



CECO Environmental Corp.

| Nasdaq: CECE |

INVESTMENT RESEARCH REPORT

*"Polluted Outlook"*

RECOMMENDATION: *Strong Sell*



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## Spruce Point Capital is an industry recognized research activist investment firm founded in 2009

- Founded by Ben Axler, a former investment banker with 16 years experience on Wall Street
- Ranked the #1 Short-Seller in the world by [Sumzero](#) after a comprehensive study of 12,000 analyst recommendations dating back to 2008 (March 2015)
- Ranked the #13 Most Influential FinTweeter on Twitter according to [Sentieo analysis](#) (Dec 2016)
- Frequent television and radio commentator on [CNBC](#), [Bloomberg](#), [TheStreet.com](#) and [Benzinga](#)

## Quick Updates From Selected Spruce Point Campaigns

Spruce Point Report Date	Company	Recent Earnings	Quick Update
<a href="#">1/12/17</a>	MGP Ingredients	--	Company has not responded; instead enlisted a small broker to say “buy” – most likely to find a partner to issue equity since they have no cash on the balance sheet, and borrowing heavily on their revolver. Paid Director’s fees in stock in lieu of cash recently
<a href="#">12/13/16</a>	Ultimate Software	<a href="#">2/7/17</a>	First earnings miss in 4yrs. Margins under pressure and company still shuffling its market targeting. Expecting more margin pressure and failure to hit sales targets
<a href="#">11/3/16</a>	Burlington Stores	--	Company hasn’t reiterated guidance as they did last <a href="#">Jan 2016</a> and didn’t attend the ICR Conference...why? Retail environment is terrible. Latest sell-side spin story is that discount retailers are immune to Amazon; we shall see. One director already resigned
<a href="#">9/8/16</a>	Echo Global	<a href="#">2/8/17</a>	Melting ice cube being displaced by more innovative technology players, major Sales/EPS miss this quarter; leverage rising and cash flow negative 2 quarters
<a href="#">8/16/16</a>	AECOM	<a href="#">2/7/17</a>	Numbers all down YoY and cannot raise guidance despite all the whoopla about infrastructure spending; more sizzle than steak
<a href="#">4/13/16</a>	Sabre Corp.	<a href="#">2/7/17</a>	Another Sales/EPS guide down, stock near 2yr low
<a href="#">8/19/15</a>	Caesarstone	<a href="#">2/8/17</a>	Margins and EPS collapsing YoY and will collapse further. Largest Indian competitor <a href="#">Pokarna</a> and a big exporter to the US will double capacity



# Spruce Point's Activist Targets Often Result in Corporate Actions Post Report Publication

Company	Date of Report	Fraud / Delisted	Privatized from Public Market	CFO Resignation / Removal	CEO /Chairman or Director Resignation
ZST Digital (Nasdaq: ZSTN)	11/3/10	Delisted 4/26/12	--	3/23/11: Dr. John Chen resigns 3/29/13: Henry Ngan resigns	--
China Integrated Energy (Nasdaq: CBEH)	12/5/10	Delisted 6/16/11 SEC Registration Revoked	--	9/18/12: Jeff Chan resigns	--
Camelot Info Systems (NYSE: CIS)	8/5/11	--	3/28/14: Take private	11/10/11: Gordon Lau resigns	--
BazaarVoice (Nasdaq: BV)	6/14/12	--	--	1/24/13: Stephen Collins removed	10/7/13: Brett Hurt resigns 11/20/13: CEO Collins resigns
The Active Network (NYSE: ACTV)*	2/12/13	--	11/15/13: Take private	--	5/1/13: Matt Landa resigns 5/1/13: Chairman Alberga resigns
Boulder Brands (Nasdaq: BDBD)*	2/26/13	--	1/15/16: Acquired by Pinnacle Foods	--	6/10/15: Steve Hughes resigns
Just Energy (NYSE: JE)	7/31/13	--	--	--	2/26/14: Ken Hartwick resigns
InnerWorkings (Nasdaq: INWK)*	4/30/13	--	--	1/19/15: Joseph Busky resigns	--
LKQ (Nasdaq: LKQ)*	1/15/14	--	--	2/26/15: John Quinn reassigned	--
Ametek (NYSE: AME)	11/13/14	--	--	1/14/16: CFO Mandos "retires"	5/4/16: CEO Hermance "retires"
Greif (NYSE: GEF)	2/10/15	--	--	--	10/13/15: CEO David Fischer resigns
NCR Corp (NYSE: NCR)	4/23/15	--	Failed to attract a buyer after SP report effects strategic process	--	11/12/15: Board member and 6% owner Marcato resigns
Caesarstone (Nasdaq: CSTE)	8/19/15	--	--	--	9/25/15: Avner Naveh resigns 9/17/15: Ram Belinkov resigns 11/4/15: Chairman resigns 4/23/16: CEO Yos Shiran resigns
The Intertain Group (TSE:IT)	12/17/15	--	Failed to attract a buyer after SP report effects strategic process	2/22/16: CFO Laslop reassigned	2/22/16: CEO Fitzgerald resigns 3/16: Directors Redmond/Dunford resign
Sabre Corp. (Nasdaq:SABR)	4/13/16	--	--	--	6/20/16: CEO Klein resigns
AECOM (NYSE:ACM)	8/16/16	--	--	12/27/16: CAO Osborne transitions	--
Burlington Stores (NYSE:BURL)	11/3/16	--	--	--	12/8/16: Director Cooper resigns

Source: Public Information. \* Denotes Prescience Point Report.





## *Executive Summary*



# *Spruce Point is Short CECO Environmental For the Following Reasons:*

**Spruce Point is short CECO Environmental (Nasdaq: CECE, “CECO” or “the Company”), a poorly constructed roll-up serving the environmental, energy, fluid handling and filtration industrial segments. Based on our forensic financial analysis, insider behavior, and anticipated changes in the regulatory environment driving its business, we believe CECO is at high risk of a covenant breach in 2017. We urge investors to consider the following when evaluating CECO:**

- CECO has acquired 7 companies since 2013 at the expense of punitive dilution, and mounting leverage on its balance sheet. With 55% of its assets as goodwill and intangibles, we believe CECO is forestalling a crippling goodwill impairment of Met-Pro, its largest acquisition, and a deal it touted as a “success.” CECO’s shares appreciated 83% in 2016 on the false perception that its recent PMFG acquisition has also been a winner. However, we believe CECO pulled forward cash flow through rapid synergy realization and working capital maneuvers to pay down debt ahead of schedule. However, recent performance suggests that both CECO and PMFG are now declining organically by double digits, and management stopped disclosing key contribution metrics
- We thank Street Watchdog Research’s recent note alerting us to CECO and the fact that its single most important business driver is a stringent environmental regulation regime that drives its clients to comply with issues such as air pollution control. With the election of President Trump, and his new Executive Order designed to expedite environmental reviews and eliminate burdensome environmental compliance issues, CECO’s future is at best uncertain, and at worst materially impaired. Not surprisingly, the same day of the Executive Order, the Company’s CEO abruptly resigned, but not before cashing in options, and leaving unexpired RSUs tied to 2017 EBITDA. Based on our research, we found other key executive departures at CECO, particularly in Asia, where it touts a large and growing opportunity to gain market share
- The Company’s CFO also left his position prior to the CEO’s departure. We are concerned that CECO recently appointed its 5<sup>th</sup> CFO since 2011. Pay close attention to new language about material weaknesses of financial controls in the recent 10-K. Specifically, the Company cited issues with accounting for revenues. This should be a big red flag to investors, particularly because CECO uses the “percentage-of-completion” method of accounting, which is notoriously abused and a focus of SEC investigations according to a recent speech from the enforcement director
- CECO’s governance is weak and should give investors’ cause for concern. The current Chairman is the son of the former CEO Phillip DeZwirek, who settled with the SEC for insider trading, without admitting guilt. The rest of the Board is stacked with allies of the DeZwirek family, and many have questionable backgrounds that offer little relevant experience to CECO’s core businesses. The Board has shown a willingness to pay management cash bonuses for completing bad deals, and rubber stamping annual cash bonuses for failure to hit financial targets



## *We See 30% – 60% Downside As Covenant Breach Comes Into Focus:*

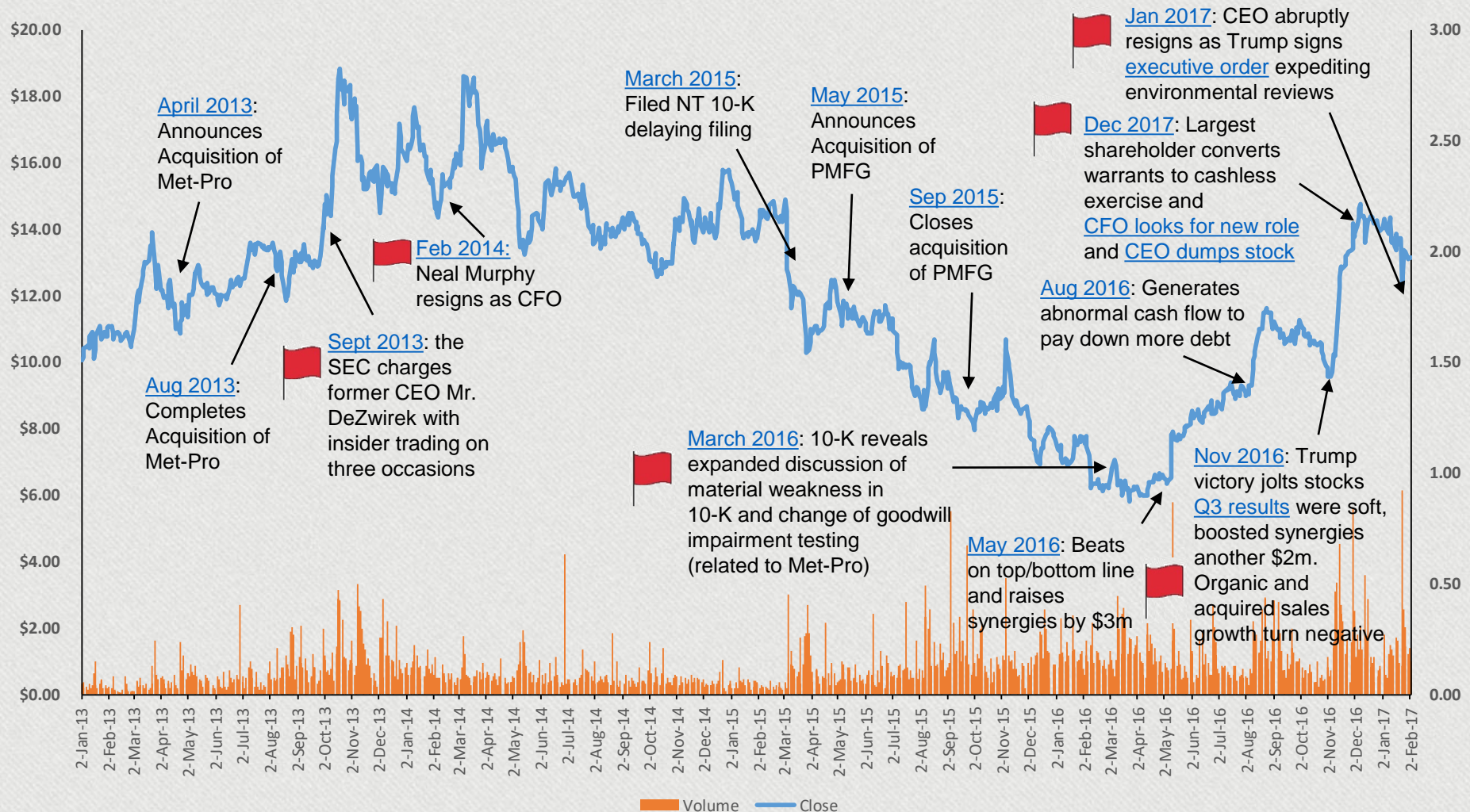
- CECO has been touting to investors that it has been successful in delevering its balance sheet post-PMG acquisition, and that its current Net Debt to EBITDA ratio is down from 3.6x to 1.6x as of 9/30/16. On the surface, this appears impressive, but the picture is not so simple. CECO should be pointing investors to its “Leverage Ratio” covenant per its credit agreement which looks at gross leverage (not net of cash) and includes significantly more debt obligations beyond just its term loan. When factoring in CECO’s earnout obligations, leases, and outstanding letters of credit, we find that its current leverage is closer to 3.4x
- CECO has no room for misstep in 2017 given its Leverage Ratio covenants will tighten twice, from 3.5x to 3.25x in September, and finally to 3.0x in December. Based on our analysis, at CECO’s current LTM EBITDA of \$56.5m, it will most certainly trip a covenant absent material improvement in EBITDA or a dilutive equity raise. CECO has also said it has no additional assets of materiality to sell to accelerate the deleveraging process. In short, the Company is stuck between a rock and hard place
- Optically, CECO’s share price looks cheap, and analysts argue that its valuation discount to peers will narrow, while its organic growth accelerates and its margins improve. The average analyst price target is \$13.40/share, implying 7% upside. This is wishful thinking, and represents a terrible risk/reward. Don’t be fooled: there is no visibility in CECO’s business, it has suffered significant executive turnover, and its #1 risk factor just materialized. The easiest way to value CECO is on a book value basis. We expect a goodwill impairment to eliminate \$79m of equity. By adjusting the book value and applying a generous 1.0x – 1.5x multiple, we get \$4.85 to \$7.25 per share or 40% - 60% downside. We also conservatively estimate sales declines of 8% – 12%, which at 1.0x to 1.2x multiple (in line with its small cap peers) and using our adjusted debt gets us a valuation range of approximately \$6.25 to \$9.00 per share or 30% - 50% downside
- Follow the money: The CEO just exercised options and dumped shares prior to resigning, and as a reminder, left on the table restricted stock units (RSUs) specifically tied to 2017 EBITDA, a critical target necessary to avoid a covenant breach. CECO’s Chairman and largest shareholder just altered the terms of his large warrant to allow for “cashless exercise” – a way to avoid tying up capital in the stock, and using stock sales to fund the warrant exercise. The remaining executive team owns virtually no equity, and has little at stake if CECO fails





# CECO's Stock Appreciation Merits Scrutiny In The Face Of Multiple Red Flags

CECO's 83% share price appreciation in 2016 was aided by abnormal and unsustainable cash flow generation and debt pay down. Results not likely sustained in 2017 with organic growth in decline, regulatory changes, and covenant breach increasingly likely.







## *CECO's Poorly Executed Acquisition Spree and Deal Promotion*



# CECO Is A Motley Collection of Speculative Acquisitions

Our focus will be on CECO's two largest deals to acquire Met-Pro (2013) and PMFG (2015) which entailed substantial shareholder dilution and leverage. In our opinion, both deals have been failures.

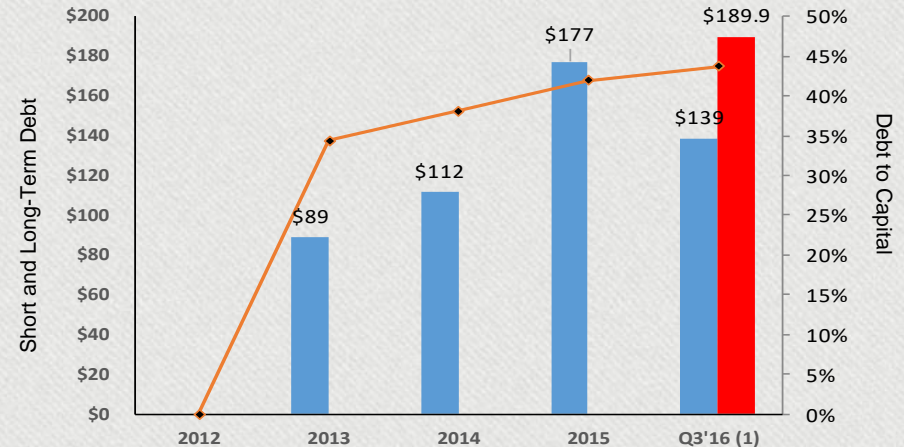
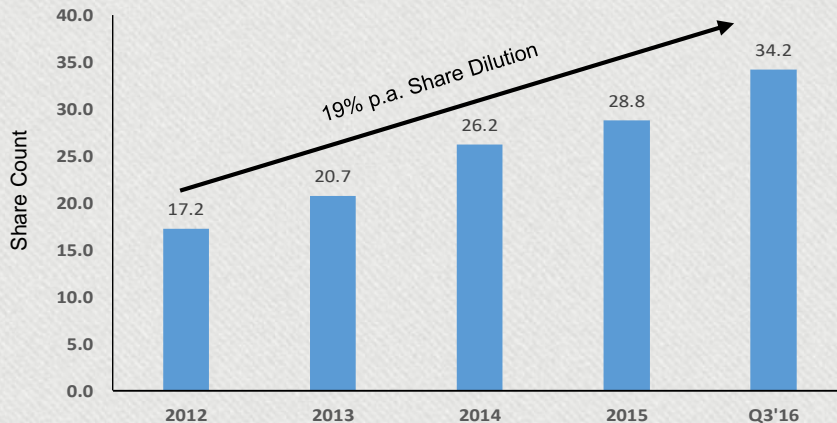
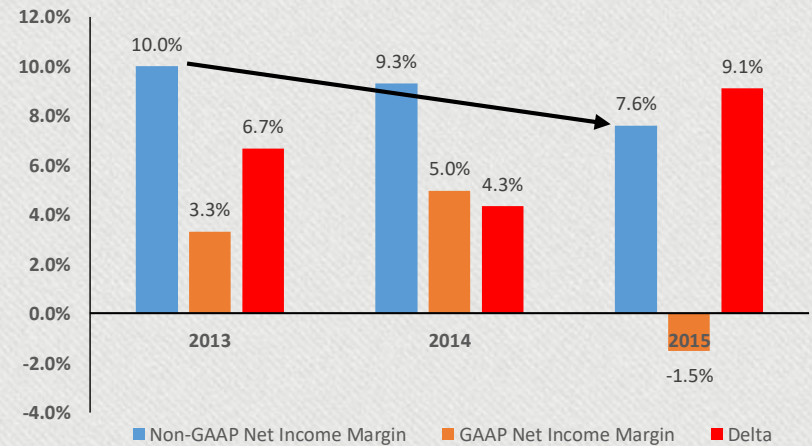
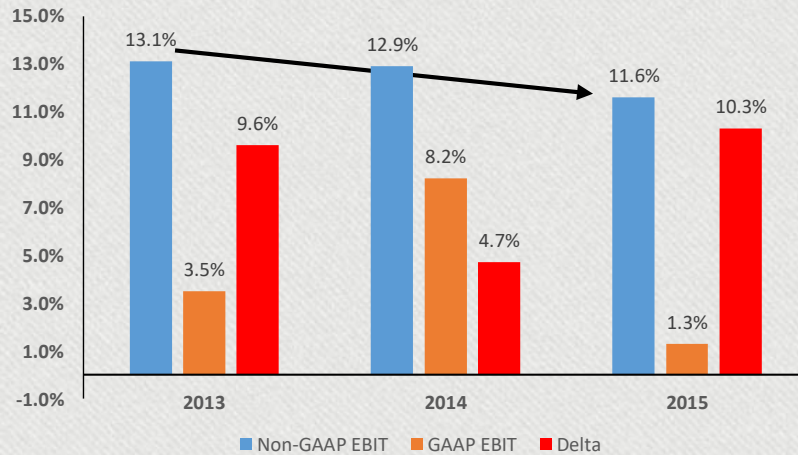
Date	Company	Description	Location	Deal Value	Structure	Deal Value / Sales	Deal Value / EBITDA	Employees
<a href="#">5/4/15</a>	PMFG	Engineered equipment for the abatement of air pollution, the separation and filtration of contaminants from gases and liquids, and industrial noise control equipment	Dallas, TX	\$136.7	\$64.6m in cash and 7.6m shares issued for \$72.1m	0.9x	6.0x (inc. synergies)	500 (inc China JV employees)
<a href="#">11/5/14</a>	Zhongli Industrial Technology (1)	Design and manufacture of power industry flue gas dampers and ball mill systems in China	Jiangyin City, China	\$34.0	\$7m in cash and earnout up to \$27m	1.2x	--	200
<a href="#">11/4/14</a>	Emtrol LLC	Design and manufacture of fluid catalytic cracking (FCC) & industrial cyclone technology	Long Island, NY	\$37.7	\$31.9m in cash and \$5.8m in stock	1.2x	18.5x	33
<a href="#">9/30/14</a>	SAT Technologies	Volatile Organic Compounds (VOCs) abatement solutions for the Chinese air pollution control market	Shanghai, China	\$2.4	\$1.4m in cash and Est. earnout of \$1.0m	0.5x	--	17
<a href="#">8/14/14</a>	HEE Environmental	Air pollution control scrubbers, biological scrubbers and FRP fans for chemical and odor control fume applications	Ontario, CA	\$9.5	\$0.5m in shares and \$7.0m cash. Est. earnout of \$2.0m	1.0x	--	35
<a href="#">4/22/13</a>	Met-Pro	Provider of product recovery, pollution control, fluid handling and filtration solutions across multiple diversified end-markets	Harleysville, PA	\$203	7.7m shares and \$104.4m in cash	1.8x	13.0x (7x inc. synergies)	337
<a href="#">3/4/13</a>	Aarding Thermal Acoustics	Gas turbine downstream engineered exhaust systems and silencing products focused on the natural gas, power and petrochemical industries	Netherlands	\$37.2	\$24.4m of cash, \$6.8m of stock and \$6.0m earnout	1.1x	--	--

(1) Investors should be especially skeptical of this deal. Why was a company with \$28m of sales sold for just \$7m of cash and a \$27m earnout (80% of the deal value)



# CECO's Business Under Pressure

Despite numerous acquisitions from 2013 – 2015, it's clear CECO's business is under pressure. We base our view on evidence from the Company's declining margins and widening GAAP vs. Non-GAAP results. (top two charts)  
This was the likely motivation to acquire PMFG, which closed Sept 3, 2015. We will demonstrate this recent deal has been a failure and came with heavy dilution and dangerous leverage (bottom charts).



(1) Pro forma adjusted for recent lease deals and to show debt in accordance with credit agreement leverage. See [here](#) for details





# CECO Promotes Its Met-Pro Deal As A “Success Story” .....

Through 2013, CECO’s largest deal was to acquire Met-Pro for \$203m.

Two years later, CECO was promoting “The CECO Met-Pro Acquisition Success Story” in the slide below. CECO used to report Met-Pro’s results as a business segment “Met-Pro Group” ([2013](#)) but effective Jan 1, 2014 CECO implemented an internal reorganization resulting in its three current reporting segments. (2014 [10-K](#), p. 33) This reorg made it difficult to track Met-Pro’s performance; but, scroll forward to see what really happened.....

**CECO ENVIRONMENTAL**

## The CECO Met-Pro Acquisition Success Story

- Acquired Met-Pro in August 2013 for implied multiple of 13x EBITDA
- Two years later, EBITDA improvements reduce purchase multiple to 7x EBITDA
- Accomplishments
  - ✓ Increased Met-Pro EBITDA from \$13M to \$23M
  - ✓ Exited and sold under-utilized facility assets
  - ✓ Grew and improved the business; boosted margins and productivity
  - ✓ Consolidated manufacturing and streamlined SG&A by 40%
  - ✓ Debt repayment and working capital excellence
- Under CECO’s leadership, legacy Met-Pro businesses have exceeded financial expectations

*We will continue our strong track record of acquisition integration; expect similar results with Peerless*

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# *But In Reality...CECO Appears To Be Forestalling A Large Goodwill Impairment At Met-Pro*

In our opinion, CECO has realigned its business segments (2014) and altered its goodwill testing methodology (2015) in order to avoid a substantial goodwill impairment. CECO now uses the market method “with a control premium” and has wide discretion to choose larger and healthier companies in its analysis. As of its last 10-Q, it appears an impairment is becoming increasingly imminent.

## **Notice Change in Goodwill Impairment Testing To Incorporate Market Method Testing ([10-Q](#), p. 10)**

*“Under the first step, the Company bases its measurement of the fair value of a reporting unit using a weighting of the income method and the market method on a 50/50 basis. **In prior years, the Company used the income method.** The income method is based on a discounted future cash flow approach that uses the significant assumptions of projected revenue, projected operational profit, terminal growth rates, and the cost of capital.... **The market method is based on financial multiples of comparable companies and applies a control premium. Significant estimates in the market approach include identifying similar companies with comparable business factors such as size, growth, profitability, risk and return on investment and assessing comparable revenue and operating income multiples in estimating the fair value of a reporting unit.** Based on the step 1 analysis, the resultant estimated fair value of the reporting units exceeded their carrying value as of October 1, 2015 and no goodwill impairment charges were recorded.*

## **Goodwill Impairment Discussion 2<sup>nd</sup> Quarter 2016 ([10-Q](#), p. 10)**

*“The Company did not identify any triggering events during the three-month and six-month periods ended June 30, 2016 that would require an interim impairment assessment of goodwill or indefinite life intangible assets. There was no impairment of goodwill or indefinite life intangible assets during the three-month and six-month periods ended June 30, 2016.”*

## **Revised Language: 3<sup>rd</sup> Quarter 2016 ([10-Q](#), p 10) Note: CECO also says the unit was acquired in 2H 2013 (Met-Pro)**

*“Although the Company has not identified any triggering events in 2016 that would require a more frequent test for impairment, the reporting unit with a lower excess fair value over its carrying value (as described above), as determined in the prior year’s annual assessment, **is experiencing lower than forecasted results through the first nine months of 2016. This reporting unit has goodwill and tradename intangible assets of \$77.9 million and \$5.0 million, respectively, as of September 30, 2016. The Company is currently in the process of analyzing internal strategic initiatives to improve operating performance, and forecasting for 2017 and future years as part of its annual impairment assessment, which is performed as of October 1, and will be completed in the fourth quarter. As of the date of this filing, the Company has not yet completed its assessment.**”*




# CECO Promotes Its PMFG Deal As A “Success Story” .....

With the Met-Pro business under pressure and needing a new growth driver, CECO announced the acquisition of PMFG in May 2015. The Company outlined eight reasons why the deal made sense and has recently been touting that the deal has exceeded expectations.

## Deal Presentation Outlines Strategic Rationale of Acquisition

**Key Transaction Benefits & Deal Rationale**



1. Strong strategic fit
2. Poised to achieve significant sales and cost synergies
3. Key step towards becoming market leader, including natural gas value chain
4. Provides access to attractive end markets to drive long-term growth
5. Enhances global footprint, particularly in China and the Middle East
6. Brings a leading portfolio of highly engineered product offerings
7. Grows aftermarket & recurring revenue opportunity
8. Poised to benefit from a balanced portfolio and diverse end markets

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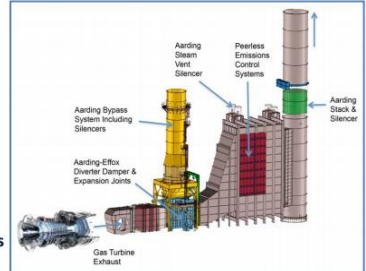
Source: [PMFG Deal Presentation](#), May 2015

## Latest Pitch Touting “Peerless Performance Exceeding Expectations”

**CECO ENVIRONMENTAL**

**Peerless Strengthens CECO’s Energy Segment**

- Acquisition closed Sept. 3, 2015
- Added critical SCR technologies, creating leader in comprehensive solutions for natural gas turbine power market
- Enhanced global footprint, particularly in China and the Middle East
- Increased installed base of equipment from \$3B to \$5B, providing cross selling & aftermarket sales opportunities
- Integration complete, one year ahead of schedule
- Achieved \$20M operational efficiencies on full-year basis, exceeding target expectations
- On track to deliver \$20M EBITDA in 2017, ahead of previous timing



*Peerless performance exceeding expectations*

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Source: [Needham Presentation](#), Jan 2017



# Deal Promotion: “Organic Growth” and “Recurring Revenue”

The CECO / PMFG was heavily promoted as a combination that would drive “organic revenue” growth and “recurring revenue” – both buzz words to get investors excited, and to achieve a higher stock price valuation. However, according to each company’s 10-K, neither [CECO](#) or [PMFG](#) ever used the terms “recurring” revenues prior to merging. Furthermore, CECO only used the word “aftermarket” twice in its pre-acquisition 10-K.

## Combination Drives Organic Revenue Growth...



### Combines Blue-Chip Technology Portfolios

- Enables combined company to provide a more comprehensive set of customer solutions from a single source provider

### Adds Critical SCR and SNCR Technologies

- Will deliver complete solutions across industrial end markets and expand CECO's presence across the complete energy value chain

### Further Growth in Key Markets

- Combination enables ability to cross sell PMFG's products in Asia and leverage PMFG's network in Europe and the Middle East to sell CECO's products

### Significantly Augments Recurring Revenue Opportunity

- Combination of installed bases (\$5 billion) significantly expands the opportunity to drive highly profitable and predictable recurring revenues

### Creates a Leading Global Provider of Silencer Technology

- Expands global presence within the noise reduction and abatement market segment with expanded product alternatives

### Adds Combustion Control Technologies to Portfolio

- Recently acquired CCA is an ideal technology to integrate within the [OneCECO](#) sales initiative

### Expands Sales Channels and Unlocks Cross-Selling Opportunities

- Ability to leverage existing sales channels and cross-sell products across all industries and geographies

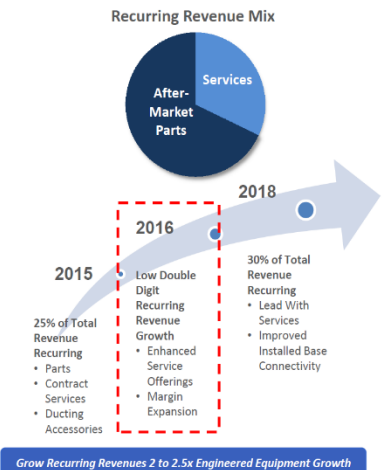
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Source: [PMFG and CECO Deal Presentation](#), May 2015

## CECO ENVIRONMENTAL

### Recurring Revenue

- Q3 Bookings on track for double digit year-over-year growth target
- Recurring revenue represents ~27% of total revenue; On track to meet 30% goal by 2018
- Significant upside growth due to low connectivity (<15%) on large installed base (300,000 units/\$5B)
- Expanding offering portfolio
- Strategic target of gross margin expansion



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Source: [Needham Presentation](#), Jan 2017



# CECO's Organic Growth Is Rapidly Deteriorating....

In our view, the Company's acquisition of PMFG in September 2015 is a disaster. Its revenues declined by approximately 29% in Q3, and the Company stopped disclosing bookings. Overall, CECO organic growth declined by 11% in Q3.

\$ in mm

Company	Metric	Q1'15	Q2'15	Q3'15 (1)	Q4'15	Q1'16	Q2'16	Q3'16
CECO Total	Sales YoY %	\$81.0 --	\$87.0 --	\$119.1 --	\$101.2 --	\$103.2 27.4%	\$112.3 29.1%	\$101.6 <b>-14.7%</b>
	Bookings	\$93.9	\$74.6	\$88.8	\$100.3	\$120.1	\$108.8	\$96.2
Less: PMFG Contribution	Sales YoY %	--	--	\$33.5 --	\$28.2 --	\$24.9 --	\$25.0 --	\$23.9 <b>-28.7%</b>
	Bookings QoQ %	--	--	\$27.8 --	\$32.0 15.1%	\$30.7 -4.1%	\$22.3 <b>-27.4%</b>	<b>Stopped Disclosing</b>
CECO Organic Growth	Sales YoY %	\$81.0 --	\$87.0 --	\$85.6 --	\$73.0 --	\$78.3 -3.3%	\$87.3 0.3%	\$77.7 <b>-11.0%</b>
	Bookings	--	--	\$78.7	\$68.3	\$89.4	\$86.5	<b>N/A</b>

Source: SEC filings and investor presentations

(1) Per CECO's [Q3'15 investor presentation](#) (slide 8), PMFG's full 3Q sales were \$33.5m and its contribution to the quarter reflecting the deal close date of 9/3/15 were \$12.6m. We have increased CECO's Q3 results of \$98.2m by \$20.9m to pro forma adjust the quarter as if PMFG had been acquired at the beginning of the quarter.

# CECO / PMFG Deal: A Complete Bust Relative To Initial Expectations



**Deal Press Release:** “CECO and PMFG’s products and end markets are highly complementary and when combined will represent one of the most comprehensive product portfolios in the industry with approximately \$500 million in environmental, energy and fluid handling-related revenue.”

## Deal Proxy: PMFG Revised Management Case Projections

(dollars in thousands)	Projected Financial Results for the Fiscal Year	
	2015E	2016P
Net bookings(1)	\$ 146,525	\$ 169,000
Revenue	160,345	163,950
Cost of goods sold	111,258	111,655
Total gross profit	48,921	52,295
Operating income	166	6,235
Adjusted EBITDA(2)	7,315	10,885

Based on our review, PMFG produced just \$112.8m of bookings and \$111.6m of revenues from June 2015 – June 2016 coinciding with its FY 2016.

PMFG’s gross margin was projected at 31.9%. For Q4’15 CECO projected 27% gross margins (slide 8), and came in at an unbelievable 35.3% (slide 8).  
**Thereafter, CECO stopped disclosing further gross margins attributable to PMFG**

CECO says PMFG added \$17.3m of EBITDA from Sept 15 -16, but that includes \$20m of synergies

1) PMFG excluded a \$28.4 million contract from fiscal year 2016 net bookings that was previously included in the March 2015 projections

2) Adjusted EBITDA does not include the impact of any potential synergies or costs related to the Mergers.

## Deal Proxy: CECO Stand Alone Management Case Projections

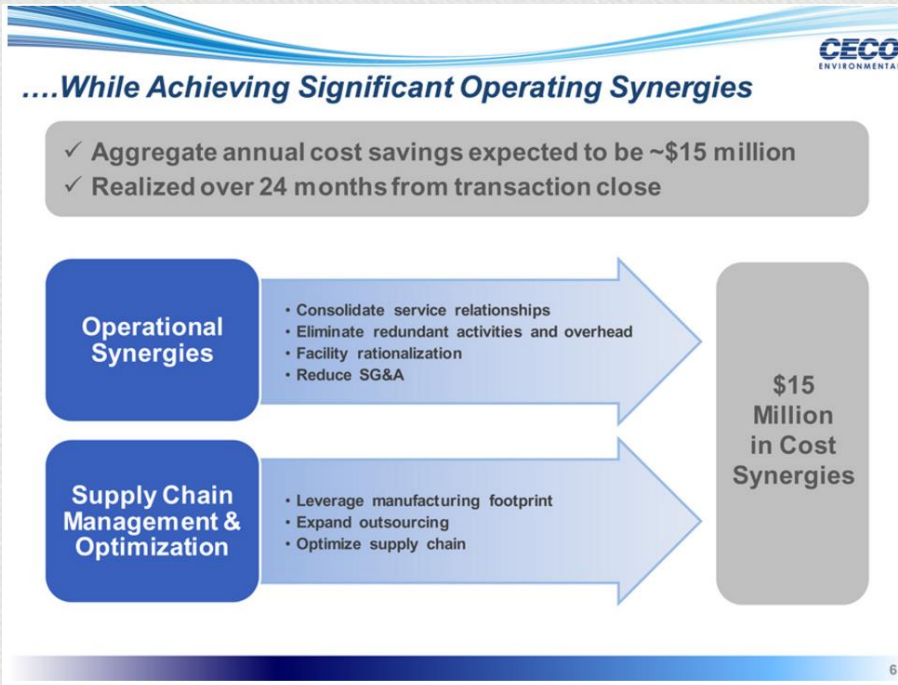
(dollars in thousands)	Projected Financial Results for the Calendar Year				
	2015E	2016P	2017P	2018P	2019P
Revenue	\$370,788	\$390,814	\$413,727	\$438,296	\$464,374
Cost of goods sold	258,068	267,489	282,207	294,582	307,462
Total gross profit	112,719	123,325	131,520	143,714	156,912
Income from Operations	38,544	36,318	45,000	56,386	78,585
Adjusted EBITDA	55,819	64,306	72,149	82,811	94,548

We calculate core CECO Revenues and EBITDA for the LTM 9/30/16 period as \$316.3m and \$39.7m, respectively. **These results are trending significantly below plan**

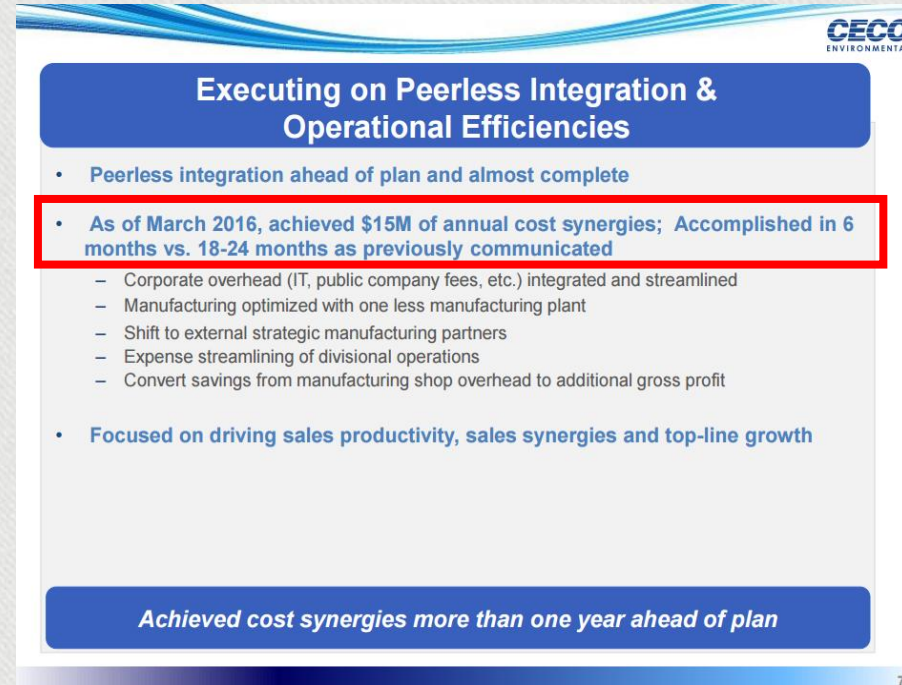


# Beware of Rapid Synergies

Spruce Point is skeptical of CECO's rapid synergy implementation. The Company originally forecast \$15m of synergies to be realized over 24 months. Yet, by March of 2016, the Company achieved its target in only 6 months. CECO then went on to increase its realized synergies twice, increasing them to \$18m by [Q2'16](#) and then to \$20m by [Q3'16](#) and didn't provide any further explanation. These rapid synergy realizations support our belief that further upside to CECO's substantial cash flow benefits in 2016 are not likely to be repeated going forward.



Source: [Deal Presentation](#), May 4, 2015



Source: [Q1 Investor Presentation](#), March 2016

# CECO “Trumped” By A President With A Disdain For Environmental Regulation

We thank Street Watchdog Research for initially bringing CECO to our attention following the resignation of CEO Lang on Jan 24, 2017 which came on the same day the *Executive Order* signed by the Trump administration targeting the streamlining of environmental review processes. (1) It's no secret that our President wants to cut government red-tape, and that he views the EPA as prime target for budget cuts. According to reports, it is reasonable to expect cuts of \$1 billion from the EPA's \$8 billion annual budget. (2) These actions are likely to have a significant impact on CECO. CECO's 10-K lists the #1 demand driver for its business and says “*increasingly stringent environmental regulations are the principal factor that drives our business.*” Accordingly, changes in environmental regulation are its #1 risk factor.

**We believe demand for our products and services in the United States and globally will continue to be driven by the following factors:**

*Stringent Regulatory Environment.* The adoption of increasingly stringent environmental regulations in the United States and globally requires businesses to pay strict attention to environmental protection. Businesses and industries of all types from refineries, power, chemical processes, metals and minerals, energy market and industrial manufacturing must comply with these various international, federal, state and local government regulations or potentially face substantial fines or be forced to suspend production or alter their production processes. **These increasingly stringent environmental regulations are a principal factor that drives our business.**

**Changes in current environmental legislation could have an adverse impact on the sale of our environmental control systems and products and on our financial condition, results of operations and cash flows**

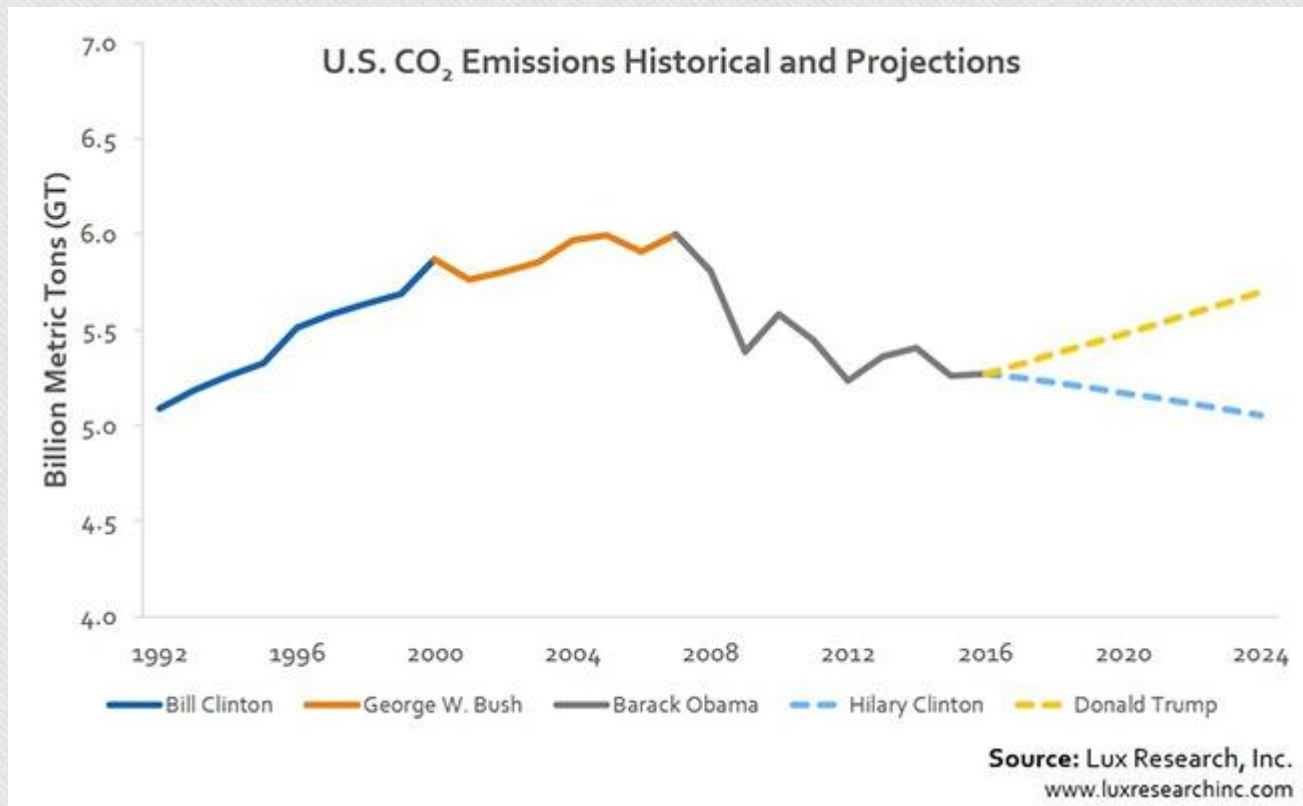
Our business is primarily driven by capital spending, clean air rules, plant upgrades by our customers to comply with laws and regulations governing the discharge of pollutants into the environment or otherwise relating to the protection of the environment or human health. These laws include, but not limited to, U.S. federal statutes such as the Resource Conservation and Recovery Act of 1976, the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, the Clean Water Act, the Clean Air Act, the Clean Air Interstate Rule, and the regulations implementing these statutes, as well as similar laws and regulations at state and local levels and in other countries. These U.S. laws and regulations may change and other countries may not adopt similar laws and regulations. **Our business may be adversely impacted to the extent that environmental regulations are repealed, amended, implementation dates delayed, or to the extent that regulatory authorities reduce enforcement.**

1) [Executive Order](#): “Executive Order Expediting Environmental Reviews and Approvals For High Priority Infrastructure Projects”  
2) [Trump Wants to Slash the EPA's Workforce and Budget](#), Transition Official Says, [Time](#), Jan 27, 2017



## *Tectonic Shift In Policy*

The magnitude of the directional change in projected carbon emissions under Trump cannot be overstated. Below is an excellent chart from Lux Research showing the reversal of policy. Much of this comes at the expense of companies such as CECO that provide solutions to deal with regulations to curb emissions.





## *CECO's Cash Flow and Debt Covenant Concerns*



# Unsustainable Cash Flow

Spruce Point believes CECO's recent free cash flow is not sustainable and likely to decline. On a pro-forma basis for the acquisition of PMFG (including run-rate cost synergies of \$20m) we estimate free cash flow of \$31.8m. However, as we previously illustrated, both CECO and PMFG have experienced double digit revenue declines post-acquisition. YTD 2016, CECO has generated abnormal free cash flow of \$20.3m which it attributes a "few favorable net working capital items." – primarily collections of receivables. (1) The abnormal cash flow was used to make \$23.3m of prepayments on its term-loan – a wise move in our view before cash flow dries up.

\$ in mm	CECO Pre-Acquisition June 30, 2015	PMFG Pre-Acquisition June 30, 2015	Cost Synergies Realized	Best Case Pro Forma Combined
Operating Cash Flow	\$17.6	(\$3.3)	+\$20.0	\$34.3
Capex	(\$0.7)	(\$1.8)	--	(\$2.5)
Free Cash Flow	\$16.9	(\$5.1)	--	\$31.8
YTD 2016 Free Cash Flow	--	--	--	\$52.1
Abnormal Free Cash Flow	--	--	--	+\$20.3

Note: Simplified analysis since we do not know what the cash flow contribution of PMFG has been post acquisition. \$15m of the \$20m of synergies reported to have been realized by March 2016 post deal close of Sept 2015. Pro forma best case assumes no deterioration in the underlying businesses

1) Q3 [10-Q](#), page 32

# Unsustainable Cash Flow (Cont'd)

**CECO's recent slide on "Strong Free Cash Flow Generation" is backward looking. Based on our view, there are numerous reasons to believe the recent performance is unsustainable and cash flow will contract.**

**CECO**  
ENVIRONMENTAL

**Strong Free Cash Flow Generation**

(\$ in millions)	FY 2014	FY 2015	1Q16	2Q16	3Q16	1Q-3Q
Gross free cash flow	\$ 29.2	\$ 22.4	\$12.1	\$ 37.3	\$ 11.2	<b>\$60.6</b>
Cash paid for Interest & income taxes	<u>\$ (11.5)</u>	<u>\$ (9.8)</u>	<u>\$ (2.7)</u>	<u>\$ (2.6)</u>	<u>\$ (2.4)</u>	<b><u>\$ (7.7)</u></b>
Cash provided by operating activities	\$ 17.7	\$ 12.6	\$ 9.4	\$ 34.7	\$ 8.8	<b>\$52.9</b>
Capital expenditures	\$ (1.2)	\$ (0.8)	\$ (0.2)	\$ (0.4)	\$ (0.2)	<b>\$ (0.8)</b>
Proceeds from sale of property & equip.*	\$ 7.7	\$ 3.2	\$ 0.3	\$ 11.0	\$ 3.2	<b>\$14.5</b>
Dividends	\$ (5.9)	\$ (8.0)	\$ (2.2)	\$ (2.3)	\$ (2.2)	<b>\$ (6.7)</b>
Earn-out payments	\$ (1.4)	\$ (2.5)	\$ (1.1)	\$ (1.2)	\$ (7.0)	<b>\$ (9.3)</b>
Net free cash flow	\$ 16.9	\$ 4.5	\$ 6.2	\$ 41.8	\$ 2.6	<b>\$50.6</b>

\*YTD 2016 gross proceeds of \$14M from sale-leaseback of 3 facilities

CECO has an attractive free cash flow business model with working capital excellence

**Spruce Point Commentary**

Not sustainable in our view and being temporarily inflated from working capital effects

How long can a manufacturing business spend nothing on maintenance capex?

Aggressive to show asset sales as free cash flow, especially since they aren't recurring. Per the [3Q'16 earnings call](#), the CFO says they are through most of planned sales; expect zero benefit going forward

Dividend is costing CECO \$9m/year could be at risk. Earnout liabilities remain at \$21m and come due in 2017/18 ([10-K](#) Contractual Obligations, p. 39)



# Potentially Misleading View of Leverage

Spruce Point believes that CECO's display of its leverage and debt reduction is potentially misleading. The Company's recent investor slide shows "Net Debt / Adjusted EBITDA" and illustrates that it has been declining post-PMFG acquisition. However, the key leverage metrics that investors should be focused on are its financial covenants articulated in its credit agreement. CECO's Consolidated Leverage Ratio does not net cash and cash equivalents against debt. (1) CECO's Adjusted EBITDA adds back earnout amortization expense, so it is not apples-to-apples for CECO to ignore significant earnout liabilities.

## CECO Promoted Leverage

<b>CECO</b> ENVIRONMENTAL					
Sharp Focus on Debt Reduction					
(\$ in millions)					
	9/30/15	12/31/15	3/31/16	6/30/16	9/30/16
Debt	\$ 194.3	\$ 177.3	\$ 170.6	\$ 152.5	\$ 133.4
Cash	\$ 30.8	\$ 34.2	\$ 33.4	\$ 56.6	\$ 41.8
Net Debt	\$ 163.5	\$ 143.1	\$ 137.2	\$ 95.9	\$ 91.6
TTM Adjusted EBITDA	\$ 45.1	\$ 48.4	\$ 52.5	\$ 54.5	\$ 56.5
Net Debt/Adjusted EBITDA	3.6x	3.0x	2.6x	1.8x	1.6x

Note: See supplemental slide for adjusted EBITDA reconciliation and important disclosures regarding CECO's use of adjusted EBITDA.

- Term debt pay down of \$15.4M in 3Q16 and \$39.6M YTD
- Have been paying down greater than 2X required principal throughout 2016
- On track for gross debt leverage ratio of 2.0X by end of 2017, as committed

## CECO Adjusted Leverage

\$ in mm	Q1'16	Q2'16	Q3'16
Term Debt	\$170.6	\$152.5	\$133.4
Note Payable	--	--	\$5.3
Letter of Credit	\$12.9	\$17.2	\$16.9
Earnouts	\$22.6	\$28.3	\$21.1
Sales-Leaseback (2)	--	--	\$4.9
Capital Leases (3)	--	--	\$8.6
<b>Adjusted Debt</b>	<b>\$193.2</b>	<b>\$197.9</b>	<b>\$189.9</b>
TTM EBITDA	\$52.5	\$54.5	\$56.5
<b>Adjusted Leverage</b>	<b>3.9x</b>	<b>3.6x</b>	<b>3.4x</b>

Source: Q3'16 Earnings Presentation, Slide 17

Note: Per CECO's recent 10Q \$22m of its \$41.8m of cash is held abroad in China, Netherlands, UK and Canada which may explain why deducting it from debt is not accurate

- (1) [Credit Agreement](#), Form D-5
- (2) Related to Telford, PA and Indianapolis, IN
- (3) Related to Denton, TX facility

# Worrisome Covenant Cushion Analysis

Per CECO's credit agreement, its Consolidated Leverage Ratio recently tightened to 3.50x on Jan 1<sup>st</sup>, 2017. The Ratio tightens again on October 1<sup>st</sup> to 3.25x and then to 3.0x thereafter.

Our analysis suggests CECO has no EBITDA cushion and could be in breach within a few quarters.

We also remind readers that by recently resigning, CEO Lang forfeited RSUs that were tied to 2017 EBITDA objectives.

\$ in millions

Covenant Ratio Change Date	Scheduled Term Loan Reduction (1)	Term Loan Debt	Other Debt (3)	Total Debt	Leverage Covenant (2)		
					Dec 2016 3.5x	Sept 2017 3.25x	Dec 2017 3.00x
Dec 2016	\$2.1	\$129.7	\$56.5	\$186.1	\$53.2	--	--
Sept 2017	\$6.2	\$123.5	\$56.5	\$179.7	--	\$55.4	--
Dec 2017	\$3.1	\$120.4	\$56.5	\$176.8	--	--	\$58.9

(1) CECO Q3'16 '10-Q p. 11

(2) [Credit Agreement](#), Form D-5

(3) We assume current Note payable, LOCs, earnout, capital and sale-leaseback liabilities remain outstanding

CECO's Current TTM EBITDA is \$56.5m which gives it no cushion if its financials begin deteriorating which we believe is a strong possibility





## *Management Turmoil and Board Concerns*

## Suspicious CEO Departures

At the CEO level there has also been controversy. CECO's long-time CEO Mr. DeZwirek was charged with insider trading around issuing promotional press releases, while selling stock. He settled charges without admitting guilt. CECO's current CEO abruptly resigned in January 2017, but not before he cashed in options and reaped \$634k in gains. The resignation was clearly a surprise to the market; CECO's stock declined by almost 15% on the news. Mr. Lang's options are fully vested, and he still has 280,000 unexercised options struck at \$3.78/sh.

 In our view, Mr. Lang's resignation signals an inability to hit financial targets. His recent compensation plan was changed to include performance-based Restricted Stock Units (RSUs) tied to 2017 EBITDA:

*"In addition, after consultation with Meridian and consideration of general market trends, in 2015 the Compensation Committee introduced time-based RSUs and performance-based RSUs into its compensation program. Specifically, in September 2015, the Compensation Committee approved grants to Mr. Lang of time-based RSUs that generally vest on March 1, 2020 **and performance-based RSUs that generally vest based on the degree to which the Company achieves a 2017 earnings before interest, taxes, depreciation and amortization ("EBITDA") performance goal**, subject to additional service-based vesting in two substantially equal installments on March 15, 2018 and 2019. We anticipate describing in further detail the specific EBITDA goal after the applicable performance period is completed." ([Proxy](#), p. 19)*

CECO CEO	Resignation Date	Questionable Behavior
Phillip DeZwirek	<a href="#">2/15/10</a>	CEO from Aug 1979 to Feb 2010. On September 3, 2013 <a href="#">the SEC charges Mr. DeZwirek</a> with insider trading on three occasions and <i>"engaging in hundreds of violations of the trade reporting and ownership disclosure rules of the federal securities laws"</i>
Jeff Lang	<a href="#">1/24/17</a>	Abrupt and unexpected resignation of the CEO. Mr. Lang cashes in options on <a href="#">Dec 21<sup>st</sup></a> to <a href="#">Dec 28<sup>th</sup></a> reaping \$634k of gains. Upon news of his departure, CECO's stock fell almost 15%



## Rampant CFO Resignations



**CECO has a revolving door at the CFO position.  
The Company is on its 5<sup>th</sup> CFO in little more than 5 years.  
This fact alone should give most investors pause for concern.**

Executive	Role	Resignation Date	Note
Dennis Blazer	CFO	<a href="#"><u>8/29/11</u></a>	Left for the apparel industry – TSC Apparel
Brenton Cook	CFO	<a href="#"><u>9/13/13</u></a>	Resigned as interim CFO, a role he held for 2 years and is now VP of Finance and Controller
Neal Murphy	CFO	<a href="#"><u>2/28/14</u></a>	Had been the VP of Finance, CFO and Treasurer of Met-Pro. Left to become the VP and CFO of Bloomer Chocolate Company
Ed Prajzner	CFO	<a href="#"><u>12/6/16</u></a>	Transitioned to EVP and Corporate Development Role. Was the Corporate Controller and Chief Accounting Officer at Met-Pro
Matt Eckl	CFO	--	Appointed CFO. Mr. Eckl, age 36, previously served as the Vice President, Finance – Energy Group at Gardner Denver, Inc. from 2012 until January 2017. Prior to joining Gardner Denver, Mr. Eckl served at various roles within General Electric Company (2002 – 2012)

## Other Key Executive Departures

Beyond the recent departure of its CEO and CFO, CECO has experienced senior departures in a number of business areas. Most notably, CECO has lost key members of its Asia business, where it touts its focus and large opportunity to gain share.

**Annual Report Promotion:** “Our continuing focus will be on global growth, market coverage, and expansion of our Asia operations” and “Our Asia operation is positioned to benefit from the tightening of air pollution standards by China’s Ministry of Environmental Protection.” (2015 [10-K](#), p. 26)

**Investor Presentation Promotion:** “Strong CECO Asia Platform” and “CECO’s low market share in Asia – niche player in China’s \$10 trillion GDP economy –creates significant growth opportunities over the next decade” ([Nov 2015](#), Slide 21)

Executive	Employment Dates	Notes
<a href="#">Brent Becker</a> / President of CECO Asia	Jan 2014 – July 2016	We believe he was a key deal executive for acquisitions of <a href="#">Zhongli</a> and <a href="#">SAT Technologies</a> . He was quoted in both deal announcements touting the growth opportunities
<a href="#">Arthur Li</a> / VP and GM of CECO Shanghai	Aug 2014 – Dec 2016	Senior China executive
<a href="#">James Zhou</a> / Technical Director	Dec 2014 – May 2016	Lead business development and technical management of air pollution control involved in cyclone, scrubber, dust collector, RTO, filter and APC system
<a href="#">Matt Hoppe</a> / VP and GM of Adwest and Klex-Kleen	Oct 2011 – Nov 2016	VP in the Environmental segment. Led a team of 60 people in executing the company's overall strategy in Sales, Project Management and Engineering
<a href="#">Matt Corbo</a> / VP of Sales	Mar 2015 – Aug 2016	Led the Sales and Marketing efforts for CECO Filters, Keystone Filtration and Mefiag Filtration



# Board Concerns

**The Board is stacked with allies of the former CEO and largest shareholder. Many Board members lack experience relevant to CECO's business, and some are receiving compensation from the Company.**

Director	Committee	Work Experience	Comment / Concerns
Jason DeZwirek	Board Chairman	In 1999, Mr. DeZwirek founded Kaboose Inc., a family focused online media company. Former Director of API Technologies	Son of the former CEO Philip DeZwirek who was charged by the SEC with insider trading and other violations. Jason's entity Icarus has an "oral agreement" with CECO for management consulting services and was paid fees of \$360,000 in 2015
Eric Goldberg	Comp Committee and Chairman of Nominations and Governance	Since 1996, served as the President of All American Events & Tours, a Pittsburgh, PA-based sports incentive company. 1996-1999, was the general counsel for Native American Nations, a company focusing on developing strategies for Native American tribes. Served as director of API Technologies	Any relevant experience in the environmental, industrial or energy markets?
Seth Rudin	Nominations and Governance	Currently the President of Muskoka Rock Company Ltd., manufacturer of granite. Has served as VP of Business Development and Client Relations at PatientOrderSets.com, a provider of innovative clinical support services for use across all phases of health care from 2011 until 2013, Managing Director U ABS System Consultants Ltd, a health care solutions company, from 2001 until 2010 and Vice President of InternetIncubation.com	Any relevant experience in the environmental, industrial or energy markets?
Donald Wright	Audit and Compensation Committee	A principal of and real estate broker with The Phillips Group, a real estate development company and apartment building syndicator, in San Diego, CA since 1992. Since September 2010, he has served as Associate Broker and VP of Syndication of SD Homes, a real estate brokerage firm in San Diego. Served as Director of API Technologies.	Any relevant experience in the environmental, industrial or energy markets?
Claudio Mannarino	Audit Committee	Served as the SVP and CFO of API Technologies Corp. Served as Controller for two divisions of Transcontinental, Inc	Another API related individual
Jon Pollack	Assistant Secretary	Currently the President of JMP Fam Holdings, Inc., an investment and consulting company. Previously, he served as Executive Vice President of API Technologies. Former Director of Hanfeng Evergreen Inc. (TSX:HF)	Hangfeng <a href="#">described</a> as "messy state of affairs" as stock is halted. CECO is paying Pollack's company fees through and "oral agreement" – fees totaled \$670,000 in 2015 (including \$225,000 for a bonus related to the terrible PMFG acquisition)
Valerie Sachs	---	Former VP and General Counsel of OM Group, EVP and General Counsel of Jo-Ann Stores, and General Counsel of Marconi	Strongest board member with diversified public company experience but she serves on no committees

Spruce Point has repeatedly warned about avoiding companies with bad board oversight of management. In the case of CECO, we see that its Board awarded bonuses to management despite not hitting its financial target. Also, we do not believe that management should be paid bonuses for closing acquisitions, particularly when acquisitions are apart of the Company's stated business strategy.

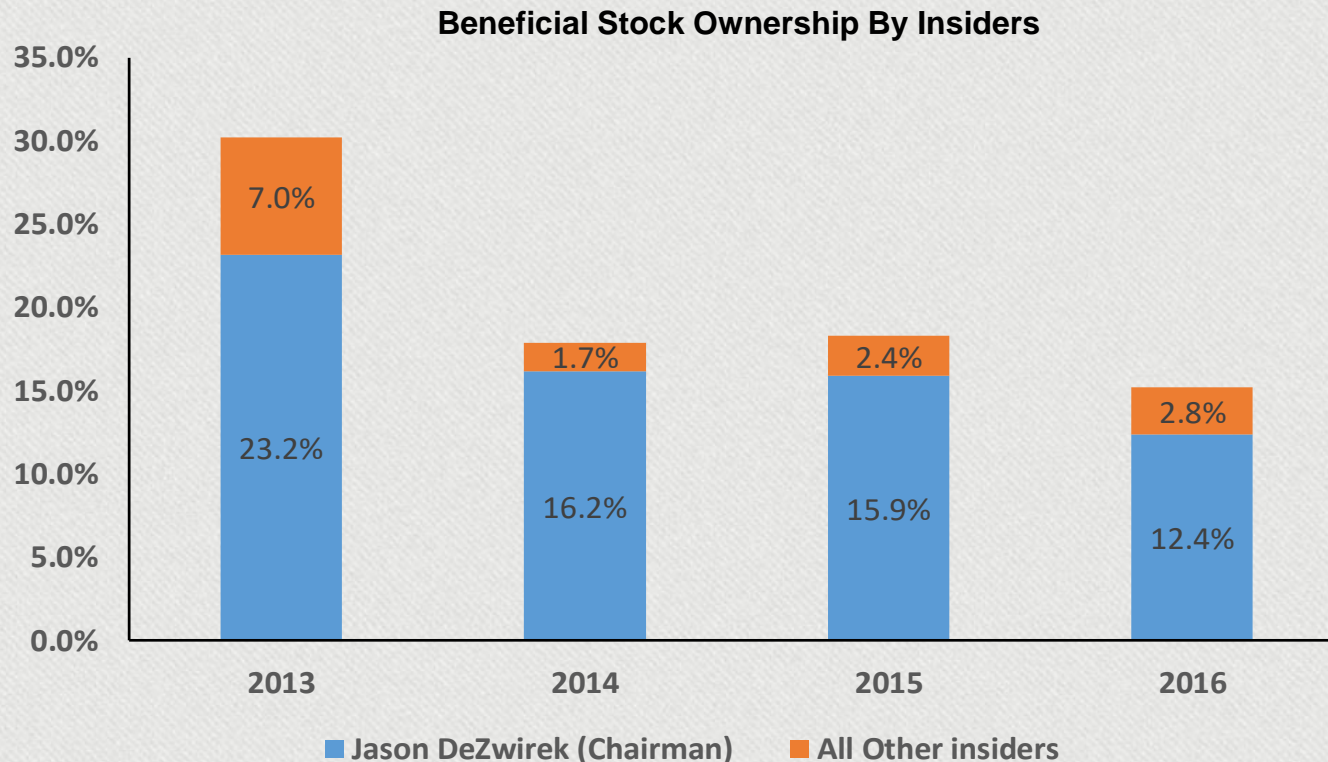
Mr. Lang is entitled, under his employment agreement, to an incentive cash bonus of up to 100% of his base salary depending on whether performance objectives, as approved by the Compensation Committee, are met. For 2015, the Compensation Committee approved and established multiple objectives. The objectives, which were both qualitative and quantitative, consisted of achieving operating income of \$60.0 million, integrating the PMFG acquisition along with Emtrol, HEE and Zhongli, growing EBITDA and operating income in 2015 over the level in 2014, building a larger platform for the future and recruiting and expanding the senior leadership team. **Although the operating income target was not met for the Company, the Compensation Committee awarded a bonus to Mr. Lang of \$431,250, which is 75% of his then-current base salary, due to his efforts with respect to the qualitative objectives in 2015. Mr. Lang also received a \$350,000 cash bonus in connection with an acquisition completed in 2015.**

**Although the quantitative targets were not met for the Company, nor were all of the individual performance targets met for both Mr. Prajzner and Mr. Cook, the Compensation Committee awarded a cash bonus of \$50,000 and \$29,530 to Mr. Prajzner and Mr. Cook, respectively, due to their efforts in helping complete and integrate strategic acquisitions during 2015. Mr. Prajzner also received an additional \$50,000 cash bonus in connection with an acquisition completed during 2015.**



## Follow The Money Carefully...

Given our views on the unattractiveness of owning CECO shares, its largest shareholder and Board Chairman has been steadily decreasing his ownership since 2013. As an additional potential indicator of his aversion to owning shares, we observe that on December 9, 2016 Icarus (his investment holding company) amended its CECO warrant agreement to allow for “Cashless Exercise.” By making this change, DeZwirek eliminates his need to commit cash to purchasing CECO shares, and will settle the warrant by selling shares to fund the exercise. (Source: [8-K filing](#)). Excluding CEO Lang’s ownership, the remaining executives own virtually no stock and have nothing at risk if CECO fails.





## *Accounting Worries and Financial Control Issues*



# Serious Accounting Concerns

CECO freely admits it has material weaknesses of internal controls. What troubles Spruce Point the most is that even its revenues are at risk of misstatement. A substantial portion of CECO revenues use the “Percentage-of-Completion” method of accounting, which requires a high degree of management judgement to estimate contract costs.

**Recent Risk Factor Warning:** *“In addition, failure to maintain adequate internal controls could result in financial statements that do not accurately reflect our financial condition, results of operations and cash flows.”*

1. The Company did not maintain internal control over financial reporting that was appropriately designed, adequately documented and operating effectively to support the accurate and timely reporting of revenue recognition. Specifically, the Company did not design and maintain effective controls to ensure:
  - **revenue recognition policies are in accordance with generally accepted accounting principles;**
  - **estimates of percent complete are accurate;**
  - **all projects are supported by executed contracts, including approved change orders;**
  - **billings are approved;**
  - **there is appropriate systems access and controls over schedules; and**
  - **appropriate review of contracts by accounting personnel.**
2. The Company did not implement effective internal control over financial reporting, either divisional specific or corporate monitoring controls for Zhongli in China acquired in December 2014 and PMFG acquired in September 2015.
3. The Company did not maintain a sufficient complement of personnel with an appropriate level of knowledge of accounting, experience and training commensurate with its financial reporting requirements and increased size due to recent acquisitions.
4. The Company did not maintain internal control over financial reporting that were appropriately designed, adequately documented and operated within its decentralized structure to:
  - determine the completeness and accuracy of reports and spreadsheets used in the execution of internal controls over financial reporting;
  - determine the appropriateness of manual journal entries;
  - maintain an effective information technology general control environment, including restricting access to certain key financial systems and records to appropriate users; and
  - maintain appropriate segregation of duties in the purchasing process.

## *Revenue Inconsistencies*

To illustrate our deep concern, we carefully reviewed CECO's financial statements.

We found a disclosure that the Company had issues with the overstatement of revenues it reported in its press release. What's even more mysterious, is that CECO has contradicted itself about the amount of the restatement, in one place saying it was a \$2.7m adjustment, but on the last page of its 10-K noting the revenue adjusted was \$5.2m  
We caution investors to tread carefully.

### **Beware of Inconsistencies In Revenue Reporting:**

“On March 10, 2016, the Company furnished a Current Report on Form 8-K with the Securities and Exchange Commission that included an earnings release issued that same day reporting results for the fourth quarter of 2015, which was furnished as Exhibit 99.1 thereto (the Earnings Release). Between the issuance of the Earnings Release and the filing of this Annual Report on Form 10-K, the Company became aware of additional information affecting its final closing adjustments, which resulted in the Company recording, for the three month period ended December 31, 2015, a decrease in net sales of \$2.7 million, a decrease in cost of goods sold of \$0.3 million, and a decrease in selling, general and administrative expense of \$2.0 million, resulting in a decrease in pre-tax income of \$0.4 million, which was offset by a decrease in income tax expense of \$0.4 million. The net impact of these adjustments had no impact on net income or diluted earnings per share as initially reported for the year ended December 31, 2015.” (Source: 2015 [10-K](#), p. 29)

### **And Then On The Last Page In The Annual Report, A Completely Different Description:**

“In making final closing adjustments for the year ended December 31, 2015, the Company became aware of additional information affecting the determination of year-to-date revenue recognition for certain business units, which resulted in the Company recording, for the three month period ended December 31, 2015, a decrease in net sales of \$5.2 million, and a decrease in cost of goods sold of \$5.0 million.” (Source: 2015 [10-K](#), p. F-44)



# Percentage-of-Completion Schemes Are A Current Focus of SEC Investigations

*“Revenue recognition issues will remain a staple of our financial fraud caseload – this fraud often takes many forms, whether by recognizing revenue through sham transactions, prematurely recognizing revenue, distorting percentage of completion accounting, using schemes to inflate sales numbers, or billing for uncompleted products through a “pre-booking” scheme.”* [SEC Enforcement Director Speech](#), 2013

## Recent Accounting Restatements and SEC Investigations of Percentage-of-Completion Accounting Cases

Company	Year	Note
Archrock	<a href="#">2017</a>	Financial statements for FY 2013-2015 should no longer be relied upon. The determination was made after considering conclusions reached by Exterran Corporation that there were material errors in such historical periods relating to the application of percentage-of-completion accounting principles to certain Belleli engineering, procurement and construction (“EPC”) contract
Orbital ATK	<a href="#">2016</a>	The Restatement is primarily a result of a non-cash error in the application of purchase accounting with respect to a limited number of long-term contracts, which are accounted for under the percentage-of-completion method
Toshiba	<a href="#">2015</a>	Toshiba Corp. must correct at least 152 billion yen (\$1.2 billion) of pretax earnings over a six year period after an internal accounting probe revealed the company overstated profits. The company initially uncovered irregularities related to “percentage of completion” estimates used on infrastructure projects, including nuclear, hydroelectric, wind-power equipment, air-traffic control and railway systems
L-3 Communications	<a href="#">2014</a>	Receives SEC subpoena and DOJ investigation and pays fine of \$1.6m and \$4.6m, respectively to each agency ( <a href="#">source</a> ). The cases relate to improper revenue accounting at L3’s aerospace systems segment that resulted in the contractor’s correcting financial results over a roughly four-year period starting in 2011 and firing at least four employees.
Cubic Corp	<a href="#">2012</a>	Changes will result in an increase in revenues and net income cumulatively over the period
Computer Sciences Corp	<a href="#">2011</a>	The anticipated result of the restatement is to reduce net income by ~\$50 in FY 2010 and ~\$3.69 billion in FY 2011 and to increase net income in FY 2012 by ~\$3.90 billion. Settled with the SEC for \$190m

## Slow To Recognize Losses in Earnings?

Pay close attention to the footnotes.

**CECO is starting to slowly recognize provisions for estimated losses on uncompleted contracts**

*“Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. **No provision for estimated losses on uncompleted contracts was needed at December 31, 2015, 2014 and 2013.**” (Source: 2015 [10-K](#), p. 39)*

*“Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes to job performance, job conditions, and estimated profitability may result in revisions to contract revenue and costs and are recognized in the period in which the revisions are made. **No provision for estimated losses on uncompleted contracts was required at March 31, 2016 or December 31, 2015.**” (Source: Q1’16 [10-Q](#))*

*“Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes to job performance, job conditions, and estimated profitability may result in revisions to contract revenue and costs and are recognized in the period in which the revisions are made. **A provision of \$0.1 million for estimated losses on uncompleted contracts was recognized at June 30, 2016.** No provision for estimated losses on uncompleted contracts was required at December 31, 2015.” (Source: Q2’16 [10-Q](#))*

*“Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes to job performance, job conditions, and estimated profitability may result in revisions to contract revenue and costs and are recognized in the period in which the revisions are made. **A provision of \$0.2 million for estimated losses on uncompleted contracts was recognized at September 30, 2016.** No provision for estimated losses on uncompleted contracts was required at December 31, 2015.” (Source: Q3’16 [10-Q](#))*





## *Valuation and Bear Summary*

# *Analyst's Too Optimistic And Not A Compelling Risk/Reward To Own CECO*

A majority of CECO's analysts have Buy recommendations and see upside to \$13.40 on average (implying just 7% upside). Given our views on the risk and uncertainties for CECO, it doesn't appear to be a compelling risk/reward.

We congratulate the lone analyst at Jefferies for having a price target below the current price.

Analyst	Recommendation	Price Target
Cowen	Outperform	\$17.00
Roth	Buy	\$13.00
Needham	Buy	\$13.00
Seaport Securities	Buy	\$13.00
Jefferies	Hold	\$11.00
William Blair	Outperform	--
Drexel Hamilton	Hold	--
<b>Average Price Target % upside</b>		<b>\$13.40 7%</b>





## *Bull vs. Bear Debate*

### **Bull's View**

"The company does not provide official guidance, but management said the margin outlook for the next couple quarters should be consistent with the 2016 year-to-date averages for gross and operating margin (about 31% gross margin and 12% operating margin). Management also intimated the level of revenue (in absolute dollars) seen in the next few quarters should be consistent with the level reported in third quarter 2016 (\$102m)."



"Upside Scenario: Operating margin reaches 15% goal before 2018, on improving organic sales growth."



"Looking forward, we are lifting our EBITDA and EPS estimates driven by uptick in margins in spite of revenue cuts."



"Cash and cash equivalents were \$43 million and total debt was \$133 million (down from \$177 million in fourth quarter 2015). The ratio of net debt to pro forma EBITDA was 1.6 times as of the end of the third quarter."

Free Cash Flow Yield. On a free cash flow basis CECE is yielding 14%, normalizing for large working capital improvements FCF is likely approximately \$40 mm or 11% - very compelling. At our target price FCY yield would be 9%



"We believe the valuation is attractive, given the deep discount relative to the peer group and the potential for upside to our earnings estimates, the company's margin expansion initiatives, and the potential for accretion from the PMFG acquisition. We maintain our Outperform rating"



### **Spruce Point's Bearish View**

No guidance but giving guidance anyway sound unusual? Post this guidance, why did the CEO abruptly resign if he believed in a positive outlook? Also, how can investors get comfortable with management's guidance when it has consistently misguided in the past. The initial guidance on revenue offered for the PMFG acquisition has been horribly missed

Largest margin expansion is already behind CECO, particularly with the repeated cost synergy increases well beyond expectations and timing. Other headwinds to margins include rising raw material (steel) costs due to CECO's manufacturing

Adjusted debt is closer to \$190m. This is what investors should be focused on given that CECO's debt covenants are set to tighten significantly in 2017. CECO's cash should be discounted too since \$22m is invested abroad and would be subject to taxation or conversion restrictions (China) upon repatriation

We agree the cash flow should be normalized, but we think \$40m is still too aggressive. We view \$30m of free cash flow more likely, and that doesn't include remaining cash payments for earnouts of \$18-\$20m. Scheduled debt payments are \$9m in 2017

Don't be fooled by a cheap valuation. We believe CECO is forestalling a \$79m goodwill impairment and that its earnings are about to roll over. The easiest margin expansion initiatives are long past. CECO is expensive considering its business has declining organic growth and grim prospects

# Comparable Companies

**CECO “looks cheap” on Street estimates, but any buyer should beware that organic revenue is quickly declining and the uncertainty in CECO’s end markets provide little long-term visibility. We benchmark CECO against small and microcap industrial companies serving the environmental, filtration, and power industries.**

\$ in millions, except per share figures

Company Name (Ticker)	Stock	% of	Enterprise	2017E - 2018E		Price /		Enterprise Value				Price /	Debt /	Dividend
	Price	52-wk		Revenue	EPS	Consensus EPS	EBITDA		Sales					
	2/10/2017	High		Value	Growth	Growth	2017E	2018E	2017E	2018E	2017E			
US Ecology (ECOL)	\$53.20	99%	\$1,440	5.8%	11.5%	29.2x	26.2x	11.6x	11.0x	2.9x	2.7x	4.2x	51%	1.4%
Aegion (AEGN)	\$22.97	88%	\$1,083	-3.3%	-2.6%	15.0x	15.4x	7.5x	7.8x	0.8x	0.8x	1.4x	40%	0.0%
Gorman-Rupp (GRC)	\$32.43	94%	\$1,160	4.7%	0.0%	32.8x	32.8x	23.3x	22.3x	3.0x	2.9x	2.8x	0%	1.5%
Calgon Carbon (CCC)	\$16.45	88%	\$1,149	5.2%	10.1%	18.5x	16.8x	10.2x	9.4x	1.8x	1.7x	2.1x	41%	1.2%
Circor (CIR)	\$64.81	93%	\$1,367	7.3%	29.3%	26.8x	20.7x	15.4x	13.4x	2.0x	1.9x	2.6x	18%	0.2%
NV5 Global (NVEE)	\$40.20	97%	\$377	5.8%	26.1%	22.3x	17.7x	9.7x	8.4x	1.3x	1.2x	3.0x	10%	0.0%
Ameresco (AMRC)	\$5.02	80%	\$351	NA	NA	15.7x	NA	6.3x	NA	0.5x	NA	0.8x	31%	0.0%
Heritage-Clean (HCCI)	\$15.20	91%	\$378	3.5%	-4.5%	23.0x	24.1x	7.8x	7.6x	1.0x	1.0x	1.8x	26%	0.0%
			Max Average Min	7.3%	29.3%	32.8x	32.8x	23.3x	22.3x	3.0x	2.9x	4.2x	51%	1.5%
				4.1%	10.0%	22.9x	22.0x	11.5x	11.4x	1.7x	1.7x	2.3x	27%	0.5%
				-3.3%	-4.5%	15.0x	15.4x	6.3x	7.6x	0.5x	0.8x	0.8x	0%	0.0%
CECO Env't (CECE)	\$12.52	84%	\$527	2.9%	11.6%	13.2x	11.8x	8.3x	7.8x	1.2x	1.2x	1.8x	36%	2.2%
Spruce Point Adjusted	\$12.52	84%	\$578	N/A	N/A	34.5x	N/A	15.4x	N/A	1.6x	N/A	2.6x	53%	2.2%

Source: Company information, Wall St. and Spruce Point estimates



# Spruce Point Estimates 30% – 60% Downside

Spruce Point believes that 2017 could be a major re-set year for CECO's earnings and valuation. We believe the biggest catalyst will be significant earnings misses from continued organic growth declines, and a realization that its debt covenant has no cushion. Other headwinds include a high exposure to foreign sales (38% of 2015 sales) which are muted by a strong dollar and to rising steel prices, which the company cites as a key raw material input cost and have rebounded sharply from last year and are expected to rise (1).

## Spruce Point Intermediate View vs. 2017/18 Street View

\$ in millions, except per share amounts

Metric	17/18 Street	Spruce Point	Note
<b>Sales</b> % Growth	\$425 / \$437 1.6% / 2.9%	\$365– \$385 -7.8% to - 12.6%	Driven by organic growth decline and other headwinds
<b>Adj EBITDA</b> % margin	\$63 / \$67 14.9% / 41.4%	\$38– \$44 10.3% – 11.3%	Assumes generous 30% gross margin
<b>Adj EPS</b> % Growth	\$0.95/ \$1.06 13.1% / 11.6%	\$0.36 – \$0.44 -57% to -48%	32% tax rate and 34.4m shares

## Spruce Point Intermediate Term Price Reference Ranges

\$ in millions, except per share amounts

Metric	Low	High	Note
<b>Mult. of Book</b>	1.0x	1.5x	Adjusted Book Value Might Be the Cleanest Way to Value CECO given extreme earnings uncertainty
<b>Book Value</b>	\$244	\$244	
<b>Less: Met-Pro Charge</b>	(\$78)	(\$78)	
<b>Dil. Shares</b>	34.4	34.4	
<b>Price Target</b>	\$4.85	\$7.27	
<b>% Downside</b>	-61%	-42%	
<b>Sales Mult.</b>	1.0x	1.2x	
<b>2017 Sales</b>	\$365	\$385	
<b>Plus: Cash</b>	\$42	\$42	
<b>Less: Adj Debt</b>	(\$190)	(\$190)	
<b>Dil. Shares</b>	34.4	34.4	
<b>Price Target</b>	\$6.35	\$9.15	
<b>% Downside</b>	-49%	-27%	

(1) [Steel Price Forecasts](#)