Advisory

Project Poseidon
Phase 2 - monitoring (September 2018 results)

Strictly Private and Confidential

30 November 2018

pwc

[redacted]

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

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.

We previously issued this report in draft with highlighted specific queries which would require the report to be amended. Management has not answered these queries so we have left them outstanding and market in red in this report. We have not amended the date of this report as the above information has not been received.

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

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Summary

801/2 is behind but management has not amended the delivery dates for 801/2 as it believes the slippage can be recovered. Labour hours are noted to be below September reforecast for the year to date.

Further work is being won (an air cushioned barge with forecast revenues of £3.8m) but is not yet being delivered. Management remain confident of additional work wins.

Funding is now critical. Management forecasts that funds will run out in the week ending 21 December unless there are additional loan drawdowns.

This monitoring report is based on the information provided in the September management information pack. On 29 and 30 November 2018 management provided us with revised cash flows and noted matters that would require [redacted]

Summary of key points

September 2018 performance

- Management has not produced comparable complete MI for its latest reforecast (balance sheet or indirect cash flow) but our analysis of trading shows that it is already behind the September 2018 reforecast by £0.3m in terms of net profit. In addition, Management's reporting pack for September contained year to date figures which do not reconcile to previous information. This has been queried with Management.
- The result is due to staffing levels below those required (by c.80 full time equivalents) , as management has struggled to identify sufficient skilled labour at an economic price, although management's efforts are raising staff levels back up. Whilst staffing levels were below target in September, as noted on page 6, significant recruitment has taken place in October to address the shortfall and as noted on page 13, the operational expert believes the 801 delivery date is still achievable.
- Non 801/2 work is £0.2m behind year to date reforecast but there has been a recent signed contract for a £3.8m win and management believes others will follow.
- [redacted]

801/2

- Management is still retaining the stated delivery dates. SG's expert notes some recoverable slippage and use of 'slack' in the build plan. TS notes CMAL is less confident on the delivery dates being met.

[redacted]

Funding

- An updated short term cash flow for the period to the week ending 1 March 2018 was provided on 27 November 2018. With no further support from SG, cash is forecast to run out in the week ending 21 December 2018.
- We note SG is continuing its discussions with CBC to try to resolve the funding issues, with our support. Given the immediate cash requirement, these discussions need to be accelerated.
- The 2018 statutory accounts have not yet been filed. All fieldwork is completed and we understand that [redacted] local team and FMEL have agreed a draft of the accounts. [redacted] now subjecting the draft accounts to further, more senior review, given the going concern risks.

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	July-18	Aug-18	Sept-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 September 2018 to the February 2018 budget provided by management, and to the September reforecast.

Profit & loss account: September 2018

£ in ms	Note	Actual	Feb budget	Variance	Reforecast	Variance
801/2 revenue	1	5.4	5.8	(0.4)	6.2	(0.8)
Other revenue	2	0.1	1.4	(1.3)	0.3	(0.2)
Gross margin	**3**	**(0.2)**	**0.5**	**(0.7)**	**0.1**	(0.3)
Selling, general and administrative		(0.2)	(0.2)	-	(0.2)	-
Addback depreciation		0.1	0.1	0.0	0.1	-
EBITDA		**(0.3)**	**0.4**	**(0.7)**	**0.0**	**(0.3)**
Exceptional items		-	(0.1)	0.1	(0.1)	0.1
Interest		(0.3)	(0.2)	(0.1)	(0.3)	(0.0)
Depreciation		(0.1)	(0.1)	-	(0.1)	-
Net profit		**(0.7)**	**0.0**	**(0.7)**	**(0.4)**	**(0.3)**

1 – 801/2 revenue is £0.4m behind budget and £0.8m behind reforecast as management has not been able to recruit sufficient labour. Actual hours show a shortfall against budget and reforecast (Actual: £26k, Reforecast £35k, Budget £49k).

However, staff numbers are increasing month by month. The following staff numbers at the end of October have been provided:

- Permanent 168 (August: 162)
- Temporary 132 (August: 138)
- Contractors 75 (August: 58)

Management have not reported any changes to key personnel in September 2018.

[redacted]

[redacted]

4 – Gross margin would be expected to be £nil as almost all work is on 801/2 which has zero margin. It is £(0.2m) as there has been an under-recovery on direct labour overheads i.e. there has been insufficient work on 801/2 to fully recover the fixed element of overheads.

Profit and loss account year to date

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: September 2018 YTD

£ in ms	Note	Actual	Feb budget	Variance	Reforecast	Variance
801/2 revenue	1	25.1	34.1	(9.0)	21.4	3.7
Other revenue	2	1.8	5.7	(3.9)	2.3	(0.5)
Gross margin	3	**(1.0)**	**1.4**	**(2.4)**	**(0.9)**	(0.1)
Selling, general and administrative		(1.8)	(1.8)	-	(1.8)	(0.0)
Addback depreciation		0.8	0.8	0.0	0.8	-
EBITDA		**(2.0)**	**0.4**	**(2.4)**	**(1.8)**	**(0.2)**
Exceptional items		(0.9)	(0.7)	(0.2)	(0.9)	0.0
Interest		(2.1)	(1.7)	(0.4)	(2.0)	(0.1)
Depreciation		(0.8)	(0.8)	-	(0.8)	-
Net profit	4	**(5.9)**	**(2.8)**	**(3.0)**	**(5.6)**	**(0.3)**

Management's reporting pack contained year to date figures that do not reconcile to previous information. We have queried this with management but have not yet received an answer. We have therefore prepared the above table using previous information updated for the month of September. This information may be amended when management responds to our query.

1. Revenue remains behind the February budget, due to cash constraints. Year to date revenue remains ahead of the September reforecast, but by a reduced level due the adverse September variance described earlier in this report (August showed a significant positive variance relative to the September reforecast).
2. Other revenue remains behind the February budget which had greater work wins, but is now also falling behind the reforecast in which other revenue was beginning to be forecast by management.
3. Gross margin remains behind the February budget and the September reforecast.
4. In net profit terms, trading remains behind the February budget and is now behind the September reforecast.

Balance sheet

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

An updated balance sheet has not yet been provided by management for the September reforecast.

Balance sheet: September 2018

£ in 000s	Note	Actual	Feb budget	Movement
Intangible assets		0.3	0.2	**0.1**
Tangible fixed assets	1	17.8	18.6	**(0.8)**
Total non current assets		**18.1**	**18.8**	**(0.7)**
Inventory		0.0	-	0.0
Accounts receivable		0.4	0.2	0.3
WIP	2	12.5	6.3	6.2
Prepayments and other debtors		1.2	1.4	(0.2)
Accounts payable	3	(2.5)	(4.3)	1.8
Accruals & other creditors		(3.2)	(2.6)	(0.6)
Total Net Assets (before funding items)		**26.5**	**19.8**	**6.8**
Cash & cash equivalents		9.5	2.2	7.3
SG loan	4	(34.4)	(17.2)	(17.3)
Cash collateral		4.5	4.5	-
Total Net Assets		**6.1**	**9.3**	**(3.2)**
Capital & Reserves		22.0	22.0	0.0
Retained Losses		(15.9)	(12.8)	(3.1)
Total Net Equity		**6.1**	**9.2**	**(3.1)**

Note: an updated balance sheet has not been provided within the reforecast

[redacted]

[redacted]

3. Accounts payable is described in more detail later in the report.

4. The SG loan balance is considerably greater than budget as the budget doesn't include the loan.

Medium term cash flow

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

Management has not provided a cash flow for the reforecast in a format comparable to that shown opposite.

Cash flow September 2018

£ in 000s	**Note**	**Actual**	**Feb budget**
EBITDA (excluding exceptionals)		(0.3)	0.4
Exceptionals [redacted]			
Cash from trading		**(0.3)**	**0.3**
Movement in working capital	2	(4.2)	(1.5)
Operating cash flow		**(4.6)**	**(1.1)**
Purchase of fixed assets		(0.2)	(0.2)
New loans drawn	3	6.0	-
Increase/(decrease) in cash and cash equivalents		**1.3**	**(1.3)**
Opening balance		8.2	3.5
Closing balance		9.4	2.2

Note: management has not provided a reforecast cashflow on an indirect basis for comparison

[redacted]

2. The movement in working capital is mainly due to the WIP budget being greater than budget, ie greater costs have been prepaid than was budget as the work is behind budget.

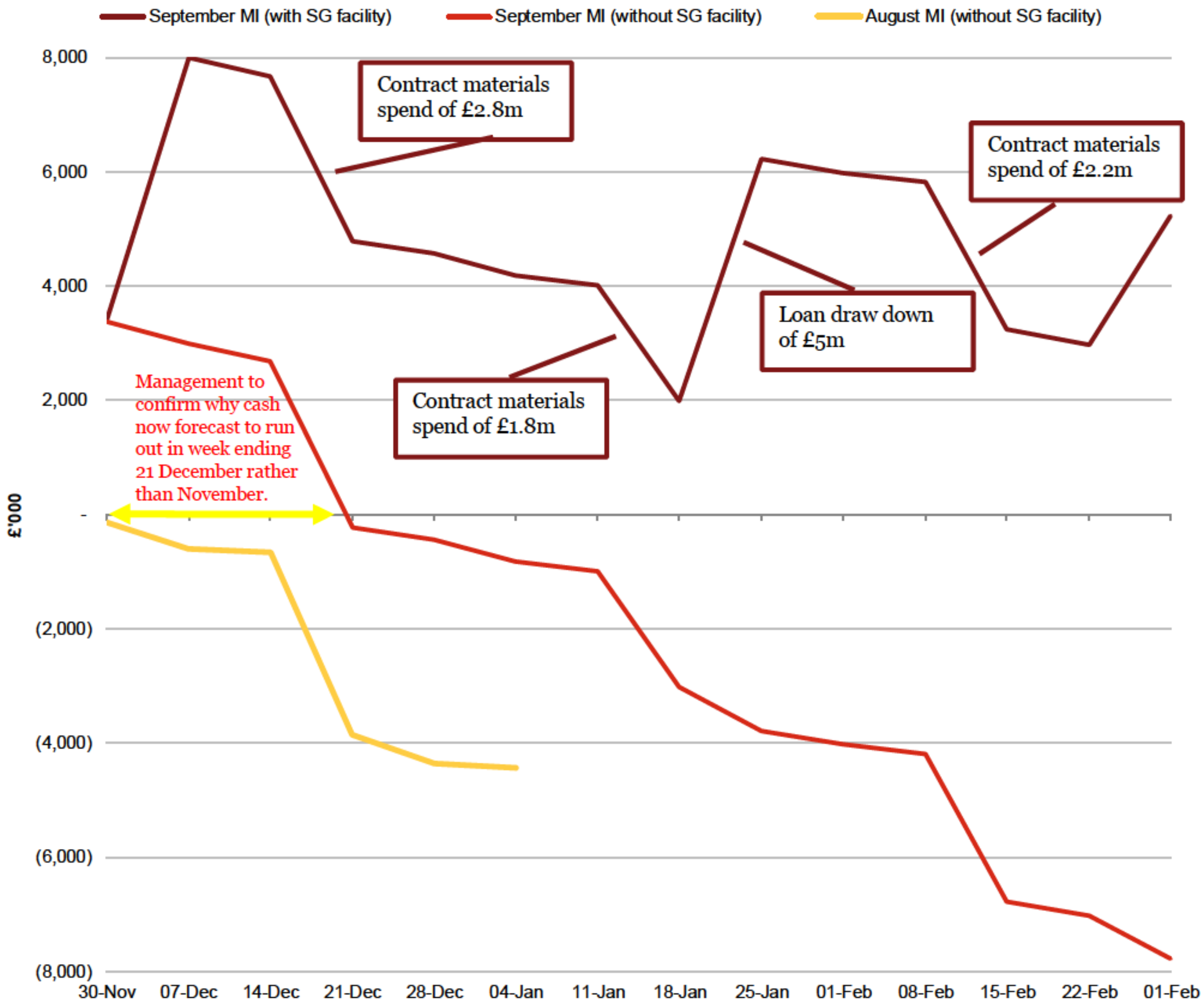
3. £6m of SG's loan was drawn down on 13 September 2018.

Short term cash flow forecast

The graph shows the short term cash flow forecast (provided by management on 27 November 2018) compared with the previous short term cash flow (provided by management on 2 October 2018 with no draw downs) and the 27 November cash flow with no further draw downs.

Management forecasts to make three further drawdowns in the period of the short term cash flow: £5.0m in the week ending 7 December and 25 January and £3m in the week ending 1 March.

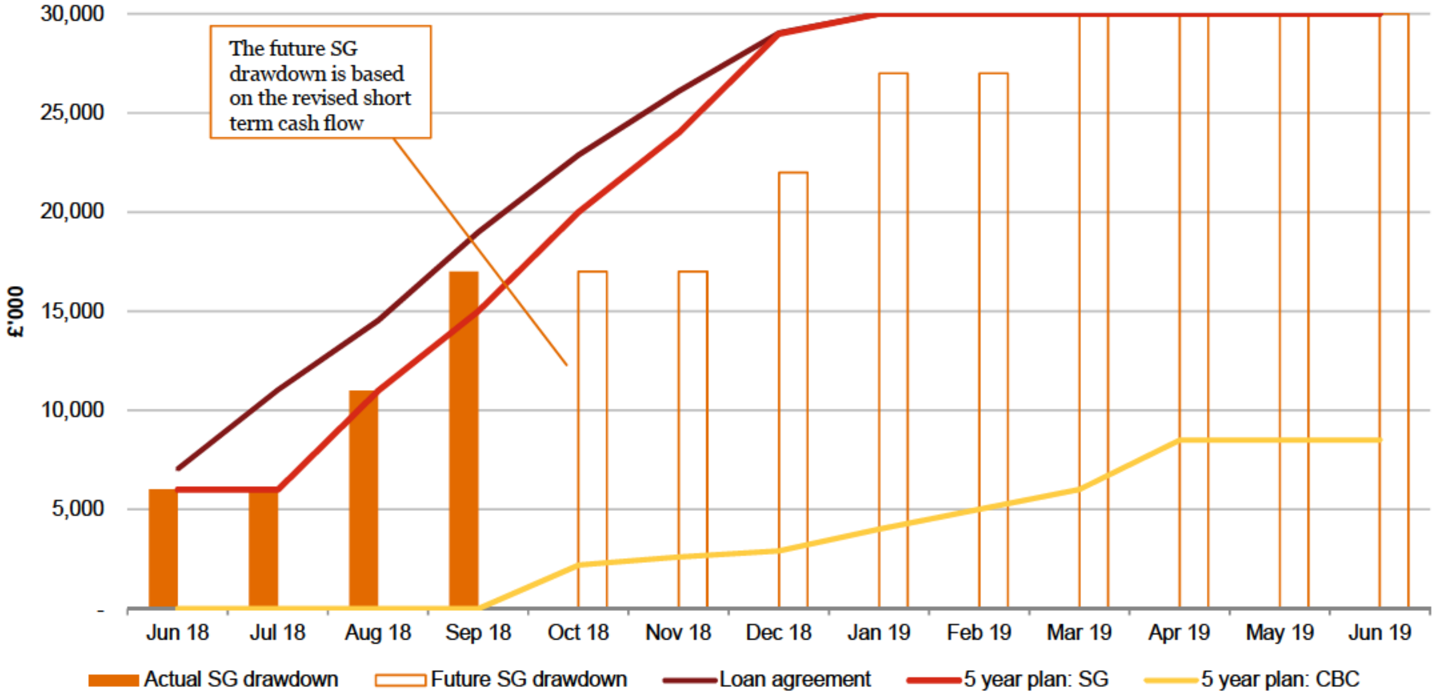
This would result in the £30m facility being fully drawn.



Cumulative loan drawdown

The graph shows the cumulative loan drawdown as projected in the loan agreement together with those forecast in the latest five year management projection.

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 contract costs in August and September 2018.

Vessel contract costs

£'000	Aug-18 801 total	Aug-18 802 total	Aug-18 801/802 Total	Sep-18 801 total	Sep-18 802 total	Sep-18 801/802 Total	Total Variance
Total contract costs paid to date	55,600	36,750	**92,350**	56,800	36,500	**93,300**	950
Total costs to completion	15,600	28,150	**43,750**	14,400	28,400	**42,800**	(950)
Total contract costs	**71,200**	**64,900**	**136,100**	**71,200**	**64,900**	**136,100**	-
Paid to date	44,300	40,000	**84,300**	44,100	39,300	**83,400**	(900)
Payments to completion	5,000	9,300	**14,300**	5,200	10,000	**15,200**	900
Total payments	**49,300**	**49,300**	**98,600**	**49,300**	**49,300**	**98,600**	-
Direct labour hours to date	782	250	**1,032**	797	261	**1,058**	26
Direct labour hours to completion	158	410	**568**	143	399	**542**	26
Total direct labour hours	**940**	**660**	**1,600**	**940**	**660**	**1,600**	-

Paid to date in August18 is £84.3m and in September 18 is £83.4m. We have raised this query with management.

Operational expert comments

We met with SG's operational expert on 7 November 2018 who notes that:

- Headcount was increasing and would reach the required level.
- [redacted]

Risks identified by the expert were:

1. In the experts opinion, a poor and deteriorating relationship with CMAL; CMAL are being more difficult with operational matters.
2. Commissioning work is due to begin on 7 January 2019 and this is always an uncertain period, made more so by CMAL's current stance and lack of flexibility.
3. Weather, eg snow has historically, and would again directly impact the timeline.

801/2 cost split

[redacted] has commented that costs for 802 could be estimated as being the same as 801, notwithstanding management's expectation of greater efficiency.

As can be seen this would increase total costs from £136m to £142m as total costs for 802 £75m and £71m for 801. This could be considered too prudent as it does not take account of efficiencies note by management.

Direct labour hours

Based on direct labour hours only, 801 is 85% through construction and 802 is 40% through construction with delivery due in June 2019 and March 2020 respectively.

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	Sept-18
Personnel changes	Y	*	*	N	Y	Y	Y	Y	Y	Y
Profit & loss	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Balance sheet	Y	Y	N	*	*	*	*	Y	Y	Y
Cash flow statement	Y	Y	N	N	Y	*	*	Y	Y	Y
P&L comparison v budget	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
BS comparison v budget	*	N	N	N	*	*	*	Y	Y	Y
CF comparison v budget	*	N	N	N	*	*	Y	Y	Y	Y
801/2 build report	Y	*	*	N	*	Y	Y	Y	Y	Y
801/2 cost over runs	N	*	*	N	*	Y	Y	Y	Y	Y
Permitted fees	Y	Y	N	N	Y	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.