A CAUTIONARY TALE

The UK's second-biggest contractor has posted some pretty alarming figures recently, from its £695m debt to its £845m writedown. But how did it get into this state, how can it get out again, and what does it mean for the wider industry? **Joey Gardiner** reports

When Carillion released its half-year trading update at 7am on Monday 10 July, the City was already braced for bad news. Its joint venture partners on a £745m Scottish road-building project, Balfour Beatty and Galliford Try, had already made big write-downs related to the scheme, and there were reports of delays and problems on other contracts. According to Canaccord Genuity Wealth Management it was the most "shorted" stock in the UK prior to the announcement, meaning investors were already betting against Carillion in order to make money if the share price fell in value.

But the sheer scale of the problems finally admitted to by the £5bn-turnover contracting giant took investors, competitors and the wider industry completely by surprise. Following a review by accountancy firm KPMG, Carillion admitted contract revenues would be £845m lower than expected, that net debt had soared by another £110m to £695m, and that it was exiting the PFI market and parting company with its chief executive, UK buildings boss and three divisional finance directors. Sam Cullen, equity analyst at Jefferies International, says: "People suspected a write-down was coming. But everyone was shocked just at the scale of it."

While interim chief executive Keith Cochrane pointed to the firm's continued success in winning work and "great capabilities", analysts were united in concluding that Carillion needed an urgent injection of equity of £400m-600m. However, given the subsequent 70% collapse in the share price, there is no obvious route to get it. Suddenly, from the presumption it was simply going to join the long list of contractors to be beleaguered by a few underperforming contracts, the UK's second biggest construction firm could be facing a threat to its very existence. The impact on the supply chain of it actually going under, given its sheer scale, makes it a problem for the whole industry. Steve Beechey, group strategy director at rival contractor Wates, says: "Suddenly Carillion is on everyone's agenda. It's the talk of board meetings across the industry. It's big news."

So, how did it get into this situation, can it get out of it, and what does it mean for the rest of the industry?

Big news

In some ways Carillion's shock announcement just makes it the latest of a very long list of UK contractors to report financial woes on the way out of a recession longer and deeper than anyone had expected. Already this year Galliford Try and Skanska have revealed problems, following the likes of Balfour Beatty, Kier, Sir Robert McAlpine, Vinci and ISG. But with a writedown of £845m, Carillion has been saving the biggest till last. The firm said it stemmed from its £2bn-turnover construction business, and primarily related to difficulties getting paid what it expected. About 40% of the figure – £375m – related to the UK, and the rest – £470m – to the Middle East and Canada. Jefferies' Cullen says: "It's classic problems we've seen with contractors, such as carrying out work without agreeing cost or value. But with Carillion it's on top of a balance sheet already layered with debt."

Richard Howson stepped down as chief executive of Carillion last month

However, the predicted £900m average net debt for the second half of the year is not its only balance sheet difficulty, as it also has a pension fund deficit of £587m, and a £400m-plus debt facility set up to pay its supply chain early. This leaves – according to Cenkos analyst Kevin Cammack – shareholders' funds of just £300m. Cammack says this "is simply unsustainable as a structure and a risk profile" for a £5bn-turnover business, meaning it needs new equity to prop up the balance sheet – and fast. Cammack thinks the firm has until the end of the year to come up with a plan, while Cullen says it needs to act even more quickly – by the time of half-year results in September. Carillion has promised to report on a strategic review it has commissioned from accountant EY by that time, for which interim chief executive Cochrane said: "nothing is off the table." Stephen Rawlinson, analyst at Applied Value, says: "The share price is now arguably a sideshow, at present, as the average net debt, supplier early payments and the £600m pension deficit will govern survival."

Aggressive expansion

While quick action is needed, analysts and peers say the firm's problems have had a long gestation. After being formed from the construction arm of Tarmac in 1999, Carillion set about moving quickly into the higher value support services arena. However, the 2006 purchase of struggling contractor Mowlem for £313m, which necessitated a £90m writedown due to unforeseen problem contracts, set the tone for aggressive acquisition-led expansion, which saw it spend £572m on a hostile takeover of Alfred McAlpine just two years later. While this saw it take more than £200m in net debt onto its balance sheet, selective sales of some of its operating businesses and buoyant contracting revenues retrieved the position, right until its 2011 purchase of energy services business Eaga for £298m.

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STEVE BEECHEY, WATES

Eaga, rebranded Carillion Energy Services, was quickly hit hard by government changes in renewables subsidies and within six months of purchase Carillion was spending £40m "restructuring" the business fit for a less ambitious future. Cammack describes the value for money for shareholders of both the Mowlem and Eaga purchases as "miserable", but most important was what they did to the firm's balance sheet. By 2012 Carillion again had more than £200m of debt on the books, but with a deepening recession forcing the firm to shrink its construction business, there was no organic way to bring cash back in. One rival listed contractor chief executive says: "The rot started with the Eaga deal. Everyone had bad jobs, but this took £300m off the balance sheet."

Against this backdrop, Carillion sought expansion in the Middle East, where it had already worked successfully for years alongside local partners in Oman and the United Arab Emirates. This time the target was the booming Qatari economy, where in 2011 it picked up a prized project – Msheireb Properties' £395m Downtown Doha regeneration scheme, which Msheireb describes as "the world's first sustainable downtown regeneration project, »

» designed to regenerate and preserve the historical heart of Doha" seemingly vindicating the strategy.

After last month's writedown announcement, of which £325m related to the Middle East, the venture looks like a high-stakes gamble that went spectacularly wrong. Cullen says: "Going into Qatar in 2011 was a risk. Getting paid in the Middle East is often difficult." The Downtown Doha scheme is pointed to by several analysts as being the cause of Carillion's Middle Eastern problems, with Rawlinson saying he understands that "the Msheireb project accounts for a large portion of the outstanding cash owed to the company." Carillion has said only that much of the Middle Eastern losses stem from one contract, and Msheireb Properties said it "does not comment on speculation".

Squeezing the pips

In the UK, Carillion has for years been reporting healthy contracting margins, but here too the chickens have come home to roost. Accounting rules allow contractors some leeway in exactly when they book revenue and profit on jobs, and former Balfour Beatty UK construction chief executive Mike Peasland says Carillion had always been seen by peers as on the aggressive side in this sense. "While everyone else has struggled in recent years Carillion has kept on going at a decent margin. It looks like they've been squeezing the pips and they've been found out." Carillion declined to comment on whether it had been too optimistic in the way it accounted for projects, but Cochrane told analysts it had made the provision now because of the scale of deterioration of cash coming in, and following "dialogue with customers we've experienced in recent weeks."

Carillion says the UK problems largely relate to three PFI projects, which again it has declined to name. However, they are widely understood to be the Aberdeen Western Peripheral Route, the Royal Liverpool hospital project and the Midland Metropolitan hospital project. While none of the clients will comment on the extent of cost rises on the jobs, all of the projects have seen delays of at least six months due to unforeseen construction issues (see Carillion's possible problem projects, opposite). Ex-Balfour chief executive Peasland says it is not surprising, therefore that costs are adding up: "On PFI projects liquidated damages for delays can commonly be hundreds of thousands of pounds a week. And with your additional site costs, that can easily turn into half a million. It doesn't take long to rack up." Carillion is now withdrawing from bidding for PFI projects, and in its presentation to analysts admitted it had allowed projects to go ahead with "a high degree of uncertainty around key assumptions" and where its success was "contingent on the performance of others not under our control."

THE FACT IS IT'S TOO BIG TO FAIL. YOU'D BE A BRAVE BUSINESS SECRETARY TO LET IT FALL OVER
MIKE PEASLAND, BALFOUR BEATTY UK

Tricky situation

All of which leaves Carillion in a difficult situation. The crash in its share price gives the business a current market value of just £250m at the time of going to press, meaning in practical terms it can't call on shareholders to give it the half a billion it needs. But, according to Cammack, its borrowing comes from a range of different banks, meaning negotiating a debt-for-equity swap with its banks could be fiendishly difficult. Meanwhile attempting to shrink the business to a size more appropriate to its balance sheet would suck cash out, meaning that can't be done quickly.

Which leaves the option of other outside investors either buying the whole business or carving it up and taking constituent elements. But purchasers may be put off by the size of the pension fund deficit, with the firm already paying £50m a year to the fund, and a "triennial review" ongoing to determine if that figure needs to be increased. The chairman of the pension fund trustees, Robin Ellison, declined to comment when asked whether the fund would seek a share of any equity raised by Carillion. But Rawlinson said: "Unless the pension trustees make clear their position investors will not invest just to see their new money be absorbed by the pension [...] the pension issue could be crucial in the months to come." Carillion declined to say whether the pension fund trustees would seek extra money in the triennial review, but group finance director Zafar Khan told analysts "any future [pension] recovery plan will clearly need to take into account our current balance sheet position."

Besides this, few of Carillion's UK peers look in the right shape to attempt such an acquisition anyway. Overall, Cullen concludes it is "a bit of a zombie company" in its current shape, and Cammack says this combination of factors makes it "virtually impossible" to put a value on the company until the balance sheet is secured.

In the meantime, there is the risk the firm will lose senior operational staff concerned about their future in the business. The rival plc chief executive says: "The CVs of people from Carillion are all over the place. It's not a flood yet but it's a constant flow." Another senior executive at a rival says: "At the level below the top leadership, we've been flooded with CVs." Cammack says this is a concern, as it is experienced Carillion executives who have the best chance of negotiating reasonable settlements of contracts. "We don't want a blood-letting of senior people. These are the people they need." Carillion declined to comment on whether it was concerned about the possibility of losing experienced staff.

GEOPIC / ALAMY STOCK PHOTO

Right: The Royal Liverpool hospital PFI project has been delayed for a year
Far right: Carillion picked up the Downtown Doha regeneration project in 2011

CARILLION'S POSSIBLE PROBLEM PROJECTS

Chief executive Keith Cochrane told analysts that four individual projects were responsible for about half of the total £845m contract provision. He said one stemmed from the Middle East, and three were PFI projects in the UK, though he declined to identify the specific contracts, saying it would jeopardise Carillion's chances of getting what they believe they're owed. However, there are three obvious contenders for which UK jobs are the guilty parties. These are:

■ **The Royal Liverpool hospital PFI project**, worth £335m. The Royal Liverpool and Broadgreen Hospital Trust said in March that opening of the Hospital had been delayed by a year from summer this year to summer 2018. At the time, a Carillion spokesperson blamed the discovery of more asbestos than anticipated, poor weather, and cracks found above beams in the building, requiring remedial work. "We are disappointed that the opening of the new Royal Liverpool hospital has been delayed," the spokesperson added.

■ **The Aberdeen Western Peripheral Route and Balmedie-Tipperty road**, together worth £745m under a PPP deal in joint venture with Balfour Beatty and Galliford Try. The Scottish government revealed in December 2016 that opening of the Balmedie-Tipperty road was being delayed by almost a year from spring 2017 to winter 2017/18, because earthworks could not be completed before the winter period.

■ **The Midland Metropolitan hospital PF2 project**, worth £430m. In May, Sandwell and West Birmingham NHS Trusts admitted that delays to M&E work meant the building's opening would be delayed from October 2018 to "early spring" 2019, with an exact opening date to be confirmed this summer. Carillion project director, David Hollywood, said at the time: "The mechanical and electrical (M&E) design, which covers building systems such as heating, lighting and ventilation, is behind schedule and we are working closely with the Trust and our specialist design consultant to complete the M&E design and confirm a new completion date."

The clients of these buildings declined to comment to Building on what impact the delays had had on project costs, because under PFI deals, all cost increases are absorbed by the PFI consortiums themselves.

In terms of the Middle East, several analysts spoken to by Building believe the problem project is the £395m Msheireb Properties Downtown Doha scheme. A spokesperson for Msheireb Properties said the firm did not comment on speculation.

There have also been suggestions Carillion has faced difficulties on the £400m Battersea Power Station project and the Sheffield Tram-Train project, on which Network Rail's budget has increased from £15m in 2012 to £75m today. Battersea Power Station's chief executive Rob Tincknell recently told Building Carillion had "done a brilliant job" on the contract but said he did not know if the contractor had made money.

Carillion declined to comment on any specific schemes.

Good news

Despite all of this, there are number of factors in Carillion's favour that mean there are fortunately few – if any – in the sector who think the firm will ultimately fall. Most obviously, there is the quality of its support services business, which makes up half its income and three-quarters of its profit, and where revenue is secured for many years ahead, with no major contract renewals until 2019. In addition, there is no immediate risk of it breaching banking covenants, and its four big problem contracts are all within 18 months of completion.

ROBERTHARDING / ALAMY STOCK PHOTO

But even more important is the sheer scale of the business, which makes it in the interest not only of the industry but of the government too that it survives. Carillion is one of the 30 named "strategic suppliers" that government most relies on to deliver its services and is a linchpin of an industry worth nearly 10% of GDP.

"The fact is it's too big to fail," says Peasland, while Jefferies' Cullen says: "You'd be a brave business secretary to let it fall over." Since Carillion's announcement, two major government contracts have been awarded to the firm – a £158m facilities management contract for the Defence Infrastructure Organisation, and £1.4bn worth of HS2 work in joint venture – which has been seen as a sign of government support. Mark Farmer, founder of consultant Cast, says: "The selection process would have pre-dated this news. But someone has taken a conscious decision to award contracts that could have been delayed. It's the right thing to do politically."

Consequently, while it has been reported that major customer BT Openreach is investigating whether Carillion will be able to fulfil its £1.5bn contract, there have been few signs of customers or suppliers walking away from the business. One specialist who is a significant supplier to the firm told Building that "It's an amber light at the moment, but it's not a red light." Another major customer said it was not reducing business with the firm at the moment: "We are concerned, but Carillion is doing everything it can to make us feel comfortable."

The analysts' consensus is that Carillion – which has already announced cost cutting measures, cancellation of the dividend and the sale of £125m of its businesses to bring in cash – will devise a plan to slowly rebuild its balance sheet – probably by calling on both shareholders and lenders. Rawlinson says: "We remain positive that Carillion will avoid the fate of Jarvis, Spice, Connaught and others but it will take time and an early accommodation with the banks and some customers." For his part, Carillion's Cochrane says he intends to "simplify" the business and remains positive given Carillion's "good market positions, great capabilities and excellent people. However, we must look afresh at the way we operate, [and] learn the lessons of our recent challenges."

This doesn't mean its problems won't impact the sector. Peasland says: "It's a bit of a disaster anyway. People will look at the industry and say 'if it can happen to them then it can happen to anyone.'" It also, he says, raises questions about the sustainability of the current PFI model.

For Cast's Farmer, however, the whole sorry tale has a wider significance, symptomatic of an industry in trouble. "This reinforces the idea that the contracting business model looks increasingly broken," he says. "Managing contracts to lump-sum fixed prices is increasingly risky. Ultimately, the ability for contractors to take risks on behalf of their clients and offer them an outcome looks compromised." Whether Carillion's travails will act as a wake-up call to others remains to be seen.