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New Rec: Washington Group Intl. (WGII: $34.95) Aug. 15, 2004

Position: Buy **Target: $49.00** **Timing: 2 (1=aggressive; 5=cautious)**

	2Q04a	3Q04e	4Q04e	F2003a	F2004e	F2005e
Rev ($M)	684.5	710.0	734.8	2,501.2	2,883.4	3,129.7
EPS ($)	0.49	0.44	0.49	1.66	1.89	2.34
Y/Y Growth	-14.1%	-14.3%	448.9%	na	13.9%	23.5%
PSR	na	na	na	0.38	0.33	0.30
P/E	na	na	na	21.1	18.5	15.0
Consensus	na	0.43	0.48	na	1.87	2.13

Shares Out: 25.3M **Market Cap: $882.8M** **FYE: Jan 2**

Summary: Washington Group International Inc. (WGII) is one of the largest engineering and construction (E&C) companies in the U.S. and provides a full range of specialized services to businesses and governments worldwide. WGII has

roughly 700 projects in progress across major markets including energy, environmental, government, heavy civil, industrial, manufacturing, mining, nuclear services, transportation, water resources, and weapons demilitarization.

On 5/14/01, WGII filed for voluntary reorganization under Chapter 11 due to near-term liquidity problems resulting from excessive cost overruns on jobs inherited through its July 2000 acquisition of Raytheon Engineers & Constructors International, Inc. (RECI) from Raytheon Company. WGII emerged from bankruptcy on 1/25/02 with a fresh balance sheet and a $350M revolving credit facility.

After emerging from Chapter 11, WGII's revenues declined from $4.0B in F2001 to $3.7B in F2002, and down to $2.5B in F2003. However, as revenues declined, operating income actually improved. Excluding restructuring and reorganization costs, operating income was a much healthier $150.5M (6.0%) in F2003 compared to $141.7M (3.9%) in F2002 and $25.2M (0.6%) in F2001. This divergence occurred because several large projects performed during F2001 and F2002 were legacy projects from RECI which achieved minimal margins.

Over the past year and a half, WGII has been successfully rebuilding its franchise and regaining market share lost during the bankruptcy. During each the last seven quarters, new bookings have exceeded revenues, resulting in a growing backlog balance. Backlog, a key indicator of future earnings potential, grew from $2.8B at 1/3/03 to $3.5B at 7/2/04. As a result of its improved business and backlog trend, WGII has been steadily generating cash. As of 7/2/04, WGII has built up a cash balance of $214.1M, and is debt-free. What is more impressive is that WGII has achieved this growth organically.

In addition to its scale, WGII has a unique advantage over its competitors in that it is extremely diversified across six broad segments: Power, Infrastructure, Mining, Industrial/Process, Defense and Energy/Environment. Furthermore, WGII is viewed as among the best in many of its sectors. While many competitors offer basic construction services, much of WGII's services are highly technical and specialized. In fact, WGII's capabilities in the nuclear, environmental and power segments are considered proprietary. While WGII experienced weakness in some of its markets over the last couple of years, the recent 2Q04 results showed that all six segments are now profitable. Future prospects also look good as demand is increasing across all of WGII's market segments (albeit at a very tempered pace for the Industrial business).

By virtue of WGII's broad business segments, WGII has a significant mix of stable and recurring work from government contracts which allow it to weather downturns in its more cyclical units (e.g., Industrial and Infrastructure). WGII's Defense and Energy segments perform work primarily for the U.S. Government (for the Department of Defense (DOD) and the Department of Energy (DOE), respectively). During F2003, the DOD accounted for 24% and the DOE accounted for 14% of total revenues. At 7/2/04, government contracts accounted for 36% of total backlog. Furthermore, these government contracts are performed on a cost-plus basis, mitigating the risk of losses due to cost overruns.

For E&C companies, the earnings stream is generally lumpy and difficult to predict. There is also accounting risk associated with this type of business, as revenues and profits are determined based on management's estimates through the use of percentage-of-completing accounting. This risk is somewhat mitigated by management's history of conservative accounting practices.

Management is also conservative in its reporting of backlog. For instance, WGII's Infrastructure and Power segments perform substantial work for the U.S. Army Corps of Engineers (USACOE) to rebuild the infrastructure in Iraq. Because these jobs are awarded on an "as needed" basis, and given the geopolitical risk, management excludes these amounts in reported backlog as well as in its earnings guidance. To date, WGII has won four contracts which could potentially provide up to $3.1B of future work, but has recorded only $550M in "task orders" specifically awarded. Also, WGII's backlog at 7/2/04 excludes another $1.7B of government contracts in progress for which work is to be performed beyond 2Q06. The unbooked portion of existing government contracts together with future USACOE task orders provide significant upside opportunity not reflected in WGII's current $3.5B backlog figure.

WGII's steady flow of cash from operations also lends support to the integrity of WGII's reported financial results. During F2003, WGII generated free cash flow of $102.3M (12% yield on current market value) and EBITDA of $158.6M. On an EBITDA basis, WGII currently trades at a mere 4.2x trailing EV/EBITDA multiple, compared to an average of 9.8x for its peer group. We argue that WGII should not be trading at such a drastic discount to its peers, given its competitive positioning, as well as its exceptional earnings improvement and cash generating capabilities. We think WGII is undervalued because it is still perceived as a "problem company" tainted by its history. Investors are not giving WGII due credit for having rebuilt its franchise post-bankruptcy. As WGII continues to deliver solid results over the next several quarters, we think the market will start to take notice that WGII is now a healthy, cash-generating company, and WGII's earnings multiples and share price should rise as a result.

In fact, this is already beginning to happen. On 8/12/04, WGII reported yet another solid quarter, with 2Q04 revenue of $684.5B and diluted EPS of $0.49, beating consensus estimates by $0.03. Over the past five quarters, WGII has beaten estimates by anywhere from 5% to 111% ($0.1 to $0.30). Since the earnings release, WGII's share price has jumped to $34.95 from $32.21. Despite the 9% gain already experienced, we think further upside opportunity exists. Based on our approach described below, we estimate WGII's 12-month target price to be $49.00, a 40% upside.

We valued WGII based on our estimated F2005 EPS, on both a cash-basis as well as a GAAP-basis. We also considered the cash-basis EPS because WGII derives significant and recurring cash savings from expected tax deductions for goodwill amortization and net operating loss (NOL) carryovers. Until these deductions expire in about 10 years, WGII will not pay federal taxes on at least the first $138M of federal taxable income for F2004 and $88M of federal taxable income for the following nine years.

Considering these tax savings, we estimate F2005 cash-basis and GAAP-basis EPS to be $3.41 and $2.34, respectively. Applying a 14.0x multiple (represents peer group average) to our $3.41 cash-basis EPS, we get a preliminary price of $47.70. Including $5.31 of excess cash (67% of total cash balance), we derived a price of $53.01. Alternatively, applying a 14.0x multiple to our $2.34 GAAP-basis EPS resulted in a preliminary price of $32.70. We then included $5.31 of excess cash per share as well as $7.14 per share for the estimated present value of future tax savings, to arrive at a share price of $45.15. We averaged the results from these two methods and arrived at a target price of $49.00.

We also note that on an EBITDA basis, if we applied a 6.5x multiple (a slight discount to the peer mean) to our estimated F2005 EBITDA of $170.6M, and add the present value tax savings, we arrive at a share price of $53.34. However, we will use the more conservative target price of $49.00.

Background:

Washington Group International Inc. ("WGII" or the "company") provides a broad range of design, engineering, construction, construction management, facilities/operations management, environmental remediation and mining services. WGII performs work in over 40 states and 30 countries and across major markets including energy, environmental, government, heavy civil, industrial, manufacturing, mining, nuclear services, transportation, water resources, and weapons demilitarization. WGII has over 27,000 employees, of which 13% are covered under union contracts.

WGII was originally incorporated in April 1993 under Kasler Holding Company, and changed its name to Washington Construction Group, Inc. in April 1996. In September 1996 the company purchased Morrison Knudsen Corporation and changed its name to Morrison Knudsen Corporation, and finally, in September 2000, changed its name to Washington Group International, Inc. Although the surviving company dates back only a decade, the company's long roll-up history (of over 20 heritage companies) spans over a century of experience that includes high-profile projects such as the Hoover Dam, the San Francisco Bay Bridge and the TransAlaska Pipeline.

On 5/14/01, WGII filed for voluntary reorganization under Chapter 11 due to severe liquidity problems resulting from excessive cost overruns on jobs acquired through its 7/7/00 acquisition of Raytheon Engineers & Constructors International, Inc. (RECI) from Raytheon Company. WGII paid $53M (plus $8M transaction costs) and assumed liabilities of $450M for RECI. Unexpected project losses soon escalated and WGII ultimately recognized total asset impairment costs of $1.2B related to this acquisition. On 1/25/02, WGII emerged from bankruptcy with a fresh balance sheet and a $350M revolving credit facility to fund new projects. In connection with emergence from bankruptcy, WGII adopted fresh-start reporting effective 2/1/02 in accordance with SOP 90-7, and issued 25M shares of New Common Stock and warrants to purchase 8.5M of the New Common Stock. The reorganization value of the company's equity was assigned a value of $550M, or $22 per share.

WGII operates through the following six business segments which are separately managed and serve different markets and customers: Power (22% of 2Q04 revenues), Infrastructure (29%), Mining (4%), Industrial/Process (15%), Defense (17%) and Energy/Environment (14%). The segments are described below:

Power. WGII has designed and built more than 200,000 megawatts of electricity around the world and is known for its work on some of the largest water projects in history, including the Hoover Dam. Power provides engineering, construction and operations and maintenance services for power generating facilities, and the systems that transmit and distribute their electricity. This segment also performs substantial work with USACOE to rebuild Iraq's electrical, water, and power systems. This business is dependent on domestic demand for new power generating facilities and the modification of existing power facilities.

Infrastructure. WGII is perhaps most recognized for its long history of work on notable highways, bridges, airports, tunnels, railroad and transit lines, water storage and transport, water treatment, and hydroelectric facilities. The business unit usually performs as a general contractor or as a joint venture partner with other contractors on domestic and international projects. This segment also performs substantial work with USACOE to rebuild Iraq's infrastructure. This business is affected by availability of public sector funding for transportation projects and the availability of bonding required to perform these projects.

Mining. Mining provides engineering, construction, operations and operations management, contract mining, and mine closure and reclamations services to the mining industry globally. Through its joint ventures, WGII also owns and operates mines around the world. This segment is affected by demand for coal and other extractive resources.

Industrial/Process. Industrial/Process provides engineering, design, procurement, construction services and total facilities management for general manufacturing, pharmaceutical & biotechnology, oil & gas, metals processing, automotive, aerospace, food & consumer products, and pulp & paper industries. This business is affected by growth prospects in the U.S. economy and more directly by the capital spending plans of customer base.

Defense. WGII has supported the U.S. defense efforts since WWII, providing a range of engineering, construction, and management services. As world affairs develop, WGII has evolved with the government's changing priorities. As a result of the recent terrorist activities, WGII has evolved into a leader for homeland security and threat reduction services, helping to protect embassies, military bases, transportation systems and other critical infrastructure worldwide. As a result of the Cold War legacy, WGII's status as a leader in elimination of weapons of mass destruction (WMD) began with the Manhattan Project and continues today in the U.S. and the former Soviet Union. This unit is largely dependent on spending levels of the U.S. government, and the DOD in particular.

Energy & Environment. Energy & Environment has been providing services to the DOE and the EPA since the 1940's. Services include decontamination, decommissioning, and demolition services for nuclear facilities, as well as administration and environmental cleanup and restoration services. This unit is largely dependent on spending levels of the U.S. government, and the DOE in particular.

WGII also conducts its business through construction joint ventures, often as sponsor and manager of projects, which are formed for the sole purpose of bidding, negotiating and completing specific projects. WGII participates in two mining ventures: Westmoreland Resources, Inc. (20% owner), a coal mining company in Montana, and MIBRAG mbH (50% owner), which operates lignite coal mines and power plants in Germany. WGII also hold 60% interest in two government contracting ventures with British Nuclear Services, Inc.

Joint ventures that WGII controls are fully consolidated in the financial statements. For those construction joint ventures which WGII does not control, WGII reports its pro rata portion of revenue and costs, but the balance sheet reflects only the net investment in the project. Joint ventures that WGII does not control and that do not involve construction or engineering activities, are reported using the equity method of accounting. The MIBRAG joint venture is reported on an unconsolidated basis.

WGII's services are structured through four types of contracts: 1) fixed-price contracts providing for a fixed price for all work to be performed; 2) fixed-unit-price contracts providing for a fixed price for each unit of work to be performed; 3) target-price contracts providing for an agreed upon price whereby WGII absorbs cost escalations to the extent of its expected profit and is reimbursed for costs which continue to escalate beyond the expected fee; and 4) cost-type contracts providing for reimbursement of costs plus a fee. Engineering, construction management, maintenance, environmental and hazardous substance remediation contracts are typically awarded pursuant to a cost-type contract. Although the fixed-price contracts offer greater profit potential, they are also much riskier. As a result, customers typically require WGII to take out surety bonds for fixed-price contracts.

In accordance with the provisions of SOP 81-1, WGII recognizes revenue on engineering and construction-type contracts using the percentage-of-completion method of accounting whereby revenue is recognized as performance under the contract progresses.

WGII future revenue and earnings potential is tracked through its backlog and its new work booked. New work booked represents the value of new contracts awarded/signed, while backlog represents the total accumulation of new work awarded less the amount of revenue recognized (i.e., the total value of awarded contracts not yet completed and therefore, future revenue expected to be recognized over the remaining life of the projects in process). New work booked during 2Q04 totaled $882.5M compared to $782.5M the prior quarter and $862.1M during the prior year.

Based on the different types of contracts, WGII records new work and backlog in the following manner:

Government contracts. Most of WGII's government contracts cover several years. However, funding for the contracts is subject to annual appropriations by Congress. To account for the risk that future amounts may not be appropriated, WGII only includes the most immediate two years of forecast revenue in its backlog. As time passes and appropriations occur, additional new work is recorded on these existing government contracts. At 7/2/04, U.S. government funded contracts comprised approximately 36% of total backlog. All contracts with agencies of the U.S. government are subject to unilateral termination at the convenience of the customer.

Mining contracts. The duration of mining contracts varying greatly depending on the life span of the resource. For new work and backlog purposes, WGII limits the amount recorded to five years. Similar to its practice with government contracts, WGII recognizes additional new work as commitments for that future work are firmed up. At 7/2/04, mining contracts comprised approximately 11% of total backlog.

At-risk and agency contracts. The amount of new work and related backlog recognized depends on whether the contract or project is determined to be an "at-risk" or "agency" relationship between the client and WGII. For "at-risk" relationships, the expected gross revenue is included in new work and backlog. For relationships where WGII acts as an agent for the client, only the expected net fee revenue is included in new work and backlog. At 7/2/04, agency contracts comprised approximately 7% of total backlog.

Discussion

1. WGII does not appear to be receiving full credit from investors for delivering continually improving financial results post-bankruptcy.

After emerging from Chapter 11, WGII's revenues deteriorated from a high of $4.0B in F2001 to $3.7B in 2002 and $2.5B in F2003. However, the decline in revenues did not impact operating income. Excluding restructuring and reorganization charges, operating income actually increased from $25.2M (0.6% of revenues) in F2001 to $141.7M (3.9%) in F2002 and $150.5M (6.0%) in F2003. The poor margins in F2001 and F2002 resulted from large legacy projects inherited from RECI that achieved minimal to negative margins. Operating income for 1H04 was $63.2M (4.4%). The margins are lower in 1H04 compared to F2003 because of favorable contract incentives, claim settlements and renegotiations that were recognized in F2003, and did not recur in F2004. Also, a $5.0M charge for unexpected costs on an Infrastructure project was recorded in 1Q04, and higher

G&A expense was incurred in 1H04 due to compliance with the Sarbanes-Oxley Act.

WGII has been successfully rebuilding its book of business and its lost market share over the past year and a half. This momentum is reflected in WGII's improving financial position and backlog trend. During 2Q04, new work booked of $882.5M exceeded revenues of $684.5M. This similar trend was repeated during the past seven quarters, resulting in backlog growth from $2.8B at 1/3/03 to $3.5B at 7/2/04 (sequential growth rates ranging from 0.5% to 7.3% per quarter). It is important to note that WGII has achieved this impressive growth organically by building on its own franchise.

2. WGII continues to generate significant cash from operations.

WGII generated $102.3M of free cash flow in F2003 (12% yield). Free cash flow for 1H04 was negative $16.7M, but this was due to $61.5M of working capital increases during the period. The significant amount of working capital was required to commence work in the Middle East, and such levels should not be required in the future. Therefore, management expects positive free cash flow for F2004.

After a couple years of steady cash generation, by 7/2/04, WGII had built its cash balance to $214.1M ($7.90 per diluted share). WGII continues to be debt-free. However, $65.8M of the cash balance is restricted for operations of WGII's joint ventures and for WGII's self-insurance program. Investors have expressed concern for the company to return some cash to investors or find more productive uses of cash in order to improve the company's return on capital. However, management reiterated that it has no intention to reduce its excess cash balance through dividends or share repurchases. WGII thinks that, as it works to rebuild its franchise, it needs this strong cash position and debt-free balance sheet to demonstrate to the marketplace that is now a healthy company with enough liquidity and flexibility to take on significant jobs. It continues to believe that a strong cash balance is needed to successfully bid for business. Cost-type contracts typically require one to two months of funding up front. Also, this positive liquidity position has allowed WGII to renegotiate better credit terms.

So far, WGII's solid liquidity position has allowed it to continue negotiating better terms on its credit facility. On 8/5/04, WGII announced that for the second time this year it has improved the terms of its $350 million credit facility, which had previously been renegotiated in March 2004. The improved terms reduce the cost of the $235M institutional portion of the facility (Tranche B) by 100 bps and extend the Tranche B maturity to August 2008.

Since there is no borrowing outstanding under the credit facility, cash interest costs are comprised of commitment fees and letter of credit fees (required for surety bonds). WGII had previously been paying extremely high fees on its credit facility due to its tainted history. WGII will now save between $9M-$10M in F2004 compared to F2003. As of 7/2/04, $141.8M of letters of credit were issued and outstanding.

3. WGII's impressive diversification provides a unique advantage over its competitors.

The product of a roll-up of over 20 companies, WGII's expertise now stretches across dozens of markets dating back over 100 years. As a result, WGII is extremely diversified and its fortunes are not tied to any single market. WGII addresses its broad markets through six different segments: Power (22% of 2Q04 revenues), Infrastructure (29%), Mining (4%), Industrial/Process (15%), Defense (11%) and Energy/Environment (14%). Furthermore, WGII is viewed as a leader in a majority of these sectors (Infrastructure, Defense, Energy, Power).

4. WGII is seeing increased demand across all business segments.

While some E&C companies have reported weak 2Q04 results relative to expectations, WGII reported 2Q04 profit across all six business segments, and is seeing increased demand in all its sectors, with particular strength in Power, Infrastructure, and Mining.

a. Power. The power business had experienced declines over the past couple of years, due in part to completion of some large RECI power projects, as well as to the downturn in the U.S. power plant market as the economy slumped and excess reserves accumulated. With increased focus on clean air issues, WGII is starting to see improving prospects. In early August 2004, WGII won a number of new jobs in this segment, including a $153M power plant in Puerto Rico, as well as a $16M project for the National Enrichment Facility in Louisiana (both announced early August 2004). WGII is currently pursuing two domestic steam generator projects. There is also an increase in Iraq task orders to help rebuild Iraq's electrical, water, and power systems. Work in Iraq accounted for $75.5M in 1H04, and is expected to continue, with new work of $24.4M from Iraq task orders.

b. Infrastructure. This unit suffered during F2002 due to the company's inability to win new work on par with historical levels during its bankruptcy period. Beginning 2Q03, this segment has ramped up significantly as a result of two large highway projects in NV and CA, and from sizable task orders from

USACOE to help rebuild infrastructure in Iraq, Afghanistan, and Kuwait. Revenues declined from $277.7M in 1Q04 to $199.4M in 2Q04, raising some concern about reduced level of reconstruction activity in Iraq going forward. However, volume should again rise in 3Q04 as $433.9M of new work was booked in 2Q04 compared to $284.3M in the previous quarter. The most significant increase is $300.2M from a new contract to design and build a six-mile-long light rail extension in Los Angeles (WGII is sponsor and 50% participant in this joint venture). The remainder consists of $83.4M of new Iraq task orders as well as $50.3M from new engineering, operations and maintenance and other contracts. Iraq is one of the world most oil-rich nations with one of the least developed infrastructure system. Furthermore WGII has successfully worked with USACOE for over 70 years, dating back to WWI and Vietnam. WGII therefore expects work from that region to continue for many more years. However, WGII is also actively pursuing major opportunities in the domestic market (WA, VA, GA, TX, FL and NV). The new work signed is not yet contributing to revenues as management does not begin to recognize revenues and profits until the project is 20% completed.

c. *Mining*. The mining sector continues to be strong, with continued strong coal demand in Germany and the U.S. Revenues were up 20% Y/Y for 2Q04 with earnings up 26%. Demand in this segment should continue to strengthen as the rising price of precious metals results in increased mining activity. During 2Q04, WGII signed a contract extension with two different mines in Venezuela, (extending through 2005 and 2007). The company is also pursuing a silver/lead/ zinc project in Bolivia, a copper mine in NV and additional opportunities in Jamaica and Western Canada.

d. *Industrial/Process*. Over the past couple of years, this segment has been affected by weakness in the domestic and international economies, causing a reduction in demand and delays in capital spending by Fortune 100 companies. Although management expects capital spending will increase as the economy recovers, the rate of economy recovery is still somewhat uncertain. While this segment remains relatively weak, WGII recently won a $53.2M food processing contract. Management acknowledges that it is still working hard to improve this segment. In the meantime, it has managed to control the unit's costs while waiting for a recovery. The talent within this segment is currently being directed toward the oil & gas and the life sciences markets, which management believes will be the two strongest sectors going into 2005 and beyond. In the oil & gas market, the company is most interested in developing opportunities in the LNG market. WGII also cites an uptick in the pharmaceutical and biotechnology markets, where it hopes to see robust opportunities driven by the growing number of aging Americans.

e. Defense. This segment continues to perform well as WGII continues to be a key player in this market. While slightly down Y/Y, revenues remains at a high level of $118.6M for 2Q04. WGII is in various stages of work on at least four chemical demilitarization sites and has been awarded two new contracts in KY and CO. This business provides long-term work for WGII as it will take until about 2012 to destroy the nation's chemical weapons stockpiles. According to the company, it takes about 3-4 years to build the site, 7-8 years to destroy the weapons and 2-3 to "greenfield" the facilities. The U.S. plans to build 8-9 demilitarization sites so far. During 2Q04, $181.2M of new threat reduction work was booked in new work. The company also performs threat reduction work in the former Soviet Union, and expects substantial opportunities in that region to continue.

f. Energy & Environment. All projects are performing well in this segment. Work flow and demand remain stable. Increased revenue for the quarter resulted from a new decontamination and demolition contract and a large DOE management services contract. During 2Q04, $78M of new work was booked, consisting of $26.7M on energy projects, $40.9M on new DOE management contracts and $10.4 on new commercial operations projects.

5. Stable recurring business base from government contracts enables WGII to weather weakness from cyclical segments.

WGII has a stable, recurring base of business from its government contracts which help buffer against segments such as Industrial and Infrastructure that are more sensitive to economic downturns. Two of WGII's business segments, Defense and Energy, perform work substantially for the U.S. Government. Almost all of the revenues from the Energy segment are from contracts funded by the federal government, with the DOE accounting for 97% of the revenues. During F2003, the DOD accounted for 24% and the DOE accounted for 14% of total revenues. At 7/2/04, government contracts accounted for 36% of total backlog. Furthermore, these government contracts are performed on a cost-plus basis, mitigating the risk of losses due to cost overruns.

WGII has been a key service provider in Defense and Energy work for numerous years. Given its long history with these agencies, its specialized expertise, and the government's current focus on threat reduction and nuclear remediation, we think these areas will remain a priority for the government, and funding should continue in the foreseeable future.

6. Management follows conservative accounting practices.

Earnings are difficult to predict for an E&C company, as the revenue stream is based on the timing of new project wins. Furthermore, recognition of revenues and earnings are based on percentage of progress completed on these projects, as estimated by management. WGII indicates it has a history of making reasonable estimates of its progress toward completion, contract revenue and contract completion costs on its long-term contracts.

WGII defers profit recognition on fixed-price and certain target-priced construction contracts until progress is sufficient to estimate the probable outcome, which generally does not occur until the project is at least 20% complete. Claims recovered occur all the time, but it is impossible to predict the timing of these cash receipts. Therefore, no profit is recognized on claims until work related to the claims have been completed and final settlement is received.

For government cost-plus contracts, indirect (allowable) costs charged to the contracts are subject to audit and renegotiation by the U.S. government. Audits for years up to 2000 are completed, and audits of 2001 allowable costs are underway. Management believes it establishes adequate reserves for estimated allowable costs and does not anticipate any material impact to result from these audits.

Management is also conservative in its reporting of backlog. For instance, work in Iraq for the U.S. Army Corps of Engineers (USACOE) is not included in backlog and is not built into management guidance. Because these jobs are allocated on an "as needed" basis, and given the geopolitical risk, management excludes these amounts in reported backlog. These contracts do not identify a specific quantity of services, but place ceilings on the total amount of work that can be awarded. WGII is currently working on two different contracts, but has won bids on a total of four contracts. Each contract has a work order ceiling of at least $500M plus several one-year options to extend. WGII has already been awarded task orders from these contracts in excess of $550M. However, with the potential "ceiling" of all USACOE contracts totaling $3.1B, there is significant upside opportunity still to come. Furthermore, WGII's reported backlog at 7/2/04 also excludes $1.7B of government contracts in progress in which work is to be performed beyond 2Q06. This figure was only $713M at 1/2/04. The increase is due primarily to modifications of existing DOD contracts.

WGII also manages its guidance conservatively. Over the past five quarters when, WGII has beaten consensus estimates by anywhere from 5% to 111% ($0.1 to $0.30).

7. Other Downside Risks

a. Cost overruns on fixed-type contracts. The inability to collect additional compensation due to cost overruns is a significant risk, but is a risk inherent to all E&C companies. This risk arises primarily from 1) uncertainties inherent in estimated contract completion costs; 2) contract modifications by customers resulting in claims; and 3) failure of subcontractors and JV partners to perform. Of WGII's $3.5B backlog at 7/2/04, 46%, or $1.6B represents fixed-price contracts. Fixed-type contracts accounted for 26% of total revenues for 1H04. WGII's history has certainly proved the devastating impact of this risk. We expect that management, having learned from past experience, will exercise extreme caution in estimating the scope of work required when it bids for fixed-type business. However, there are numerous unforeseen events and conditions that could occur which are outside of management's control.

b. Economic downturn. Unfavorable economic or political conditions could adversely affect the E&C industry as a whole or some of WGII's key markets. However, WGII's strength in numerous diverse markets should lessen the impact of downturns in any one market.

c. Concentration of customer risk. During F2003, approximately 24% of revenues were from the DOD and 14% of revenues were from the DOE. In all, 42% of F2003 revenues were from contracts funded by the U.S. government. At 7/2/04, 36% of the backlog represented government contracts. There is a risk if government funding is reduced. However, due to the high priority placed on homeland security as well as nuclear and environmental concerns, we think government funding should continue.

d. Risks involved with international operations. International operations accounted for approximately 10% of F2003 revenues. WGII's business and financial condition could be adversely affected by: 1) unstable political, economic, financial and market conditions; 2) restrictions on repatriating foreign profits; 3) civil disturbances or acts of terrorism; 4) risk of injury to employees or subcontractors traveling to high security risk countries. Ongoing security issues in Iraq continue to be a very real risk. The cost of providing security for employees in Iraq is substantial. WGII indicated that there could be as many two security personnel to every employee working in Iraq. However, from a financial standpoint, because WGII's work in Iraq is primarily cost-type projects, the burden of the security cost is not directly borne by WGII. The risk is that the significant cost of security is a drain on funding otherwise available for actual construction work.

e. Accounting risk. Substantial portion of WGII's revenues are recognized under the percentage-of-completion method of accounting. Although the financial statements are audited, there is considerable amount of management judgment and subjectivity in the percentage-of-completion estimates. Actual results could differ materially from management estimates, and could result in reduction of previously reported profits.

8. Financial Results and Assumptions

On 8/12/04, WGII reported 2Q04 revenues of $684.5M (8% Y/Y growth), operating income (excluding reorganization credit) of $29.1M (4.2% operating margin) and diluted EPS of $0.49, beating consensus estimates by $0.03.

Management indicated that operating margin for F2004 will not be as robust as the 6% margin achieved in F2003. This is due to some large claims recoveries and contract renegotiations on certain F2003 jobs, which will not recur in F2004. However, management did increase F2004 guidance on all metrics (backlog, new work, revenue, operating income, net income, basic EPS) and provided diluted EPS guidance for the first time at $1.65-$1.83.

We estimate revenues of $2.9B and $3.1B for F2004 and F2005, with diluted EPS of $1.89 and $2.34, respectively. This assumes operating margins of 4.5% and 4.8%, which includes G&A expenses of 2.1% and 2.0% for F2004 and F2005, respectively. G&A expense for 2Q04 was 2.3% of revenues compared to 2.1% in 2Q03 and 1.9% in 1Q04. G&A expenses was approximately $2M higher as a result of costs related to Sarbanes-Oxley compliance requirements. Management expects these costs will decrease in 2H04 and in F2005.

Management also expects contributions from MIBRAG during 2H04 to be lower than 1H04 as MIBRAG's two power plants customers typically undergo outages in 3Q.

With the credit terms improved again as of beginning of August, management expects interest expense to decline to $15-16M for F2004 and a run rate of $14M in F2005 ($10M cash interest and $4M amortization of deferred financing fees). Since there is no borrowing outstanding under the credit facility, cash interest costs is comprised of commitment fees and letter of credit fees required to post surety bonds.

9. Income Tax Savings

For at least the next 10 years, WGII's cash income tax payments will be materially lower than its GAAP taxes. For F2004, WGII expects it will be able to utilize tax goodwill amortization of $61M and NOL carryovers of $77M, meaning it will not pay federal taxes on the first $138M of taxable income, except for a small alternative minimum tax. For F2005 and forward, WGII expects it will not pay federal income taxes on at least the first $88M ($61M goodwill and $27M NOL) of taxable income. The additional $50M deduction for F2004 resulted from unused limitation from F2002 and F2003 that can be carried over into F2004.

The tax goodwill balance arises primarily from the acquisition of RECI and the Westinghouse business. The respective goodwill balances were $634M and $60M at 1/2/04. This tax goodwill will be deductible for roughly the next 10 years. The federal NOL carryovers expire in years 2019 through 2022. WGII also has foreign NOL carryovers ($175M at 1/2/04) most of which are not subject to expirations.

We estimate the present value of the future tax savings to be $7.14 per diluted share. This is based on a 33% tax savings (effective tax rate of 40.5% less assumed cash tax rate of 7.5%) on $138M of taxable income for F2004 and $88M of taxable income for F2005 through F2013, discounted at 10% over 10 years.

Alternatively, using the same tax rate and deductibility amounts described above, we estimated cash-basis diluted EPS for F2004 and F2005 to be $3.27 and $3.41, respectively.

10. Valuation

Based on WGII exceptional earnings improvement, cash generating capabilities, and solid business prospects, we think WGII is undervalued relative to its peers. We think WGII is still perceived as a "problem company" based on its past history. Investors are not giving WGII due credit for having rebuilt its franchise post-bankruptcy. As WGII continues to deliver solid results over the next several quarters, we think the market will start to take notice that WGII is now a healthy, cash-generating company, and WGII's earnings multiples and share price should rise as a result.

On 8/12/04, WGII reported yet another solid quarter, with 2Q04 revenue of $684.5B and diluted EPS of $0.49, beating consensus estimates by $0.03. Since then, WGII's share price has jumped to $34.95 from $32.21. Despite the 9% gain already experienced, we think there is still room for upside. Based on our approach described below, we estimate WGII's 12-month target price to be $49.00, an upside opportunity of approximately 40%.

We valued WGII based on our estimated F2005 EPS, on both a cash-basis as well as a GAAP EPS. We think it is appropriate to consider the cash-basis EPS because WGII derives significant and recurring cash savings from expected tax deductions for goodwill amortization and from use of NOLs, as described in the previously.

Considering these tax savings, we estimate that cash-basis EPS will be $3.41 compared to GAAP-basis EPS of 2.34 for F2005. We use a 14.0x multiple, which represents the average F2005 EPS multiple for WGII's peer group. First, applying a 14.0x multiple to our $3.41 cash-basis EPS resulted in a price of $47.70. We then added $5.31 of excess cash (assumed to be 67% of total cash balance) and arrived at a price of $53.01. Second, applying a 14.0x multiple to our GAAP EPS of $2.34 resulted in a price of $32.70. In this case, we added $5.31 of excess cash per share as well as an estimated $7.14 per share for the present value of future tax savings. This resulted in a share price of $45.15. We averaged the results from these two methods and arrived at a target price of $49.00.

We also note that on an EBITDA basis, WGII is trading at a significant discount to its peer group. The average trailing EV/EBITDA multiple for the peer groups is 9.8x, whereas WGII is currently trading at a mere 4.2x multiple. We argue that WGII should not be trading at such a drastic discount to its peers. If we applied a 6.5x multiple (a slight discount to the peer mean on a forward basis) to our estimated F2005 EBITDA of $170.6M, and add the present value of tax savings, we arrive at a share price of $53.34. However, we will use the more conservative target price of $49.00

11. Projections

INCOME STMT ($000s)	1Q04a	2Q04a	3Q04e	4Q04e	1Q05e	2Q05e	3Q05e	4Q05e
Total Revenue	754,164	684,484	710,007	734,789	757,595	775,506	791,681	804,887
Cost of Contracts	716,775	646,748	668,779	691,258	713,166	729,272	743,313	755,554
Equity Income	-10,680	-7,119	-5,500	-5,558	-6,408	-6,407	-5,775	-5,836
General/Admin.	13,962	15,792	15,620	15,431	15,152	15,510	15,834	16,098
Reorganization Items	0	-1,245	0	0	0	0	0	0
Total Operating Expense	720,057	654,176	678,899	701,130	721,910	738,375	753,372	765,816
Investment Income	594	596	600	600	600	600	600	600
Interest Expense	-4,414	-3,602	-3,938	-3,938	-3,563	-3,563	-3,563	-3,563
Other, Net	-529	-740	-750	-750	-750	-750	-750	-750
Net Income Before Taxes	29,758	26,562	27,020	29,572	31,973	33,419	34,597	35,359
Provision for Income Taxes	12,052	10,758	10,943	11,976	12,949	13,535	14,012	14,320
Net Income After Taxes	17,706	15,804	16,077	17,595	19,024	19,884	20,585	21,039
Minority Interest	-4,640	-2,524	-4,225	-4,202	-4,173	-4,257	-4,342	-4,429
Net Income	13,066	13,280	11,852	13,393	14,850	15,627	16,243	16,610
Basic Weighted Avg. Shs.	25,133	25,216	25,216	25,216	25,216	25,216	25,216	25,216
Basic EPS	0.52	0.53	0.47	0.53	0.59	0.62	0.64	0.66
Diluted Weighted Avg. Shs	27,580	27,111	27,111	27,111	27,111	27,111	27,111	27,111
Diluted EPS	0.47	0.49	0.44	0.49	0.55	0.58	0.60	0.61

Y/Y CHANGE	1Q04	2Q04	3Q04e	4Q04e	1Q05e	2Q05e	3Q05e	4Q05e
Total Revenue	14.7%	7.8%	20.7%	18.3%	0.5%	13.3%	11.5%	9.5%
Cost of Contracts	15.6%	10.2%	25.2%	18.5%	-0.5%	12.8%	11.1%	9.3%
Equity Income	21.9%	9.4%	25.0%	-5.0%	-40.0%	-10.0%	5.0%	5.0%
General/Admin.	38.1%	21.2%	9.9%	-23.5%	8.5%	-1.8%	1.4%	4.3%
Reorganization Items	na	na	na	na	na	na	na	na
Total Operating Expense	15.9%	10.4%	24.0%	18.0%	0.3%	12.9%	11.0%	9.2%
Investment Income	62.3%	28.2%	40.8%	22.2%	1.0%	0.7%	0.0%	0.0%
Interest Expense	-36.4%	-44.1%	-43.0%	-72.1%	-19.3%	-1.1%	-9.5%	-9.5%
Other, Net	624.7%	21.9%	5.5%	5.6%	41.8%	1.4%	0.0%	0.0%
Net Income Before Taxes	0.9%	-25.2%	-19.2%	137.8%	7.4%	25.8%	28.0%	19.6%
Provision for Income Taxes	-6.1%	-31.4%	-14.8%	116.5%	7.4%	25.8%	28.0%	19.6%
Net Income After Taxes	6.2%	-20.3%	-21.9%	154.9%	7.4%	25.8%	28.0%	19.6%
Minority Interest	19.4%	-54.4%	-46.0%	-10.0%	-10.1%	68.7%	2.8%	5.4%
Net Income	2.2%	-7.1%	-7.1%	499.0%	13.7%	17.7%	37.0%	24.0%
Basic Weighted Avg. Shs.	0.5%	0.9%	0.9%	0.8%	0.3%	0.0%	0.0%	0.0%
Basic EPS	2.0%	-7.6%	-7.8%	490.2%	13.3%	17.7%	37.0%	24.0%
Diluted Weighted Avg Shs.	10.2%	7.9%	7.4%	4.7%	-1.7%	0.0%	0.0%	0.0%
Diluted EPS	-7.8%	-14.1%	-14.3%	448.9%	16.5%	17.7%	37.0%	24.0%

% OF TOTAL REVENUE	1Q04	2Q04	3Q04e	4Q04e	1Q05e	2Q05e	3Q05e	4Q05e
Total Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Contracts	95.0%	94.5%	94.2%	94.1%	94.1%	94.0%	93.9%	93.9%
Equity Income	-1.4%	-1.0%	-0.8%	-0.8%	-0.8%	-0.8%	-0.7%	-0.7%
General/Admin.	1.9%	2.3%	2.2%	2.1%	2.0%	2.0%	2.0%	2.0%
Reorganization Items	0.0%	-0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total Operating Expense	95.5%	95.6%	95.6%	95.4%	95.3%	95.2%	95.2%	95.1%
Investment Income	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Interest Expense	-0.6%	-0.5%	-0.6%	-0.5%	-0.5%	-0.5%	-0.4%	-0.4%
Other, Net	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%
Net Income Before Taxes	3.9%	3.9%	3.8%	4.0%	4.2%	4.3%	4.4%	4.4%
Provision for Income Taxes	1.6%	1.6%	1.5%	1.6%	1.7%	1.7%	1.8%	1.8%
Net Income After Taxes	2.3%	2.3%	2.3%	2.4%	2.5%	2.6%	2.6%	2.6%
Minority Interest	-0.6%	-0.4%	-0.6%	-0.6%	-0.6%	-0.5%	-0.5%	-0.6%
Net Income	1.7%	1.9%	1.7%	1.8%	2.0%	2.0%	2.1%	2.1%

INCOME STATEMENT ($000s)	F2003a	F2004e	F2005e
Total Revenue	2,501,151	2,883,443	3,129,669
Cost of Contracts	2,324,802	2,723,559	2,941,305
Equity Income	-25,519	-28,857	-24,426
General/Admin.	57,520	60,805	62,593
Other Op. Income	-6,182	0	0
Reorganization Items	4,900	-1,245	0
Total Operating Expense	2,355,521	2,754,261	2,979,472
Investment Income	1,748	2,390	2,400
Interest Expense	-34,418	-15,891	-14,250
Other, Net	-2,101	-2,769	-3,000
Net Income Before Taxes	110,859	112,912	135,347
Provision for Income Taxes	46,888	45,730	54,816
Net Income After Taxes	63,971	67,182	80,531
Minority Interest	-21,908	-15,591	-17,201
Net Income	42,063	51,591	63,330
Basic Weighted Average Shares	25,007	25,193	25,216
Basic EPS	1.68	2.05	2.51
Diluted Weighted Average Shares	25,322	27,282	27,111
Diluted EPS	1.66	1.89	2.34

Y/Y CHANGE	F2003a	F2004e	F2005e
Total Revenue	-31.7%	15.3%	8.5%
Cost of Contracts	-33.6%	17.2%	8.0%
Equity Income	-16.2%	13.1%	-15.4%
General/Admin.	9.9%	5.7%	2.9%
Other Op. Income	80.8%	na	na
Reorganization Items	-93.5%	-125.4%	-100.0%
Total Operating Expense	-34.5%	16.9%	8.2%
Investment Income	31.8%	36.7%	0.4%
Interest Expense	23.0%	-53.8%	-10.3%
Other, Net	-260.3%	31.8%	8.3%
Net Income Before Taxes	173.6%	1.9%	19.9%
Provision for Income Taxes	79.4%	-2.5%	19.9%
Net Income After Taxes	345.0%	5.0%	19.9%
Minority Interest	0.9%	-28.8%	10.3%
Net Income	-92.5%	22.7%	22.8%
Basic Weighted Average Shares	0.0%	0.7%	0.1%
Basic EPS	-679.3%	21.9%	22.6%
Diluted Weighted Average Shares	1.3%	7.7%	-0.6%
Diluted EPS	-672.4%	13.9%	23.5%

% OF TOTAL REVENUE	F2003a	F2004e	F2005e
Total Revenue	100.0%	100.0%	100.0%
Cost of Contracts	92.9%	94.5%	94.0%
Equity Income	-1.0%	-1.0%	-0.8%
General/Admin.	2.3%	2.1%	2.0%
Other Op. Income	-0.2%	0.0%	0.0%
Reorganization Items	0.2%	0.0%	0.0%
Total Operating Expense	94.2%	95.5%	95.2%
Investment Income	0.1%	0.1%	0.1%
Interest Expense	-1.4%	-0.6%	-0.5%
Other, Net	-0.1%	-0.1%	-0.1%
Net Income Before Taxes	4.4%	3.9%	4.3%
Provision for Income Taxes	1.9%	1.6%	1.8%
Net Income After Taxes	2.6%	2.3%	2.6%
Minority Interest	-0.9%	-0.5%	-0.5%
Net Income	1.7%	1.8%	2.0%