenues for the Current Quarter and the Current Period increased 1.8% and 20.5% from the Prior Quarter and Prior Period, respectively. The slight increase in revenue during the Current Quarter is primarily related to an increased number of projects in progress in our California market. The increase in revenue during the Current Period is primarily due to an increase in the number of projects in progress with increased productivity, largely in our Texas and California markets.

In the Current Quarter and Current Period, our overall margins decreased to 4.4% and increased to 5.5%, respectively, as compared to a 4.5% gross margin and a 1.6% gross margin deficit in the Prior Quarter and Prior Period, respectively. The decrease in gross margin during the Current Quarter is primarily attributed to the impact of downward revisions of gross profits related to three problem jobs, two in Texas and one in California. During the Current Quarter, unanticipated expenses were incurred related to these projects resulting in a decrease to our gross

margin in the Current Quarter as compared to the 6.4% gross margin maintained during the three months ended June 30, 2014. The increase in gross margin in the Current Period is primarily attributed to the Prior Period impact of downward revisions of gross profits related to three problem jobs, two in Texas and one in Arizona.

For the first nine months of 2014, gross margins have been adversely impacted by our efforts to complete the problem jobs mentioned above which were awarded prior to January 1, 2012. Significant effort has been made to bring these jobs to closure and while these highway jobs were open to traffic in the second quarter of 2014, they will not be entirely complete until the fourth quarter of 2014. Excluding these jobs, we have seen a steady improvement in gross margins in addition to strong growth in revenue and backlog.

In the 2013 Form 10-K, we discussed various factors which impact the profitability on individual projects as well as the competitive pressures that have adversely affected our ability to secure construction projects at favorable margins. Our highway and related bridge work is generally funded through federal and state authorizations. Federal and state legislation related to infrastructure spending has been slow to pass due to the partisan standoff in Congress. However, with the passage of MAP-21 and the expanded federal Transportation Infrastructure Finance and Innovation Act (TIFIA) loan program, the transportation market has some degree of certainty for its near term funding. This funding has marginally helped, and as a result, the heavy highway construction sector is expected to grow modestly for the remainder of the year. See “Item 1. Business — Our Markets, Competition and Customers” in the 2013 Form 10-K for a more detailed discussion of our markets and their funding sources.

## Results of Operations

### Backlog at September 30, 2014

At September 30, 2014, our backlog of construction projects was \$759 million, as compared to \$687 million at December 31, 2013. Our contracts are typically completed in 12 to 36 months. At September 30, 2014, there was approximately \$82 million excluded from our consolidated backlog for which we were the apparent low bidder, but had not yet been formally awarded the contract or the contract price had not been finalized. Backlog includes \$18 million attributable to our share of estimated revenues related to joint ventures for which we are a noncontrolling joint venture partner. Our backlog reflects, in part, our recently implemented strategy to target smaller, shorter duration projects with a particular focus on improved gross margins.

### Results of Operations for the Current Quarter as Compared to the Prior Quarter and for the Current Period as compared to the Prior Period

|  | Three Months Ended September 30, |            |          | Nine Months Ended September 30, |             |          |
|--|----------------------------------|------------|----------|---------------------------------|-------------|----------|
|  | 2014                             | 2013       | % Change | 2014                            | 2013        | % Change |
| Revenues   | \$ 189,275                       | \$ 185,935 | 1.8%     | \$ 518,618                      | \$ 430,320  | 20.5%    |
| Gross profit (loss)  | \$ 8,356                         | \$ 8,359   | 4.6      | \$ 28,724                       | \$ (6,891)  | NM       |
| General and administrative expenses  | (9,326)                          | (8,176)    | 18.8     | (27,316)                        | (27,273)    | 1.6      |
| Other operating income (expense), net  | (603)                            | 1,514      | NM       | (4)                             | 1,965       | NM       |
| Operating income (loss)  | (1,573)                          | 1,697      | NM       | 1,404                           | (32,199)    | NM       |
| Gains (loss) on the sale of securities   | -                                | (11)       | NM       | -                               | 472         | NM       |
| Interest income  | 113                              | 335        | (66.3)   | 644                             | 871         | (26.1)   |
| Interest expense   | (211)                            | (306)      | (31.0)   | (766)                           | (614)       | 24.8     |
| Income (loss) before taxes and earnings attributable to noncontrolling interests | (1,671)                          | 1,715      | NM       | 1,282                           | (31,470)    | NM       |
| Income tax (expense) benefit   | (546)                            | 380        | NM       | (573)                           | 12,928      | NM       |
| Net income (loss)  | (2,217)                          | 2,095      | NM       | 709                             | (18,542)    | NM       |
| Noncontrolling owners' interests in earnings of subsidiaries and joint ventures  | (1,718)                          | (2,284)    | (24.8)   | (3,238)                         | (3,250)     | (0.4)    |
| Net loss attributable to Sterling common stockholders                            | \$ (3,935)                       | \$ (189)   | NM       | \$ (2,529)                      | \$ (21,792) | (88.4)   |
| Gross margin (deficit)   | 4.4%                             | 4.5%       | 2.2      | 5.5%                            | (1.6)%      | NM       |
| Operating margin (deficit)   | (0.8)%                           | 0.9%       | NM       | 0.3%                            | (7.5)%      | NM       |



NM – Not meaningful.

|                                 | Amount as of             |                  |                      |
|---------------------------------|--------------------------|------------------|----------------------|
|                                 | September<br>30,<br>2014 | June 30,<br>2014 | December 31,<br>2013 |
| Contract Backlog, end of period | \$759,000                | \$727,000        | \$ 687,000           |

23

---

## Revenues

Revenues increased \$3.3 million, or 1.8%, in the Current Quarter compared with the Prior Quarter and increased \$88.3 million, or 20.5%, for the Current Period compared with the Prior Period. The slight increase in revenue during the Current Quarter is primarily related to an increased number of projects in progress in our California market. The increase in the Current Period is primarily attributable to an increase in the number of projects in progress along with increased productivity, largely in our Texas and California markets.

## Gross Profit

Gross profit remained flat for the Current Quarter compared with the Prior Quarter and increased \$35.6 million for the Current Period compared with the Prior Period. Gross margins decreased to 4.4% in the Current Quarter from 4.5% in the Prior Quarter and increased to 5.5% in the Current Period from a deficit of 1.6% in the Prior Period. The decrease in gross margin during Current Period is primarily attributed to the impact of downward revisions of gross profits related to three problem jobs, two in Texas and one in California. During the Current Quarter, unanticipated expenses were incurred related to these projects resulting in a decrease to our gross margin in the Current Quarter as compared to the 6.4% gross margin maintained during the three months ended June 30, 2014. The increase in gross margin in the Current Period is primarily attributed to the Prior Period impact of downward revisions of gross profits related to three problem jobs, two in Texas and one in Arizona.

At September 30, 2014 and 2013, we had approximately 113 and 111 contracts-in-progress, respectively, which were less than 90% complete. These contracts are of various sizes, of different expected profitability and in various stages of completion. The nearer a contract progresses toward completion, the more visibility we have in refining our estimate of total revenues (including incentives, delay penalties and change orders), costs and gross profit. Thus, gross profit as a percent of revenues can increase or decrease from comparable and sequential quarters due to differences among contracts and depending upon the stage of completion of contracts.

## General and administrative expenses

General and administrative expenses increased \$1.1 million to \$9.3 million during the Current Quarter from \$8.2 million in the Prior Quarter and remained flat at \$27.3 million in the Current Period compared to the Prior Period. The increase during the Current Quarter as compared to the Prior Quarter is primarily the result of a slight increase in headcount and employee benefit costs and a decrease in employee benefit costs in the Prior Quarter.

As a percent of revenues, general and administrative expenses increased 0.5% to 4.9% and decreased 1.0% to 5.3% in the Current Quarter and Current Period, respectively, compared with 4.4% and 6.3% in the Prior Quarter and Prior Period, respectively. The increase in general and administrative expenses, as a percentage of revenue, for the Current Quarter as compared to the Prior Quarter is primarily the result of a decrease in employee benefit costs in the Prior Quarter. The decrease in the Current Period as compared to the Prior Period is primarily the result of investments made in our information systems infrastructure and operational and financial process improvements which allowed us to increase our productivity without a significant increase in general and administrative expenses.

## Income taxes

Our effective income tax rates for the Current Quarter and Prior Quarter were 32.7% and 22.2%, respectively, and for the Current Period and Prior Period were 44.7% and 41.1%, respectively. The Company is not expecting a current federal tax liability for 2014. The Company does expect a state tax liability for 2014. Therefore, a current tax expense has been recorded for those states for the three and nine months ended September 30, 2014. Additionally, we have recorded a current tax expense for the reduction of our net tax receivable. In the Prior Quarter and Prior Period, the effective income tax rate varied from the statutory rate primarily as a result of net income attributable to

noncontrolling interest owners which is taxable to those owners rather than to us, state income taxes, and other permanent differences.

In order to determine that a valuation allowance was necessary, management assessed the available positive and negative evidence to estimate whether sufficient future taxable income would be generated to use the existing deferred tax assets. A significant piece of objective negative evidence evaluated was the cumulative loss incurred over the three-year period ended September 30, 2014. Such objective evidence limits the ability to consider other subjective evidence such as our projections for future growth. The ability to realize deferred tax assets and the need for a valuation allowance is evaluated and assessed quarterly. The amount of the deferred tax asset considered realizable could be adjusted if objective negative evidence or cumulative losses are no longer present, and additional weight may be given to subjective evidence such as our projections for growth. For the quarter ended September 30, 2014, there was no change in management's assessment of the amount of deferred tax asset considered realizable from the assessment made at December 31, 2013 and June 30, 2014.

## Historical Cash Flows

The following table sets forth information about our cash flows and liquidity (amounts in thousands):

|   | Nine Months Ended<br>September 30, |             |
|---|------------------------------------|-------------|
|   | 2014                               | 2013        |
| Net cash provided by (used in):                 |                                    |             |
| Operating activities                            | \$(14,118 )                        | \$(11,838 ) |
| Capital expenditures                            | (14,404 )                          | (11,333 )   |
| Proceeds from sales of property and equipment   | 4,874                              | 4,517       |
| Net sales of short-term securities              | -                                  | 27,291      |
| Net drawdown on the Credit Facility             | 26,335                             | (3,578 )    |
| Distributions to noncontrolling interest owners | (1,190 )                           | (3,244 )    |
| Net proceeds from stock issued                  | 14,078                             | -           |
| Other   | (447 )                             | 57          |
| Total   | \$15,128                           | \$1,872     |

|                           | Amount as of             |                      |
|---------------------------|--------------------------|----------------------|
|                           | September<br>30,<br>2014 | December 31,<br>2013 |
| Cash and cash equivalents | \$17,000                 | \$ 1,872             |
| Working capital           | \$53,700                 | \$ 8,686             |

## Operating Activities

Significant non-cash items included in operating activities include depreciation and amortization expense which was \$13.8 million and \$14.0 million in the Current Period and Prior Period, respectively. The depreciation expense has remained consistent from the Prior Period to the Current Period as a result of our efforts to maintain our current fleet of equipment and supplement it as necessary with leased equipment.

Besides the net income and net loss in the Current Period and Prior Period, respectively, and the non-cash items discussed above, other significant components of cash flows from operations were:

- contracts receivable increased by \$28.1 million in the Current Period and increased \$19.8 million in the Prior Period while the net cash effect of billings in excess of costs and estimated earnings and costs, and estimated earnings in excess of billings decreased cash by \$23.1 million in the Current Period and increased cash by \$1.3 million in the Prior Period;
- accounts payable increased by \$19.5 million in the Current Period and \$31.3 million in the Prior Period; and
- accrued compensation and other liabilities increased by \$6.6 million in the Current Period and increased by \$3.9 million in the Prior Period.

## Investing Activities

Capital equipment is acquired as needed to support increased levels of production activities and to replace retiring equipment. Expenditures for the replacement of certain equipment and to expand our construction fleet of equipment for the Current Period and Prior Period totaled \$14.4 million and \$11.3 million, respectively. Proceeds from the sale of property and equipment for the Current Period and Prior Period totaled \$4.9 million and \$4.5 million, respectively, with an associated net gain for the Current Period and Prior Period of \$0.9 million and \$0.8 million, respectively. The

level of expenditures in the Current Period increased by a minimal \$3.1 million from the Prior Period as a result of management's efforts to optimize utilization of our existing fleet of equipment based on current and projected workloads while supplementing our fleet with leased assets where appropriate.

During the Current Period, we had no sales of short-term securities as compared to net sales of short-term securities of \$27.3 million in the Prior Period. The net sales in the Prior Period were primarily used to repay borrowings under on our Credit Facility that were used to purchase the remaining 20% interest in RLW in December 2012.

#### Financing Activities

Financing activities in the Current Period consisted of net proceeds from our common stock offering of \$14.1 million which was used to strengthen our balance sheet. In addition, the net drawdown on our Credit Facility of \$26.3 million was used to fund our operating activities. In the Prior Period, there was a net payment of \$3.6 million on our Credit Facility. During the Current Period, we distributed \$1.2 million to the noncontrolling interest owners. During the Prior Period, \$3.2 million was distributed to the noncontrolling interest owners. Of this amount, \$2.3 million was distributed to the former RLW owners as their final distribution for RLW's earnings in 2012.

## Liquidity and Sources of Capital

The level of working capital for our construction business varies due to fluctuations in:

- contract receivables and contract retentions;
- costs and estimated earnings in excess of billings;
- billings in excess of costs and estimated earnings;
- investments in our unconsolidated construction joint ventures;
- the size and status of contract mobilization payments and progress billings; and
- the amounts owed to suppliers and subcontractors.

Some of these fluctuations can be significant. At September 30, 2014, we had working capital of \$53.7 million, an increase of \$45.0 million over December 31, 2013. The increase in working capital was the result of the following (amounts in thousands):

|  |          |
|--|----------|
| Net income   | \$709    |
| Depreciation and amortization                              | 13,809   |
| Capital expenditures                                       | (14,404) |
| Proceeds from sales of property and equipment, net of gain | 3,969    |
| Distributions to noncontrolling interest owners            | (1,190)  |
| Net drawdown on the Credit Facility                        | 26,335   |
| Net proceeds from stock issued                             | 14,078   |
| Other  | 1,708    |
| Total increase in working capital                          | \$45,014 |

In addition to our available cash and cash equivalents and cash provided by operations, from time to time we use borrowings under our Credit Facility with Comerica Bank to finance our capital expenditures and working capital needs. Subject to the terms of the Credit Facility, including the financial covenants and further amendments discussed below, up to \$40 million in borrowings and letters of credit are available under the Credit Facility, which matures on September 30, 2016. Borrowings under the Credit Facility are secured by all assets of the Company, other than proceeds from and other rights under our construction contracts which are pledged to our bond surety. At September 30, 2014, there were \$34.1 million of borrowings outstanding under the Credit Facility; in addition, there was an outstanding letter of credit of \$3.0 million which reduced availability under the Credit Facility to \$2.9 million.

The Credit Facility is subject to our compliance with certain covenants, including financial covenants relating to leverage, tangible net worth and asset coverage. The Credit Facility contains restrictions on our ability to:

- Make distributions or pay dividends;
- Incur liens and encumbrances;
- Incur further indebtedness;
- Guarantee obligations;
- Dispose of a material portion of assets or merge with a third party;
- Make acquisitions; and
- Make investments in securities.

At the end of the fourth quarter of 2013, we were not in compliance with the minimum tangible net worth and the leverage ratio financial covenants. As a result, subsequent to year end, we obtained a Waiver and Fourth Amendment to Credit Agreement (the "Fourth Amendment") with our bank which waived the noncompliance with the financial covenants as of December 31, 2013 and provided less restrictive covenant requirements. The Fourth Amendment also imposed liquidity thresholds that we are required to meet in 2014. We believe that we will be able to maintain

compliance with all covenants required under the Fourth Amendment through at least the next twelve months. Refer to the discussion below of our revised amendment which eased our required liquidity thresholds.

Among other things, the Fourth Amendment reduced the borrowings available to \$40 million from the previously available \$50 million and eliminated the option to increase the Credit Facility by an additional \$50 million. The Fourth Amendment also modified the existing borrowing interest fee schedule and increased borrowing rates by 50 basis points to 4.75% effective December 31, 2013. In addition, if certain liquidity thresholds are not met in 2014 the interest rate may increase 200 basis points and continue to increase 100 basis points every quarter after 2015 until such thresholds are met. Furthermore, the Fourth Amendment requires the payment of a quarterly commitment fee of 0.75% per annum on unused availability.

On April 29, 2014, we obtained an amendment (the "Fifth Amendment") with our bank which removed a requirement that we raise \$20 million of new equity capital by September 30, 2014, in addition to raising \$10 million of other liquidity by June 30, 2014, provided that we raise \$10 million of new equity capital by May 30, 2014. As discussed below, the Company raised \$14.1 million and the cash was used to repay a portion of our outstanding indebtedness under the Credit Facility. The equity raise did not reduce the Company's borrowing capacity.

In addition, as discussed in Note 10 to the accompanying financial statements, on April 29, 2014, an amended "shelf" registration statement filed by the Company with the SEC became effective. Under the amended shelf registration statement, the Company may offer from time to time any combination of securities described in the prospectus in one or more offerings up to a total of \$80 million, the proceeds of which may be used for working capital, capital expenditures and general corporate purposes, including future acquisitions.

On May 6, 2014, we closed a public offering with D.A. Davidson & Co. as sole underwriter (the "Underwriter"), pursuant to which the Underwriter purchased from the Company 2,100,000 shares of the Company's common stock at a price of \$6.90 per share. The net proceeds of \$14.1 million from the offering, after deducting underwriting discounts and offering expenses, was used to repay a portion of the indebtedness outstanding under our \$40 million revolving credit facility in accordance with the Fifth Amendment mentioned above.

On September 5, 2014, the Company and its lender amended the Credit Facility (the "Sixth Amendment") which accomplished the following:

- Removed the prohibition against acquisitions and amended the definition of Permitted Acquisition in the Credit Agreement to provide that the Company may, without the lender's consent, but subject to certain restrictions, acquire another entity or its assets for a price of up to \$8 million payable in shares of the Company's common stock.
- Modified the Company's Tangible Net Worth requirement.
- Eliminated the covenant which capped losses per quarter.
- Changed the monthly Covenant Compliance Reports to quarterly reports.

The foregoing summary description of the Sixth Amendment is not complete and is qualified in its entirety by reference to the full text of the Sixth Amendment, which has been filed with the SEC on Form 8-K.

Average borrowings under the Credit Facility for the Current Quarter were \$11.4 million and the largest amount of borrowings under the Credit Facility was \$36.8 million on April 21, 2014. Average borrowings under the Credit Facility for the fiscal year 2013 were \$18.6 million, and the largest amount of borrowings under the Credit Facility was \$37.4 million on July 12, 2013.

We believe that we have sufficient liquid financial resources, including the unused portion of our Credit Facility, to fund our requirements for the next twelve months of operations, including our bonding requirements, and we expect no material adverse change in our liquidity. Furthermore, we believe we have several financing options available, including additional debt or equity financing, and we are continually assessing these options to provide the Company with the lowest cost of capital possible. Future developments or events, such as an increase in our level of purchases of equipment to support significantly higher backlog or an acquisition of another company could, however, affect our



level of working capital and tangible net worth. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operation—Sources of Capital” in the 2013 Form 10-K for further discussion of the covenants and restrictions under the Credit Facility.

## Inflation

Inflation generally has not had a material impact on our financial results; however, from time to time, increases in oil, fuel and steel prices have affected our cost of operations. Anticipated cost increases and reductions are considered in our bids to customers on proposed new construction projects.

In order to mitigate our exposure to increases in fuel prices, we have a program to hedge our exposure to increases in diesel fuel prices by entering into swap contracts for diesel fuel. We believe that the gains and losses on these contracts will tend to offset increases and decreases in the price we pay for diesel fuel and reduce the volatility of such fuel costs in our operations. As of September 30, 2014, we had diesel futures contracts for 0.3 million gallons with fixed prices at an average of \$2.82 per gallon. This compares to the September 30, 2014 price for off-road ultra-low sulfur diesel published by Platts of \$2.62. We will continue to evaluate this strategy and may increase or decrease our commitments depending on our forecast of the diesel fuel market and other operational considerations. There can be no assurance that this strategy will be successful.

When we are the successful bidder on a project, we execute purchase orders with material suppliers and contracts with subcontractors covering the prices of most materials and services, other than oil and fuel products, thereby mitigating future price increases and supply disruptions. These purchase orders and subcontracts do not contain quantity guarantees and we have no obligation to the suppliers or subcontractors for materials and services beyond those required to complete the contracts with our customers. There can be no assurance that increases in prices of oil and fuel used in our business will be adequately covered by the estimated escalation we have included in our bids or derivative contracts entered into to hedge against certain such increases, and there can be no assurance that all of our vendors will fulfill their pricing and supply commitments under their purchase orders and contracts with the Company. We adjust our total estimated costs on our projects when we believe it is probable that we will have cost increases which will not be recovered from customers, vendors or through project re-engineering.

## Off-Balance Sheet Arrangements and Joint Ventures

As discussed further in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operation—Off-Balance Sheet Arrangements and Joint Ventures” in the 2013 Form 10-K, we participate in various construction joint venture partnerships in order to share expertise, risk and resources for certain highly complex projects. The venture’s contract with the project owner typically requires joint and several liability among the joint venture partners. Although our agreements with our joint venture partners provide that each party will assume and fund its share of any losses resulting from a project, if one of our partners is unable to pay its share, we would be fully liable for such share under our contract with the project owner. Circumstances that could lead to a loss under these guarantee arrangements include a partner’s inability to contribute additional funds to the venture in the event that the project incurs a loss or additional costs that we could incur should the partner fail to provide the services and resources toward project completion that had been committed to in the joint venture agreement.

At September 30, 2014, there was approximately \$61 million of construction work to be completed on unconsolidated construction joint venture contracts, of which \$18 million represented our proportionate share. Due to the joint and several liability under our joint venture arrangements, if one of our joint venture partners fails to perform, we and the remaining joint venture partners would be responsible for completion of the outstanding work. As of September 30, 2014, we are not aware of any situation that would require us to fulfill responsibilities of our joint venture partners pursuant to the joint and several liability under our contracts.

Off-balance sheet arrangements related to operating leases are discussed in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Contractual Obligations” in the 2013 Form 10-K.

## Item 3. Quantitative and Qualitative Disclosures about Market Risk

Changes in interest rates are one of our sources of market risks. Outstanding indebtedness under our Credit Facility bears interest at floating rates. The average borrowings under our Credit Facility during the Current Quarter were \$11.4 million. Based on our current level of borrowings for 2014, a change of 1.0% in our interest rate may have a \$0.1 million impact on our results from operations.

We are exposed to market risk from changes in commodity prices. In the normal course of business, we enter into derivative transactions, specifically cash flow hedges, to mitigate our exposure to diesel fuel commodity price movements. We do not participate in these transactions for trading or speculative purposes. While the use of these arrangements may limit the benefit to us of decreases in the prices of diesel fuel, it also limits the risk of adverse price movements. The following represents the outstanding contracts at September 30, 2014:

28

---

|                 |                   | Price Per Gallon |                  |                            | Fair Value of Derivatives at September 30, 2014 |
|-----------------|-------------------|------------------|------------------|----------------------------|---|
| Beginning       | Ending            | Range            | Weighted Average | Remaining Volume (gallons) | (amounts in thousands)                          |
| October 1, 2014 | December 31, 2014 | \$2.79 – 2.88    | \$ 2.83          | 240,000                    | \$ (59)   |
| January 1, 2015 | August 31, 2015   | \$2.75 – 2.79    | \$ 2.77          | 100,000                    | (14)  |
|                 |                   |                  |                  |                            | \$ (73)   |

See “Inflation” above regarding risks associated with materials and fuel purchases required to complete our construction contracts.

#### Item 4. Controls and Procedures

##### Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures include, but are not limited to, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Securities Exchange Act of 1934 is accumulated and communicated to the issuer’s management, including the principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

The Company’s principal executive officer and principal financial officer reviewed and evaluated the Company’s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based on that evaluation, the Company’s principal executive officer and principal financial officer concluded that the Company’s disclosure controls and procedures were effective at September 30, 2014 to ensure that the information required to be disclosed by the Company in this Report is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms and is accumulated and communicated to the Company’s management including the principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

##### Changes in Internal Control over Financial Reporting

We maintain a system of internal control over financial reporting that is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States. Based on the most recent evaluation, we have concluded that no significant changes in our internal control over financial reporting has occurred as of September 30, 2014 that have materially affected or are reasonably likely to materially affect, our internal control over financial reporting.

##### Inherent Limitations on Effectiveness of Controls

Internal control over financial reporting may not prevent or detect all errors and all fraud. Also, projections of any evaluation of effectiveness of internal control to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

## PART II – OTHER INFORMATION

Item 1. Legal Proceedings

We are now and may in the future be involved as a party to various legal proceedings that are incidental to the ordinary course of business. We regularly analyze current information about these proceedings and, as necessary, provide accruals for probable liabilities on the eventual disposition of these matters.

In the opinion of management, after consultation with legal counsel, there are currently no threatened or pending legal matters that would reasonably be expected to have a material adverse impact on our consolidated results of operations, financial position or cash flows.

Item 1A. Risk Factors

Reference is made to Part I, Item 1A. Risk Factors in the 2013 Form 10-K for information concerning risk factors. We are updating these risk factors to include the risk factor set forth below. The following risk factor should be read in conjunction with the other risk factors set forth in the 2013 Form 10-K. You should carefully consider such risk factors, which could materially affect our business, financial condition or future results.

We must manage our liquidity carefully to fund our working capital.

The need for working capital for our business varies due to fluctuations in the following amounts, among other factors:

- contract receivables and contract retentions;
- costs and estimated earnings in excess of billings;
- billings in excess of costs and estimated earnings;
- the size and status of contract mobilization payments and progress billings; and
- the amounts owed to suppliers and subcontractors.

We have limited cash on hand and the timing of payments on our contract receivables are difficult to predict. If the timing of payments on our receivables is delayed or the amount of such payments is less than expected, our liquidity and ability to fund working capital could be materially and adversely affected.

There have not been any material changes from the other risk factors previously disclosed in Item 1A of the 2013 Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(c) The following table shows, by month, the number of shares of the Company's common stock that the Company repurchased in the quarter ended September 30, 2014.

| Period                 | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares (or Units) Purchased as Part of Publicly-Announced Plans or Program | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|------------------------|----------------------------------|------------------------------|--|---|
| September 1 – 30, 2014 | 7,110                            | (1) \$ 7.66                  | -  | -   |

(1) These shares were repurchased from employees holding shares of the Company's common stock that had been awarded to them by the Company and that were released (in the month of September) from Company-imposed transfer restrictions in order to enable the employees to satisfy the Company's tax withholding obligations occasioned by the release of the restrictions. The repurchases were made at the election of the employees pursuant to a procedure adopted by the Compensation Committee of the Board of Directors.

Item 3. Defaults upon Senior Securities

None.

Item 4. Mine Safety Disclosures

The information concerning mine safety violations and other regulatory matters required by section 1503(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act and Item 104 of Regulation S-K is included in Exhibit 95.1 of this Quarterly Report on Form 10-Q, which is incorporated by reference.

Item 5. Other Information

None.

30

---

Item 6. Exhibits

| Exhibit No. | Description  |
|-------------|--|
| 31.1*       | Certification of Peter E. MacKenna, Chief Executive Officer of Sterling Construction Company, Inc.   |
| 31.2*       | Certification of Thomas R. Wright, Chief Financial Officer of Sterling Construction Company, Inc.  |
| 32*         | Certification pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) of Peter E. MacKenna, Chief Executive Officer, and Thomas R. Wright, Chief Financial Officer |
| 95.1*       | Mine Safety Disclosure   |
| 101.INS*    | XBRL Instance Document   |
| 101.SCH*    | XBRL Taxonomy Extension Schema Document  |
| 101.CAL*    | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF*    | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB*    | XBRL Taxonomy Extension Label Linkbase Document  |
| 101.PRE*    | XBRL Taxonomy Extension Presentation Linkbase Document   |

---

\* Filed herewith.



SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

STERLING CONSTRUCTION COMPANY, INC.

Date: November 10, 2014

By: /s/ Peter E. MacKenna  
Peter E. MacKenna  
President and Chief Executive Officer

Date: November 10, 2014

By: /s/ Thomas R. Wright  
Thomas R. Wright  
Chief Financial Officer

STERLING CONSTRUCTION COMPANY, INC.

Quarterly Report on Form 10-Q for Period Ended September 30, 2014

Exhibit Index

Exhibit

| No.      | Description   |
|----------|---|
| 31.1*    | Certification of Peter E. MacKenna, Chief Executive Officer of Sterling Construction Company, Inc.  |
| 31.2*    | Certification of Thomas R. Wright, Chief Financial Officer of Sterling Construction Company, Inc.   |
| 32*      | Certification pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) of Peter E. MacKenna, Chief Executive Officer, and Thomas R. Wright, Chief Financial Officer. |
| 95.1*    | Mine Safety Disclosure  |
| 101.INS* | XBRL Instance Document  |
| 101.SCH* | XBRL Taxonomy Extension Schema Document   |
| 101.CAL* | XBRL Taxonomy Extension Calculation Linkbase Document   |
| 101.DEF* | XBRL Taxonomy Extension Definition Linkbase Document  |
| 101.LAB* | XBRL Taxonomy Extension Label Linkbase Document   |
| 101.PRE* | XBRL Taxonomy Extension Presentation Linkbase Document  |

---

\* Filed herewith.