Advisory

Project Poseidon
Phase 2 - monitoring (August 2018 results)

Strictly Private and Confidential

8 November 2018

pwc

Scottish Government
Scottish Procurement
5 Atlantic Quay
150 Broomielaw
Glasgow G2 8LG

[redacted]

[redacted]

Dear Sirs

We report on Ferguson Marine Engineering Limited (the "Company" or "FMEL") in accordance with our agreement dated 27 November 2017.

This report has been prepared in connection with the set out purpose as stated in the engagement letter. All sections of the report should be read together.

Save as described in the agreement or as expressly agreed by us in writing, we accept no liability (including for negligence) to anyone else or for any other purpose in connection with this report, and it may not be provided to anyone else.

Yours faithfully

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
141 Bothwell Street, Glasgow, G2 7EQ
T: +44 (0) 141 355 4000
F: +44 (0) 141 355 4005

Contents

Summary

August 2018 was behind budget due to the cash constraints which meant that materials were not on site, staffing levels were low and productivity was lower than expected.

Management has presented a reforecast for the costs to complete 801/2 which highlight a further £6.9m cash cost compared to the May 2018 reforecast.

Summary of key points

August 2018 performance

- Management continues to report against the February 2018 budget.
- Against this budget, it has continued to be significantly behind the projected revenue level (£11.2m for the year to 31 August 2018), due to delays on 801/2 and due to not winning new work. However, performance is broadly on track with the recent reforecast.
- Management has been very positive about winning new work but recent publicity and overdue accounts have caused problems in securing these orders.
- Recruitment has continued and workforce levels are now approaching the budgeted level for August. Management believes it needs to recruit c.40 employees over and above the budgeted level in order to meet its delivery targets.

801/2

- Despite the delays, management is confident of meeting the latest delivery dates for 801/2.
- SG's operational expert believes management can recover the lost ground.
- Transport Scotland advise CMAL has concerns on the deliverability of these dates.

Funding

- FMEL has drawn down funds in advance of the funding actually required in its projected cash flow on the basis that management prefers to have control over the funds. An illustration of the funds draw against the loan agreement is outlined on slide 11.
- [redacted]
- CBC has stated that it will require the terms of the June loan agreements to be amended before it will invest the sums it is now required to.
- We have supported SG in its continuing discussions with CBC and do not repeat the detail of any of these discussions in this report.
- These discussions have included: status of new orders, revised financial projections, amendments to bonding arrangements, availability of funding to support trading in the short term, implications of CBC not meeting its obligations under the loan agreements, and options for SG.
- SG met with CBC to discuss the way forward and CBC has submitted a proposal to amend the loan agreement with SG. CBC is now awaiting SG's response.

Information

The table opposite sets out the monitoring information that management is required to provide under the loan agreement, together with our comment on whether it has been received.

Info. received	June-18	July-18	Aug-18
Personnel changes	Y	Y	Y
Profit & loss	Y	Y	Y
Balance sheet	Y	Y	Y
Cash flow statement	Y	Y	Y
P&L comparison v budget	Y	Y	Y
BS comparison v budget	Y	Y	Y
CF comparison v budget	Y	Y	Y
801/2 build report	Y	Y	Y
801/2 cost over runs	Y	Y	Y
Permitted fees	Y	Y	Y

Profit and loss account

The table opposite compares the actual profit and loss account for August 2018 to the February 2018 budget provided by management.

Management note that the comparison is still being made to the February 2018 budget rather than the September reforecast.

Profit & loss account: August 2018

£ in ms	Note	Actual	Budget	Variance
801/2 revenue	1	2.5	3.9	(1.4)
Other revenue	2	0.1	1.6	(1.5)
Gross margin	**3**	**(0.1)**	**0.4**	**(0.5)**
Selling, general and administrative		(0.2)	(0.2)	-
Addback depreciation		0.1	0.1	-
EBITDA		**(0.2)**	**0.3**	**(0.5)**
Exceptional items		(0.2)	(0.1)	(0.1)
Interest	4	(0.4)	(0.2)	(0.2)
Depreciation		(0.1)	(0.1)	-
Net profit		**(0.9)**	**(0.1)**	**(0.8)**

1. Revenue – continues to fall further behind budget mainly due to 31k fewer 801/802 hours being booked (£0.9m): the balance of £0.5m relates to materials.

Management notes that it is comparing to the February budget rather than the September reforecast which shows 801/2 revenue of £2.0m in August 2018.

The following staff numbers at the end of August have been provided:

- Permanent 162 (July: 166)
- Temporary 138 (July: 123)
- Contractors 58 (July: 32)

Management has tried to recruit as many as possible directly as this is considerably cheaper.

[redacted]

[redacted]

3. Gross margin – Management had budgeted that gross margin would be £0.4m in August as the work on 801/2 and on other new orders would mean that more overheads had been recovered than had been incurred. However, as work volume has not been high, the forecast over recovery has not occurred.

Over and under recovery of overhead is essentially a smoothing of overheads across the financial year. If there is a continued under-recovery, a large cost will be built up that will have to be incurred towards the year end. In the year to date, the under-recovery is £1.0m.

Management's latest projections forecast an increased loss on 801/2 due to e.g. increased bonding costs. These costs could be expected to spread across the year.

4. Interest – Management calculates interest based on weeks rather than on daily accrual. This may result in their accrual not exactly matching the charge under the loan agreement, however the difference is not likely to be significant on a month by month basis.

Profit and loss account year to date

The table opposite compares the actual profit and loss account for the year to date as at August 2018 to the February 2018 budget provided by management

Profit & loss account: August 2018 year to date

£ in ms	Note	Actual	Budget	Variance
801/2 revenue	1	19.7	28.3	(8.6)
Other revenue	2	1.7	4.3	(2.6)
Gross margin	**3**	**(0.8)**	**0.9**	**(1.7)**
Selling, general and administrative		(1.6)	(1.6)	-
Addback depreciation		0.7	0.7	-
EBITDA		**(1.8)**	**0.0**	**(1.8)**
Exceptional items		(0.9)	(0.6)	(0.4)
Interest	4	(1.8)	(1.5)	(0.3)
Depreciation		(0.7)	(0.7)	-
Net profit		**(5.2)**	**(2.8)**	**(2.4)**

The table above shows the cumulative impact of the variances reported each month on the trading performance for the year to date compared with the February 2018 budget.

1. Revenue for 801/2 is £8.6m behind budget and management has largely attributed that to pushing out work in the first half of the year when cash was constrained.

2. Other revenue is £2.6m behind budget as other fabrication work has not been won.

3. Gross margin is £1.7m behind budget £1.0m relates to other fabrication work and therefore £0.7m relates to 801/2.

4. **Interest** is £0.4m behind budget as the second loan was not forecast to be required.

The year to date performance is much more closely aligned to the reforecast (as set out on the appendices) which was being prepared in the month of August and was presented in September.

Balance sheet

The table opposite compares the actual balance sheet for August 2018 to the February 2018 budget provided by management.

Balance sheet: August 2018

£ in 000s	Note	Actual	Budget	Variance
Intangible assets		318	154	164
Tangible fixed assets	1	17,779	18,500	(721)
Total non current assets		**18,097**	**18,654**	**(557)**
Inventory		38	-	38
Accounts receivable		349	170	179
WIP	2	8,822	5,405	3,417
Prepayments and other debtors	3	2,061	1,430	631
Accounts payable	4	(4,293)	(4,800)	507
Accruals & other creditors	5	(2,950)	(2,600)	(350)
Total Net Assets (before funding items)		**22,124**	**18,259**	**3,865**
Cash & cash equivalents		8,189	3,455	4,734
SG loan	6	(28,314)	(16,963)	(11,351)
Cash collateral		4,908	4,500	408
Total Net Assets		**6,906**	**9,251**	**(2,345)**

1. **Tangible fixed assets** – Spend on fixed assets is £0.7m (July: £0.6m) behind budget due to cash constraints.

[redacted]

3. [redacted] due to an increase in VAT recoverable.

4. **Accounts payable** - £0.3m greater than forecast due to significant cash constraints with older invoices paid subsequent to the month end. Further commentary is provided on page 10.

5. **Accruals and other creditors** – The budget accruals are based on the November 2017 accruals. The actual balance is behind forecast due to less than budgeted overtime hours as a result of the continued delay of the launch of 802.

6. **SG loan** – The forecast did not account for the loan drawdown of £6.0m at the end of June 2018, the drawdown of £5.0m in August 2018 and the associated interest. A further drawdown of £5.0m was made in September 2018.

Medium term cash flow

The table opposite summarises the indirect cash flow of FMEL for August 2018.

Cash flow August 2018

£ in 000s	Note	Actual	Budget
EBITDA (excluding exceptionals)		(200)	300
Exceptionals [redacted]			
Cash from trading		**(382)**	**230**
Movement in working capital	2	(2,607)	2,900
Operating cash flow		**(2,989)**	**3,130**
Purchase of fixed assets		(40)	(167)
New loans drawn	3	5,000	-
Increase/(decrease) in cash and cash equivalents		**1,963**	**2,963**
Opening balance		6,221	570
Closing balance	4	8,184	3,533

[redacted]

2. **Movement in working capital – the** net effect of the variances set out on the balance sheet page of this report. The key driver is an increase in with WIP balance of £3.4m which is due to a number of pre-payments.
3. **New loans drawn** – a new loan of £5.0m was drawn in August 2018. £6.0m was drawn down on 13 September 2018 (the period following this monitoring report).
4. **Closing balance –** The £8.0m balance at the end of the month appears high. Management made payments of £5m to suppliers and payroll of c.£1m in September and £5.0m of the loan was drawn down. Management has stated it prefers to have control over the funds available to it and so prefers to draw down funds when possible. This is reasonable and we can appreciate that management would require a cash buffer.

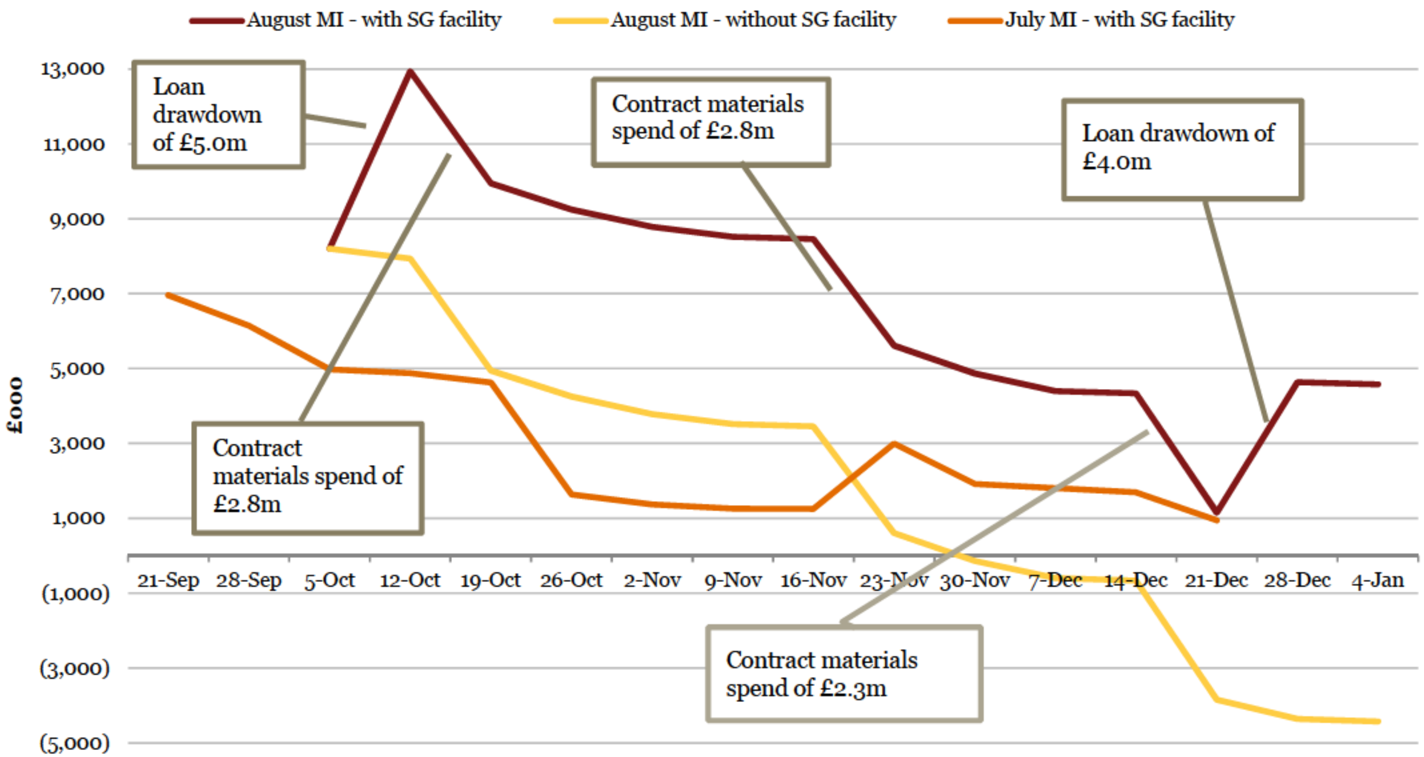
Summary of milestones

Milestone	Amount (£000)	Per Aug 17 IBR	Per Feb 18 Budget	Per May 18 Reforecast	Per Sep 18 Reforecast*
801 Delivery	4,850	Jun-18	Mar-19	Jun-19	Jun-19
802 100% fabrication	1,200	Oct-17	Oct-18	Mar-19	Mar-19
802 Hull inspection prior to paint	1,200	Nov-17	Oct-18	Mar-19	Mar-19
802 Berth join up	1,200	Nov-17	Dec-18	May-19	May-19
802 Launch	1,200	Nov-17	Dec-18	May-19	May-19
802 Delivery	4,850	Aug-18	Jun-19	>Dec 20	Mar-20

*We understand that CMAL has expressed concern on the deliverability of the Sep-18 milestone dates.

Short term cash flow forecast

The graph shows the short term cash flow forecast (provided by management on 2 October 2018) compared with the previous short term cash flow (provided by management on 14 September 2018) and the 2 October cash flow with no further draw downs.



£6.0m was drawn down on 13 September 2018 (the week before the period of the STCF).

Management forecasts to make two further drawdowns in the period of the short term cash flow: £5.0m and £4.0m in week ending 12 October 2018 and week ending 28 December 2018 respectively.

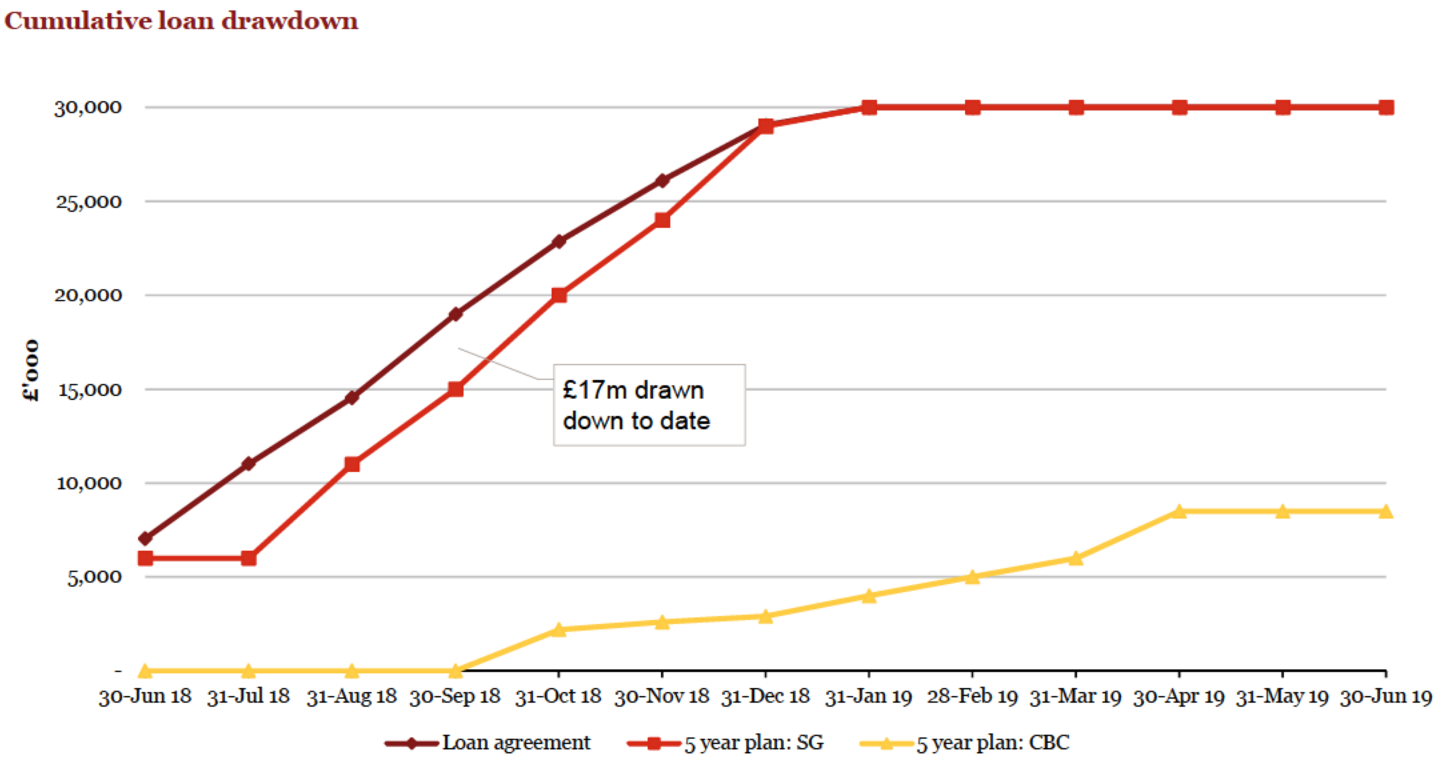
Management has submitted a the request for the £5.0m draw down but has not yet followed this up with SG.

These drawdowns allow the business to retain a positive cash balance in the forecast period.

Cumulative loan drawdown

The graph shows the cumulative loan drawdown as projected in the loan agreement in the latest projections.

The projections show the funding to be below the maximum per the loan agreement.



As at 30 September 2018, FMEL had drawn down £17m of the £30m SG loan. This is within the maximum cumulative drawdown limits per the loan agreement.

[redacted]

801/2 build report

The table opposite compares the contact costs in November 2017 to August 2018.

Vessel contract costs

£'000	Nov 17 801 total	Nov 17 802 total	Nov 17 801/802 Total	August 2018 801 total	August 2018 802 total	August 2018 801/802 Total	Variance Total
Total contract costs paid to date	48,614	33,222	**81,836**	55,561	36,753	**92,314**	(10,478)
Total costs to completion	-	-	**29,872**	15,590	28,147	**43,737**	(13,865)
Total contract costs	**48,614**	**33,222**	**111,708**	**71,151**	**64,900**	**136,051**	**(24,343)**
Paid to date	42,647	37,222	**79,869**	44,294	40,013	**84,307**	(4,438)
Payments to completion	6,353	11,778	**18,131**	5,006	9,287	**14,293**	3,838
CPIs	9,294	5,448	**14,742**	-	-	-	14,742
Total payments	**58,294**	**54,448**	**112,742**	**49,300**	**49,300**	**98,600**	**14,142**

[redacted]

Direct labour hours to date are:

- 801: 782k out of 940k; and
- 802: 250k out of 660k.

Operational expert comments

SG's operational expert noted in his last quarterly report dated 4 October 2018 that:

[redacted]

- Despite the minor slippage his overall impression is of a well motivated workforce with recruiting going well. There are 2 key ship manager posts due to be filled at the end of October and this should further improve overall project management and supervision.
- He had no significant concerns on progress on ferries 801 and 802.
- As far as sustainability of FMEL is concerned the adverse publicity has the potential to severely affect their ability to win future work.
- He remained confident that an operational date of July 2019 can be achieved for 801 and that 802 will be launched around the same time.

Appendix 1

The table opposite sets out the monitoring information that management is required to provide under the loan agreement for all months we have prepared a monitoring report.

Info. received	Sep- Nov 17	Dec-17	Jan-18	Feb-18	Mar-Apr 18	May-18	June-18	July-18	Aug-18
Personnel changes	Y	*	*	N	Y	Y	Y	Y	Y
Profit & loss	Y	Y	Y	Y	Y	Y	Y	Y	Y
Balance sheet	Y	Y	N	*	*	*	*	Y	Y
Cash flow statement	Y	Y	N	N	Y	*	*	Y	Y
P&L comparison v budget	Y	Y	Y	Y	Y	Y	Y	Y	Y
BS comparison v budget	*	N	N	N	*	*	*	Y	Y
CF comparison v budget	*	N	N	N	*	*	Y	Y	Y
801/2 build report	Y	*	*	N	*	Y	Y	Y	Y
801/2 cost over runs	N	*	*	N	*	Y	Y	Y	Y
Permitted fees	Y	Y	N	N	Y	Y	Y	Y	Y

* Please see the relevant monthly report for our comments on the differences between the information requested and the information received.

Appendix 1

The table opposite sets out the February 2018 budget used for monitoring purposes together with the September 2018 reforecast provided by management.

Profit & loss account: August 2018 year to date

£ in ms	Reforecast	Feb budget	Actual
801/2 revenue	15.2	28.3	19.7
Other revenue	2.0	4.3	1.7
Gross margin	**(0.9)**	**0.9**	**(0.8)**
Selling, general and administrative	(1.6)	(1.6)	(1.6)
Addback depreciation	0.7	0.7	0.7
EBITDA	**(1.7)**	**0.0**	**(1.8)**
Exceptional items	(0.9)	(0.6)	(0.9)
Interest	(1.8)	(1.5)	(1.8)
Depreciation	(0.7)	(0.7)	(0.7)
Profit/(loss) retained	**(5.1)**	**(2.8)**	**(5.2)**

As would be expected, the reforecast year to date is almost exactly in line with the actual trading. The only significant difference is that c>£5m of revenue has been recognised earlier for 801/2 than was included in the reforecast. This is a timing difference and, as can be seen, does not significantly impact profit as 801/2 is treated as break even at product margin level in the management accounts.