

STERLING CONSTRUCTION CO INC

Form 10-K/A

November 10, 2005

Table of Contents

**FORM 10-K/A
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2004

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
Commission file number: 0-19450

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 Number

2751 Centerville Road Suite 3131
Wilmington, Delaware
Address of principal executive offices

19803
Zip Code

Registrant's telephone number, including area code: **(281) 821-9091**

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Title of each class

Common Stock, \$0.01 par value per share

Preferred Shares Purchase Rights

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K

Indicate by check mark whether the registrant is an accelerated filer (as defined by Exchange Act Rule 12b-2).
Yes No

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Aggregate market value at June 30, 2004 of the voting stock held by non-affiliates of the registrant: \$15,557,732.

At March 1, 2005 the registrant had 7,399,681 shares of common stock outstanding

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates certain information by reference from the Registrant's definitive proxy statement for the annual meeting of shareholders to be held on May 19, 2005, which proxy statement will be filed no later than 120 days after the close of the Registrant's fiscal year ended December 31, 2004.

TABLE OF CONTENTS

PART I

Item 1. Business

Item 2. Properties

Item 3. Legal Proceedings

Item 4. Submission of Matters to a Vote of Security Holders

Item 4A. Executive Officers of the Company

PART II

Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Item 6. Selected Financial Data

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 7(A). Quantitative and Qualitative Disclosure about Market Risk

Item 8. Financial Statements and Supplementary Data

Item 9 Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

Item 9(A) Controls and Procedures

Item 9(B). Other Information

PART III

ITEMS 10-14

PART IV

Item 15 Exhibits, Financial Statement Schedules, And Reports

SIGNATURES

Consent of Grant Thornton LLP

Section 302 Certification of Patrick T. Manning, CEO

Section 302 Certification of Maarten D. Hemsley, CFO

Certification of CEO and CFO

Table of Contents

Explanatory Note

This Amendment No. 1 to the Company's Annual Report on Form 10-K for the year ended December 31, 2004 is being filed primarily to clarify certain items related to the purchase of the minority interest in Sterling Houston Holdings, Inc. (the Put Transaction), to reclassify the accretion of interest in 2003 and 2002 as a non-cash item in the cash flow statement and to clarify the effectiveness of its internal controls at December 31, 2004.

PART I

Item 1. Business

Cautionary Statement

This Report on Form 10-K contains certain forward-looking statements that involve risks and uncertainties. The cautionary statements contained in this Report should be read as being applicable to all related forward-looking statements wherever they appear in this Report. The Company's actual results in the future could differ materially from those discussed here. Important factors that could cause or contribute to such differences include those discussed in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Report.

Company Website

The Company maintains a website at www.sterlingconstructionco.com and makes available free of charge on or through its website, access to its latest Annual Report on Form 10-K, recent Quarterly Reports on Form 10-Q, any amendments to those filings, recent press releases, its Code of Ethics, and Audit Committee Charter together with other filings related to shareholdings. The website content is available for informational purposes only. The website should not be relied upon for investment purposes nor is it incorporated by reference into this Form 10-K.

Business

Sterling Construction Company, Inc. (Sterling or the Company) owns two subsidiaries (i) Sterling Houston Holdings, Inc., a heavy civil construction company based in Houston, Texas (the Construction Segment or SHH) and (ii) Steel City Products, Inc., a distributor of automotive accessories, non-food pet supplies and lawn and garden products based in Pittsburgh, Pennsylvania (the Distribution Segment or SCPI).

Further information on the businesses of the Company's operating segments is discussed below. Financial information for the segments is set forth in Note 13 to the consolidated financial statements of the Company.

Business Strategy

The Company seeks to increase long-term stockholder value by expanding profit opportunities through winning and executing more contracts and larger ones in its core construction business. This requires the continued investment in a growing staff of professional engineers and construction crews and the addition of capital equipment. Acquisitions are also part of management's growth strategy and acquisition candidates are regularly evaluated. In general, the Company is seeking acquisitions that would be accretive and have management who will continue to direct the operations of the acquired enterprise. While an acquisition that would expand the scope, either functionally and/or geographically, of the current business would be desirable, management has and will continue to consider other transactions that meet the aforementioned financial and management criteria. The Company's tax loss carryforwards are an important corporate asset and the protection and utilization of the losses is expected to assist in increasing shareholder values for the next several years. Stockholder value is measured by increases in shareholders' equity and by the appreciation of the value of the outstanding common stock over a period of years. In addition, the Company measures its success by the ability to attract and maintain experienced and capable employees and to maintain high ethical standards.

Table of Contents

The Construction Segment

Operations

SHH specializes in municipal and state contracts for the construction and paving of highways, building of bridges, installing water and sewer mains, light rail infrastructure projects and similar activities.

Raw Materials

The principal raw materials used in SHH's business include structural steel, concrete and aggregate. These and other raw materials and components which are used and are necessary in the construction business are generally available from numerous sources. Factors such as price and availability of transportation for these raw materials may limit supply at some times. SHH does not foresee shortages in these raw materials in the near term that would have a material adverse effect on the business.

Seasonality

SHH's operations can be materially affected by poor weather conditions, so that generally less construction is completed in the winter months. In particular, significant rainfall can cause construction delays adversely affecting revenues and margins on contracts in progress.

Customer Base

Most of SHH's revenues are generated in the Houston municipal market, which includes the City of Houston, the Houston Metropolitan Transit Authority and Harris County. (See Note 13)

In addition to its established operations in Houston, SHH has operations in the Dallas/Fort Worth and San Antonio markets and undertakes contracts for the State of Texas in each of its markets and elsewhere within the State. SHH also occasionally undertakes projects for private developers and corporate customers.

Most contracts are subject to a competitive public tender process.

There are no foreign revenues.

The table set forth in Note 13 to the consolidated financial statements shows contract revenues generated from SHH's largest customers which accounted for more than 10% of revenues in fiscal 2004, 2003 and 2002.

Contract Backlog

At December 31, 2004, SHH's backlog of construction contracts totaled \$232 million, the largest year-end backlog in SHH's history, and an increase of 65% compared with December 31, 2003. Of this amount, approximately \$160 million is scheduled to be completed within fiscal 2005, and approximately \$72 million in fiscal 2006 and beyond. SHH expects to add further contracts during 2005 for construction during the year and in the future. Through mid-March 2005, the Company announced new contract wins individually exceeding \$5 million with an aggregate value of \$55.5 million.

Competition

The typical public contract selection process is by sealed bid with the lowest bidder winning in a public selection process. Management undertakes a significant due diligence process in preparing each bid. Participants must post bid bonds for up to 10% of the amount bid, and on successful bids must post performance bonds for 100% of the contract amount. Contracts are priced for labor, sub-contracting, equipment use and materials against detailed specifications provided by the customer.

Table of Contents

SHH's competitors include large national and regional construction companies as well as smaller contractors. Management is unable to determine the relative size of most competitors, which are privately-owned, but believes that SHH is one of the larger participants in its marketplace, and the largest contractor in Houston that is engaged in municipal civil construction work.

SHH's size relative to its many smaller competitors in the municipal construction market gives it several advantages, including greater flexibility to manage its backlog so as to maximize its manpower and equipment resources, and the cost effective purchasing of materials, insurance and bonds. Since SHH owns and maintains most of the equipment required for its contracts and has the experienced manpower to handle many types of municipal civil construction, it is able to bid competitively on many categories of contracts, especially complex multi-task projects. In its successful effort to penetrate the state highway market, where most competitors are large, regional contractors, and individual contracts tend to be larger than the Company's municipal work and involve many specialized skills, SHH acquired the Kinsel heavy highway construction business (Kinsel) in September 2002. By fiscal 2004 state highway work had come to represent 33.0% of Construction Segment revenues, compared with 18.6% and 7.7% in fiscal 2003 and 2002, respectively.

Regulation

Management does not anticipate that existing or known pending environmental legislation or other regulations will require major capital expenditures or will adversely affect its operations. However, in the last two years, environmental issues have adversely impacted the rate at which certain highway contracts have been let in the Houston market.

Employees

At December 31, 2004, SHH employed approximately 750 persons, of whom 29 were employed in the headquarters in Houston. Most of the others are field personnel. No SHH employees are represented by a labor union. Senior SHH executives, including Patrick T. Manning (also Chief Executive Officer of Sterling) and Joseph P. Harper, Sr. (also President of Sterling) have many years of service with SHH and are employed under long-term contracts, which were renewed during fiscal 2004.

SHH's business is dependent upon a readily available workforce of both field and supervisory personnel. SHH does not anticipate any shortage of labor in the near term, but has no assurance that it will be able to continue to attract sufficient numbers of new employees to support its growth in the future.

The Distribution Segment

Operations

Since its founding in 1947 SCPI has distributed automotive accessories, now including functional and decorative car and truck accessories, car care products, chemicals and car repair and maintenance items. In fiscal 1996, SCPI expanded its merchandise selection to include non-food pet supplies and in fiscal 2000 added lawn and garden products. Sales in fiscal 2004 of pet supplies and lawn and garden products represented approximately 16.5% and 16.6%, respectively, of SCPI's total sales. SCPI's automotive and pet distribution operations are conducted from leased facilities in McKeesport, Pennsylvania and its lawn and garden operations are conducted from leased facilities in Glassport, Pennsylvania.

Many of SCPI's largest customers transmit their own orders directly to SCPI's warehouse; nevertheless, SCPI continues to provide personal service to many customers, which involves visits by its sales personnel to customers stores to count and re-order merchandise. Since most orders are generated electronically and are shipped within a few days of receipt, the size of SCPI's order backlog is not relevant to an understanding of the business. Shipments are either made directly to each of the customers' stores or are packed for onward shipment to stores via the retailers distribution centers. SCPI also provides price ticketing and associated services to those of its customers that request such services.

Table of Contents

Sources of Supply

SCPI acquires its merchandise from a large number of suppliers, the largest of which accounted for 13.5% of its purchases for fiscal 2004. Many of the products sold by SCPI carry nationally advertised brand names, but because of the diversity and number of suppliers and products carried, the business is not generally dependent on the continued availability of individual products or continued dealings with existing supply sources. From time to time, market or seasonal conditions may affect the availability of certain merchandise, but not to the extent that the Company believes would materially impact its business.

Steel City Products generally carries in inventory only those products that its customers have identified as necessary for their own merchandising needs and does not acquire significant quantities of other merchandise.

Seasonality

SCPI's automotive and lawn and garden businesses are seasonal, being slowest in the early winter months than at other times of the year. In anticipation of higher sales volume in the spring and summer, SCPI carries higher inventories of these products beginning in the winter months. As is customary in the automotive aftermarket and in the lawn and garden products business, some suppliers allow extended payment terms to SCPI for such inventory build-ups.

SCPI's pet supply business is less subject to seasonality, but usually experiences increased sales in the fourth quarter of the year.

SCPI's needs for working capital are affected by these seasonal fluctuations and other factors (see Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources).

Customer Base

SCPI's customers include supermarket chains, drug stores, general merchandise retail chains, automotive specialty stores, hardware stores, variety stores, some smaller garden centers and other automotive accessory distributors. Most customers are based in the northeastern United States, although stores operated by some customers are located outside of that area, and since 2000 SCPI has been selling to the West Coast distribution facility of one of its major customers (See Note 13). There are no foreign sales.

SCPI's customers are continually affected by changes in the retail environment, including the competitive pressures facing regional mass merchandisers and the growing influence of national automotive and pet specialty chains. These have led to fluctuations in the level of business that SCPI enjoys with individual customers. Some customers have changed their buying practices to acquire certain merchandise direct from manufacturers rather than through distributors such as SCPI.

In its efforts to offset these trends, SCPI has in recent years added new customers, especially in the supermarket and drug store sectors, has expanded its product offerings to certain customers, has enlarged the territory that it serves and has introduced new categories of products. Management believes that these efforts have resulted in a more diverse and financially secure customer base.

None of SCPI's business is based on government contracts and there are no long-term sales contracts with any customers.

Competition

The distribution business for automotive parts and accessories, non-food pet supplies and lawn and garden products is highly competitive, with several similar companies operating in SCPI's market place, and many of SCPI's suppliers also offering their products directly to retailers. Management is unable to quantify SCPI's relative

Table of Contents

size in relation to its competitors, but believes it is one of the largest independent distributors of automotive accessories in the Northeastern United States. In recent years, a number of significant competitors of SCPI have gone out of business and some of SCPI's customers have chosen to purchase some products directly from manufacturers. SCPI competes on the basis of its management's merchandise expertise, the breadth of merchandise offered, price, levels of service, order fill rates and order turnaround times. Management believes that SCPI's long history, good reputation, experienced management, product selection, pricing, and traditionally high service levels and order fill rates, enable it to compete favorably with other distributors and direct sales by manufacturers.

Regulation

SCPI's management does not anticipate that existing or known pending environmental legislation or other regulations will require major capital expenditures or will adversely affect its operations.

Employees

SCPI employs approximately 50 persons, of which about 40 are employed in the headquarters office and distribution facility in McKeesport and the Glassport distribution facility. The others are field personnel. Senior executives, including the Chairman of the Board of Directors, Bernard H. Frank (a founder of Steel City Products), the President and Chief Executive Officer, Terrance W. Allan and the Vice President of Sales, Patrick Nicholson, have many years of service with SCPI. Mr. Allan is employed under a long-term contract.

Warehouse and certain office employees of SCPI are represented by Local 636 of the International Brotherhood of Teamsters. SCPI has experienced generally good labor relations and no significant labor disputes have affected its business for many years. The union contract was extended in 2003 to December 1, 2005.

Item 2. Properties

SHH owns a 15,000 sq. ft. headquarters building in Houston located on a seven-acre parcel on which its equipment repair center is also located. It also leases small offices in Grand Prairie and San Antonio, Texas.

SCPI operates its automotive and pet supply businesses from a leased, 67,000 square-foot building located in an industrial park in McKeesport, Pennsylvania. With the addition of the lawn and garden distribution business in 2000, SCPI leased an additional 43,000 sq. ft. of warehouse space located in an industrial park in nearby Glassport, Pennsylvania.

Item 3. Legal Proceedings

The Company is involved in certain claims and lawsuits occurring in the normal course of business. Management, after consultation with outside legal counsel, does not believe that the outcome of these actions would have a material impact on the financial statements of the Company. (See Note 15)

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2004.

Item 4A. Executive Officers of the Company

Executive officers of the Company are as follows:

Name	Age	Position
Patrick T. Manning	59	Chairman of the Board and Chief Executive Officer of the Company; President and Chief Executive Officer of SHH
Joseph P. Harper, Sr.	59	President, Chief Operating Officer and Director of the Company; Treasurer of SHH

Table of Contents

Name	Age	Position
Maarten D. Hemsley	55	Chief Financial Officer and Director of the Company; Chief Financial Officer of SCPI
Roger M. Barzun,	63	Vice President, Secretary and General Counsel of the Company
Terrance W. Allan	53	President and Chief Executive Officer of SCPI

Patrick T. Manning. Mr. Manning joined SHH in 1971 and led its move from Detroit, Michigan into the Houston market in 1978. He is currently SHH's President and Chief Executive Officer. Mr. Manning has served on a variety of construction industry committees, including the Gulf Coast Trenchless Association and the Houston Contractors Association, where he served as a member of the Board of Directors and as President from 1987 to 1993. He attended Michigan State University from 1969 to 1972. Mr. Manning has served as Chairman of the Board and Chief Executive Officer of Sterling since July 2001, when the Company increased its equity investment in SHH to 80.1% (the Sterling Transaction).

Joseph P. Harper, Sr. Mr. Harper has been employed by SHH since 1972 and has performed both estimating and project management functions as well as his primary role as SHH's Treasurer. Mr. Harper has served as President and Chief Operating Officer of the Company since the completion of the Sterling Transaction in July 2001. Mr. Harper also serves as a director of SCPI.

Maarten D. Hemsley. Mr. Hemsley has been an employee and/or director of the Company or SCPI in various capacities since 1988. Mr. Hemsley served as President, Chief Operating Officer and Chief Financial Officer of the Company until July 2001, and currently serves as Chief Financial Officer of both Sterling and SCPI. Since January 2001, Mr. Hemsley has also been a consultant to (and since May 2002 an employee of) JO Hambro Capital Management Limited, an investment management company based in the United Kingdom as Fund Manager of Leisure & Media Venture Capital Trust, plc, and recently as a principal of its Trident Private Equity II investment fund.. Mr. Hemsley is a director of Tech/Ops Sevcon, Inc., a public company that manufactures electronic controls, of XN Checkout Holdings plc, a United Kingdom public company that provides electronic sales solutions to the restaurant, pub and hotel markets, and of a number of privately-held companies in the United Kingdom.

Roger M. Barzun. Mr. Barzun has been Vice President, Secretary and General Counsel of the Company since August 1991 and was a Senior Vice President from May 1994 until July 2001. Mr. Barzun has been a lawyer since 1968 and is a member of the New York and Massachusetts bars.

Terrance W. Allan. Mr. Allan has been an officer of SCPI for more than the last five years. He was appointed President of SCPI in May 2000 and its Chief Executive Officer in May 2002.

PART II**Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Prior to February 12, 2004, the Company's Common Stock traded on the OTC Bulletin Board, under the symbol STCS.OB. On February 12, 2004, the Company's stock commenced trading on the American Stock Exchange under the symbol STV.

The following table sets forth the high and low bid prices by fiscal quarter for the Company's common stock for fiscal years 2004 and 2003.

	Fiscal 2004		Fiscal 2003	
	Quarterly High	Quarterly Low	Quarterly High	Quarterly Low
Quarter 1	\$8.94	\$ 3.60	\$1.95	\$ 1.16
Quarter 2	\$4.60	\$ 2.99	\$2.80	\$ 1.55
Quarter 3	\$6.33	\$ 3.02	\$4.45	\$ 2.20
Quarter 4	\$6.34	\$ 4.32	\$5.35	\$ 2.75

Table of Contents

In its first quarter through March 15, 2005, the Company's stock has ranged from a low of \$5.13 to a high of \$7.28. Such quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

There were approximately 3,600 holders of record of the Company's common stock on March 1, 2005.

No cash dividends were declared or paid in fiscal years 2004, 2003 or 2002. The Company does not anticipate the declaration of cash dividends in the foreseeable future. The ability of the Company's operating subsidiaries, SHH and SCPI, to upstream funds to Sterling for payment of dividends is limited by their respective bank credit agreements.

On December 22, 2004, 1,794,627 shares were issued in connection with the exercise of the Put in which the Company purchased the remaining 19.9% of SHH. (See Note 4).

Table of Contents**Item 6. Selected Financial Data**

The following table sets forth selected financial and other data of Sterling Construction Company, Inc. and subsidiaries and should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, which follows, and the Consolidated Financial Statements and related Notes (amounts in thousands, except per share data).

	Fiscal 2004 December 31, 2004	Fiscal 2003 December 31, 2003	Fiscal 2002 December 31, 2002 (Restated)	Fiscal 2001 December 31, 2001 (c)(d) (ten months)	Fiscal 2000 February 28, 2001(a)(d)
Operating results:					
Revenues	\$ 154,178	\$ 169,532	\$ 134,317	\$ 66,121	\$ 20,694
Income (loss) from continuing operations before minority interest and income taxes	\$ 4,697	\$ 8,924	\$ 4,345	\$ (1,965)	\$ (7,044)
Minority interest (e)	(962)	(1,627)	(873)	(647)	
Current income tax expense	(186)	(246)	(14)	(14)	(27)
Deferred income tax benefit (expense) (b)	2,104	(1,632)	(106)		
Income (loss) from continuing operations	5,653	5,419	3,352	(2,626)	(7,071)
Income from discontinued operations (a)					399
Net income (loss)	\$ 5,653	\$ 5,419	\$ 3,352	\$ (2,626)	\$ (6,672)
Basic and diluted per share amounts:					
Basic earnings (loss) per share from continuing operations	\$ 1.06	\$ 1.06	\$ 0.66	\$ (0.52)	\$ (1.43)
Basic earnings per share from discontinued operations	\$	\$	\$	\$	\$ 0.09
Basic earnings (loss) per share	\$ 1.06	\$ 1.06	\$ 0.66	\$ (0.52)	\$ (1.34)
Basic weighted average shares outstanding	5,343	5,090	5,062	5,056	4,943
Diluted earnings (loss) per share from continuing operations	\$ 0.81	\$ 0.84	\$ 0.56	\$ (0.52)	\$ (1.43)
Diluted earnings per share from discontinued operations	\$	\$	\$	\$	\$ 0.09

Diluted earnings (loss) per share	\$ 0.81	\$ 0.84	\$ 0.56	\$ (0.52)	\$ (1.34)
Diluted weighted average shares outstanding	7,028	6,488	6,102	5,056	4,943
Cash dividends declared	\$ (0.00)	\$ (0.00)	\$ (0.00)	\$ (0.00)	\$ (0.00)
Balance sheet statistics:					
Total assets	\$ 89,544	\$ 75,578	\$ 72,757	\$ 59,138	\$ 16,507
Long-term obligations	\$ 22,012	\$ 19,958	\$ 34,323	\$ 30,241	\$ 4,633
Book value per share of common stock	\$ 4.77	\$ 3.24	\$ 2.14	\$ 1.21	\$ (2.01)

(a) Upon completion of the sale of Dowling's Fleet Services, Inc. in fiscal 2000, the Company recorded income of \$399,000.

(b) In December 2001, the Company recorded a deferred tax asset that exceeded its valuation allowance (see Note 8 to the Consolidated Financial Statements).

(c) In November 2001, the Board of Directors of the Company voted to change its fiscal year end from the last day of February to December 31. Accordingly, results for fiscal 2001 are for the ten month period

March 1 to
December 31,
2001.

- (d) In July 2001, the Company increased its percentage ownership in SHH from 12% to 80.1%. The original investments were recorded using the cost method. The subsequent acquisition in July 2001 resulted in step-acquisition treatment of the original investments. Fiscal 2000 has been restated to reflect this treatment.
- (e) Minority interest represented the 19.9% of SHH not owned by the Company until December 2004.

Table of Contents

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

As discussed in ITEM 1. BUSINESS above, the Company operates primarily as a heavy civil construction company based in Houston, Texas under the trade name Texas Sterling Construction. The Company's distribution business is conducted in Pittsburgh, Pennsylvania under the name Steel City Products.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. Management's estimates, judgments and assumptions are continually evaluated based on available information and experience, however, actual amounts could differ from those estimates. The Company's significant accounting policies are described in Note 1 of the Notes to Consolidated Financial Statements.

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 and the valuation of long-term assets. Management evaluates all of its estimates and judgments on an on-going basis.

Revenue Recognition: The Company uses the percentage of completion accounting method for construction contracts in accordance with the American Institute of Certified Public Accountants Statement of Position 81-1,

Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Revenue and earnings on construction contracts are recognized on the percentage of completion method in the ratio of costs incurred to estimated final costs. Provisions are recognized in the statement of income for the full amount of estimated losses on uncompleted contracts whenever evidence indicates that the estimated total cost of a contract exceeds its estimated total revenue.

Factors that can contribute to changes in estimates of contract profitability include, without limitation, site conditions that differ from those assumed in the original bid to the extent that contract remedies are unavailable, the availability and skill level of workers in the geographic location of the project, the availability and proximity of materials, the accuracy of the original bid, inclement weather and timing and coordination issues inherent in all projects, including design/build. Contract cost consists of direct costs on contracts, including labor and materials, subcontractor costs, direct overhead and equipment expense (primarily depreciation, fuel, maintenance and repairs). Depreciation is provided using straight-line methods for construction equipment. Contract cost is recorded as incurred and revisions in contract revenue and cost estimates are reflected in the accounting period when known. If the Company projects a loss on a project the estimated loss is immediately recognized. Claims for additional contract revenue are recognized if it is probable that the claim will result in additional revenue and the amount can be reliably estimated. The foregoing as well as weather, stage of completion and mix of contracts at different margins may cause fluctuations in gross profit achieved in different accounting periods and these fluctuations may be significant.

A significant portion of the Construction Segment's revenues is derived from contracts that are fixed unit price under which the Company is committed to provide materials or services required by a project at fixed unit prices (for example, dollars per cubic yard of concrete or per cubic yards of earth excavated). All government contracts and many of the Company's other contracts provide for termination of the contract for the convenience of the party contracting with the Company, with provisions to pay the Company for work performed through the date of termination.

The construction industry is highly competitive and lacks firms with dominant market power. The majority of the Company's business involves construction contracts obtained through competitive bidding. The volume and profitability of the Company's construction work depends to a significant extent upon the general state of the economy of Texas, especially in the Houston area, the volume of work available to contractors and competitors

Table of Contents

levels of backlog. The Company's construction operations could be adversely affected by labor stoppages or shortages, adverse weather conditions, economic downturns, shortages of supplies or government actions.

Valuation of Long-Term Assets: Long-lived assets, which include property, equipment and acquired identifiable intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment evaluations involve management estimates of useful asset lives and future cash flows. Actual useful lives and cash flows could be different from those estimated by management and this could have a material effect on operating results and financial position. Additionally, the Company had goodwill with a value of approximately \$13 million at December 31, 2004, which must be reviewed for impairment at least annually in accordance with Statement of Financial Accounting Standards No. 142 (SFAS 142). The impairment testing required by SFAS 142 requires considerable judgment and there can be no assurance that an impairment charge will not be required in the future. The Company completed its annual impairment review for goodwill effective October 1, 2004 and it did not reveal impairment of goodwill.

Deferred Taxes: Deferred tax assets and liabilities are recognized based on the differences between the financial statement carrying amounts and tax bases of assets and liabilities. The Company regularly reviews its deferred tax assets for recoverability and establishes a valuation allowance based upon projected future taxable income and the expected timing of the reversals of existing temporary differences. As a result of this review and the related SHH acquisition, in fiscal 2001 the Company reduced the valuation allowance against the deferred tax asset related to the estimated utilization of the net operating loss carryforwards. Due to the operating profitability of the Company and the expiration of loss carryforwards, in fiscal 2004, 2003 and 2002, the valuation allowance was reduced by \$18.9 million, \$4.9 million and \$1.5 million, respectively.

Liquidity and Capital Resources

At SHH, the level of working capital varies principally as a result of changes in the levels of cost and estimated earnings in excess of billings, of billings in excess of cost and estimated earnings and levels of retention and the timeliness of payment of receivables by its customers. SHH's cash requirements are also impacted by its needs for capital equipment, which have generally been financed from cash flow or from borrowings under its line of credit.

At SCPI, the level of working capital varies primarily with the amounts of inventory carried, which can change seasonally, the size and timeliness of payment of receivables due from customers and the amount of credit extended by suppliers. SCPI's working capital needs not financed by suppliers have been financed from cash flow and borrowings, principally under its line of credit.

Contractual Obligations

Fixed, noncancelable obligations of the Company at December 31, 2004 are as follows (in thousands):

	Total	Payments due by period			
		Less than one year	One - three years	Four - five years	More than five years
Debt	\$ 16,954	\$ 3,625	\$ 13,329		
Capital leases	58	25	23	10	
Operating leases	1,604	555	1,049		
Related party notes	11,349	3,593	3,878	3,878	
Other long-term liabilities	1,018	123	246	246	403
	\$ 30,983	\$ 7,921	\$ 18,525	\$ 4,134	\$ 403

To assure the material prices and sub-contracting costs used in tendering bids for construction contracts, the Company obtains firm quotations from its suppliers and sub-contractors, and is therefore rarely exposed to any price or availability risk on contracts in backlog. Such agreements do not include any quantity guarantees, so that the

Table of Contents

Company has no obligation for materials or sub-contract services beyond those required to complete the respective contracts.

The Company's obligations for interest are not included in the table above, as these amounts vary according to the levels of debt outstanding at any time. Interest on the Company's Revolving Lines of Credit is paid monthly and fluctuates with the balances outstanding during the year, as well as fluctuations in interest rates. In Fiscal 2004 such interest was approximately \$700,000. The Company also pays interest on a quarterly basis on its related party debt, as discussed further below, which amounts are expected to be approximately \$1.2 million in the next year, an aggregate of \$1.6 million for the one to three year period, and an aggregate of \$579,000 in the four to five year period. All other debt is expected to have interest of approximately \$60,000, \$120,000 and \$120,000 in the periods above.

Exercise of the Put

As part of the Sterling Transaction, the Company granted certain selling shareholders a Put option for the 19.9% of SHH stock owned by them, pursuant to which they had the right to sell the remaining SHH shares to the Company at a date of their choosing between July 2004 and July 2005 at a minimum price of \$105 per SHH share. The price of the Put was to be based on a multiple of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) for the 12 months immediately preceding the Put exercise date. The Company recorded the fair value of the Put as a \$4.1 million liability on the effective date of the Sterling Transaction, July 18, 2001. From the date of the transaction through the date of exercise the Put liability increased by \$1.5 million to \$5.6 million.

The Put was exercised on July 19, 2004 and a compilation of the results for the 12 months preceding the exercise date was performed, with the result that the purchase price was determined to be approximately \$15.0 million. The Put transaction was finalized in November 2004 and settled in December reflecting the terms of a Put Restructuring Agreement entered into in September 2003. The Put price was satisfied by cash of approximately \$2.4 million (derived from borrowings on available long-term bank facilities), five-year notes of approximately \$6.4 million, and the balance through the issuance of approximately 1,569,000 shares of the Company's common stock at an agreed value of \$4.00 per share, representing a premium to the market at the time of exercise. At the date the terms of the agreement were settled, the stock was recorded at the fair value of \$5.14. (See Note 4)

Financing

At December 31, 2004 and 2003, the Company's debt consisted of (in thousands):

	2004	2003
Related party notes:		
Subordinated debt	\$	\$ 1,500
Subordinated zero coupon notes		3,216
Convertible subordinated notes		560
Management/director notes	3,590	1,795
Management notes issued upon put settlement	6,354	
NASCIT loan	1,405	1,997
	11,349	9,068
SHH revolver	13,329	6,568
SCPI revolver	3,625	2,660
Insituform notes		563
Mortgage payable	1,018	1,141
Equipment notes and capital leases	58	58
	\$ 29,379	\$ 20,058

Related Party Debt

Table of Contents*Subordinated Debt*

As part of the Sterling Transaction, certain shareholders of SHH were issued subordinated promissory notes by SHH in the aggregate amount of \$6 million in payment for certain of their SHH shares. These notes were repaid over three years through September 30, 2004 in equal quarterly installments and carried interest at 12% per annum.

Subordinated Zero Coupon Notes/NASCIT Loan

The Sterling Transaction was funded in part through the sale of zero coupon notes combined with the issuance of zero coupon notes to certain selling shareholders of SHH. Warrants for Sterling common stock were issued in connection with the zero coupon notes and are exercisable for ten years from closing at \$1.50 per share. The zero coupon notes were discounted at a rate of 12%, maturing four years from the date of closing of the Sterling Transaction, subject to earlier payment in the event the SHH Put was exercised before such date. Employee selling shareholders of SHH received an aggregate face value of \$3.8 million in zero coupon notes, in which Mr. Manning and Mr. Harper received zero coupon notes in the face amount of \$799,000 and \$1.0 million, respectively and warrants for 63,498 shares and 81,301 shares, respectively. North Atlantic Smaller Companies Investment Trust (NASCIT), an investor in SHH, received a note in the face amount of \$4 million. In December 2003, a prepayment of \$1.3 million was made on the zero coupon note issued to NASCIT in consideration of the forgiveness of six months interest on such notes.

The Put was exercised in July 2004, which triggered payment of the zero coupon notes. Upon settlement of the Put in December 2004, the employee selling shareholders received a cash payment of \$783,000 utilizing funding from long term borrowings under SHH's line of credit. Of the balance, \$901,000 was converted into 225,326 shares of common stock at an agreed value of \$4.00 per share, which represented a premium to the market price on the date of exercise. The stock was recorded on the date the terms were settled at a fair value of \$5.14. The remaining \$1.9 million was converted into new five-year notes at 12%, with principal and interest payable quarterly beginning March 31, 2005. NASCIT received a cash payment of \$834,000, with the balance of \$1.4 million converted into a new five-year note at 12% interest, with principal and interest payable quarterly beginning March 31, 2005 (See Note 14).

Management/Director Notes

Notes with an aggregate face amount of \$1.3 million issued in connection with the October 1999 purchase of the second equity tranche of shares of SHH were restructured as part of the Sterling Transaction. Of the total, notes for \$800,000 were issued to several members of Sterling's management, including Joseph P. Harper, since elected the Company's President. Notes totaling approximately \$559,000 were due to Robert Davies, the Company's former Chairman and Chief Executive Officer, and, through a participation agreement, Maarten Hemsley, formerly the Company's President and now its Chief Financial Officer. In consideration for the extension of the maturity dates of these notes, the face amounts were increased in July 2001 by an aggregate of approximately \$342,000. Furthermore, certain amounts owed by the Company to Messrs. Davies and Hemsley aggregating approximately \$355,000 were converted into notes. All such notes were to mature over four years, unless maturity was triggered by the exercise of the Put, and carried interest at 12% per year. Principal and interest may be paid only from defined cash flow of Sterling and SCPI, or from proceeds of any sale of SCPI's business. In December 2003, prepayments of accrued interest and principal were made to certain of these noteholders. Mr. Harper received prepayment totaling \$86,000 and Mr. Davies received prepayment totaling \$411,000. Mr. Hemsley declined any prepayment of his notes.

Pursuant to a Restructuring Agreement entered into in September 2003, when the Put was exercised in July 2004, triggering payment of the Management/Director notes, one half of the balance of the notes was paid in cash utilizing funding from long term borrowings under the SHH line of credit, with the remainder converted into new five-year notes at 12% interest, amortized quarterly beginning March 31, 2005. Mr. Davies, Mr. Harper, Mr. Hemsley and Mr. Manning received cash payments of \$166,876, \$1,045,764, \$208,397 and \$460,458, respectively.

Convertible Subordinated Notes

Table of Contents

In December 2001, in conjunction with an amendment to the SCPI Revolver and in order to strengthen SCPI's working capital position through the purchase of additional inventory, Sterling obtained funding of \$500,000 principally from members of management and directors (including Messrs. Frickel (a director of the Company), Harper and Hemsley, who loaned \$155,000, \$100,000 and \$25,000, respectively) (the Convertible Subordinated Notes). In January 2002, two other members of management, including Bernard Frank funded a further \$60,000, which was used for general corporate purposes. The notes evidencing these advances were convertible at any time prior to the maturity date into the Company's common stock at a price of \$2.50 per share and otherwise matured and were payable in full in December 2004. Interest at an annual rate of 12% was payable monthly. The notes were senior to debt issued in connection with the Sterling Transaction. All notes were converted at the election of their holders into common stock on December 31, 2004.

Other Related-Party Debt

In January 2003, members of management of the Company and of SHH (including Messrs. Harper and Hemsley) further funded SCPI with a \$250,000 short-term loan to reduce SCPI's vendor payables. Interest on the notes was payable monthly at the annual rate of 10%. The notes, which are subordinated to the SCPI Revolver, matured in July 2003, but were extended beyond that date with the granting of a guarantee by SHH, and an increase in the interest rate to 12% per annum, effective January 2004. The notes were repaid in three installments in January and February 2005.

SHH Revolver and SCPI Revolver

In conjunction with the Sterling Transaction, SHH entered into a three-year agreement providing for a bank revolving line of credit with a maximum line of \$13.0 million, subject to a borrowing base (the SHH Revolver). The line of credit carries interest at prime, subject to achievement of certain financial targets and is secured by the equipment of SHH and guarantees by the parent company. In December 2004, SHH entered into an amendment of the agreement providing for a maximum line of \$17 million with a maturity date of May 1, 2007, under substantially the same terms as the original loan. The agreement was finalized in February 2005. SHH paid a fee of \$15,000 in connection with the increase in the line and the renewal. At December 31, 2004, the balance on the SHH Revolver was \$13.3 million, with an effective rate of interest of 5.25% and availability under the line of credit was \$671,000. The balance at the end of the year included borrowing of approximately \$5.0 million in late December to fund the settlement of the Put and related payments. SHH is required to maintain financial covenants of debt, current and cash flow coverage ratios, and at December 31, 2004 SHH was in compliance with these covenant requirements.

Management believes that the SHH Revolver will provide adequate funding for SHH's working capital, debt service and capital expenditure requirements, including seasonal fluctuations for at least the next twelve months through March 31, 2006.

In July 2001 SCPI entered into an agreement for a bank revolving line of credit in the amount of \$5.0 million, subject to a borrowing base (the SCPI Revolver). In fiscal 2002, the line of credit was further amended to extend the term to May 2004 and to remove certain limitations on borrowing and in fiscal 2003, the interest rate was reduced to prime plus 1% and the maturity date extended to December 2004. In March 2004, the line was extended until May 31, 2006. The credit agreement continues to mandate that SCPI utilize a lockbox arrangement with the lender and the agreement further provides that the lender may accelerate the maturity date of the SCPI Revolver if a material adverse change occurs in SCPI's business. Because of these arrangements, the Company reports the SCPI Revolver as a current liability. At December 31, 2004, the outstanding balance on the Revolver was \$3.6 million and the effective rate of interest was 6.25%. SCPI had no excess availability on its line of credit at December 31, 2004. The SCPI Revolver is secured by the assets of SCPI and is subject to the maintenance of a fixed charge coverage ratio covenant. At December 31, 2004, SCPI was in compliance with its financial covenant.

Management believes that the SCPI Revolver will continue to provide adequate funding for SCPI's working capital, debt service and capital expenditure requirements, including seasonal fluctuations for at least the next twelve months through March 31, 2006, assuming no material deterioration in current sales or profit margins.

Table of Contents**SHH Mortgage**

In June 2001, SHH completed the construction of a new headquarters building on land adjacent to its existing equipment repair facility in Houston. The building was financed principally through an additional mortgage of \$1.1 million on the land and facilities, at an interest rate of 7.75% per annum, repayable over 15 years. The new mortgage is cross-collateralized with an existing mortgage on the land and facilities which was obtained in 1998 in the amount of \$500,000, repayable over 15 years with an interest rate of 9.3% per annum.

Insituform Note

In September 2002, a wholly owned subsidiary of SHH acquired the Kinsel Heavy Highway construction business from a subsidiary of Insituform Technologies. The transaction was financed through the issuance of two unsecured two-year notes aggregating \$1.5 million to Insituform, with the balance funded through additional borrowings under the SHH Revolver. The Insituform Notes bore interest at 9% and were payable in quarterly installments plus accrued interest through September 2004.

Capital Expenditures

Capital expenditures made by Sterling and its subsidiaries during fiscal 2004 totaled \$3.6 million, consisting almost exclusively of heavy construction equipment at SHH.

Tax Loss Carry-forwards

At December 31, 2004, Sterling had the benefit of net operating tax loss carry-forwards (the Tax Benefits) of approximately \$38.9 million, which expire in the years 2005 through 2020 and, in the event of no change of control as discussed below, which are expected to shelter most income of Sterling and its subsidiaries from federal income taxes for several years. A change in control of Sterling exceeding 50% in any three-year period may lead to the loss of the majority of the Tax Benefits. In order to reduce the likelihood of such a change of control occurring, Sterling's Certificate of Incorporation includes restrictions on the registration of transfers of stock resulting in, or increasing, individual holdings exceeding 4.5% of Sterling's common stock. Shareholdings over 5% resulting from the Sterling Transaction, and changes thereto resulting from the shares issued pursuant to the exercise of the Put, were approved by the Company's Board following receipt of required opinions that these did not adversely affect the availability of the Tax Benefits.

Since the regulations governing the Tax Benefits are highly complex and may be changed from time to time, and since Sterling's attempts to reduce the likelihood of a change of control occurring may not be successful, management is unable to determine the likelihood of the continued availability of the Tax Benefits. However, management believes that the Tax Benefits are currently available in full and intends to take all appropriate steps to help ensure that they remain available. Should the Tax Benefits become unavailable to Sterling, most of its future income and that of any consolidated affiliate would not be shielded from federal taxation, thus reducing funds otherwise available for corporate purposes (see Note 8 to the Consolidated Financial Statements). In fiscal 2004, approximately \$42 million of tax losses expired unused.

Cash Flows

Cash flows for the past three years are summarized as follows (in thousands):

	December 31, 2004	December 31, 2003	December 31, 2002
Cash and cash equivalents	\$ 3,518	\$ 2,765	\$ 2,406
Net cash provided by (used in):			
Operating activities	2,937	17,799	5,106