Advisory

Project Poseidon

Phase 2 - monitoring (January and February 2019 results)

Strictly Private and Confidential
Draft

3 May 2019

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 10 December 2018.

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.

This is a draft report. Our work is not complete and the comments in this draft report are therefore subject to amendment or withdrawal. Our definitive findings and conclusions will be those set out in the final report.

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

Management has presented a new set of forecasts for the 2019 budget however the forecasts do not include a cash flow or balance sheet.

Production hours for 801/2 in January and February are broadly in line with the latest 2019 budget.

No further new work has been confirmed since the December monitoring report.

Management forecasts that **FMEL will have a positive cash balance till at least the week commencing 22 July 2019** but its directors may, in light of their fiduciary duties, **take action now to limit liabilities and extend this timetable** if a solution is not identified.

Management notes that due to ongoing funding issues, delivery dates are likely to be revised again.

Summary of key points

801/2

- Based on direct labour hours only, 801 is 87% through construction and 802 is 45%. Total contract costs to date are £109.6m, relative to the original budget of £98.5m.
- As reported in the December monitoring report, management states 801 is expected to be delivered in October 2019; 802 is expected to be delivered in July 2020.
- Management notes that due to the ongoing funding issues, these dates are likely to be revised again.

January 2019 performance

- 801/2 production hours of 19k were in line with the latest February 2019 budget.
- However relative to the prior month, production has decreased from 29k hours as the number of contractors were reduced.
- There were no other significant production activities

February 2019 performance

- 801/2 production hours of 25k were ahead of budgeted 15k hours as production was moved to 801/2 from other vessels, which were delayed. This was offset by lower materials than budgeted, because of a delay in the procurement schedule.
- There were 9k of production hours on the air cushion barge and Inverlussa vessels, but these were behind budget because of design delays.

Other work

- Management has not contracted new work since December 2018.

[redacted]

Funding

- [redacted]
- Management then drew down a further £5m from the SG loan on 14 February 2019.
- The final £5m drawdown was paid out in two receipts, £2m on 3 April 2019 and £3m on 4 April.
- FMEL notes there will be a positive cash balance till at least the week commencing 22 July 2019. At this time it is forecasting to have a cash balance of £1.2m with an additional £1.8m ring fenced for non 801/2 costs.

Updated forecasts

- Management presented a new set of profit and loss forecasts on 26 February 2019, however the forecasts do not include a cash flow or balance sheet.
- An updated 801/2 build plan from FMEL has been requested by SG, but yet to be received.

Audited Accounts

[redacted]

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.

The management information pack is missing a budget for the balance sheet and cash flow, which has been requested but have yet to be presented to us.

Info. received	Dec-18	Jan-19	Feb-19
Personnel changes	Y	Y	Y
Profit and 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	N*	N*
CF comparison v budget	Y	N*	N*
801/2 build report	Y	Y	Y
801/2 cost over runs	Y	Y	Y
Permitted fees	Y	Y	Y

Management has stated that it is working on a budget that includes a balance sheet and cash flow but it has not yet presented these to us. Budgets for the balance sheet and cash flows are important as they support the integrity of the projections model, set out the status of the business and shows how the business uses its cash.

Profit and loss account - January

The table opposite compares the actual profit and loss account for January 2019 to the 2019 budget provided by management in February 2019.

Profit and loss account: January 2019

£ in ms	Note	Jan 19 Actual	Feb 19 Budget	Variance
801/2 revenue	1	0.8	0.8	-
Other revenue	2	-	0.2	(0.2)
Gross margin	**3**	**(0.3)**	**(0.3)**	**-**
Selling, general and administrative		(0.2)	(0.2)	-
Addback depreciation		0.1	0.1	-
EBITDA		**(0.4)**	**(0.5)**	**0.1**
Exceptional items		-	(0.1)	0.1
Interest		(0.2)	(0.2)	-
Depreciation		(0.1)	(0.1)	-
Net profit		**(0.7)**	**(0.8)**	**0.1**

Note: The 2019 February budget was presented on 26 February 2019.

1. 801/2 revenue - is in line with the latest 2019 budget as would be expected given the budget was presented on 26 February 2019.

Actual hours are broadly in line with budget but lower than December because of cash constraints whilst funding arrangements were agreed (Actual 19k , Budget 17k, December 29k).

[redacted]

3. Gross Margin – is expected to be £nil reflecting there being no margin in 801/2. However, management states that due to the lower material spend on 801/2, there is now an under recovery of production overheads resulting in a gross margin shortfall of c.£0.3m.

Profit and loss account - February

The table opposite compares the actual profit and loss account for February 2019 to the 2019 budget provided by management in February 2019.

Profit and loss account: February 2019

£ in ms	Note	Feb 19 Actual	Feb 19 Budget	Variance
801/2 revenue	1	0.9	1.9	(1.0)
Other revenue	2	2.3	2.7	(0.4)
Gross margin	**3**	**-**	**0.2**	**(0.2)**
Selling, general and administrative		(0.2)	(0.2)	-
Addback depreciation		0.1	0.1	-
EBITDA		**(0.1)**	**0.1**	**(0.2)**
Exceptional items		(0.1)	(0.1)	-
Interest		(0.2)	(0.2)	-
Depreciation		(0.1)	(0.1)	-
Net profit		**(0.5)**	**(0.3)**	**(0.2)**

[redacted]

1. 801/2 revenue - is behind the 2019 budget despite being presented in the same month. Actual hours are ahead of budget driven by replanning of production activities to 801/2 from the other vessels (Actual: 25k , Budget 15k, January 19k). However the increase in hours is offset by a lower material spend. The procurement schedule has been impacted by the delay in funding, but management notes that the majority of the variance will be recognised in the March/April profit and loss account.

Staff numbers as at February were:

- Permanent 167 (December: 168)
- Temporary 138 (December: 142)
- Contractors 68 (December: 150)

[redacted]

Profit and loss account year to date

The table opposite sets out the profit and loss account year to date against the 2019 budget provided by management in February 2019.

Profit and loss account: February 2019 YTD

£ in ms	Note	Actual	Feb Budget	Variance
801/2 revenue	1	1.7	2.7	(1.0)
Other revenue	2	2.3	2.8	(0.5)
Gross margin		**(0.3)**	**(0.2)**	**(0.1)**
Selling, general and administrative		(0.4)	(0.4)	-
Addback		0.2	0.2	-
EBITDA		**(0.5)**	**(0.4)**	**(0.1)**
Exceptional items		(0.2)	(0.2)	-
Interest		(0.4)	(0.4)	-
Depreciation		(0.2)	(0.2)	-
Net profit		**(1.3)**	**(1.2)**	**(0.1)**

Note: The year to date net profit figure is higher than the sum of January and February net profit figure due to an immaterial rounding variance.

1. 801/2 revenue is behind the 2019 budget despite being presented in February 2019.
2. Other revenue remains behind the 2019 budget as forecast work has been delayed to later months.

In summary, Management has noted trading is below budget due to cash constraints on 801/2 and due to other work being delayed to later months.

Balance sheet

The table opposite shows the balance sheet from December 2018 to February 2019.

Management is in the process of preparing the 2019 budget for the balance sheet and cash flow.

Balance Sheet February 2019 **£ in m**	**Note**	**Feb Actual**	**Jan Actual**	**Dec Actual**
Intangible assets		0.4	0.3	0.3
Tangible fixed assets		17.6	17.7	17.8
Total non current assets		**18.0**	**18.0**	**18.1**
Accounts receivable		0.2	0.2	0.4
WIP	1	(7.9)	(9.6)	(8.2)
Prepayments and other debtors		1.4	1.6	2.6
Accounts payable		(2.3)	(3.9)	(5.8)
Accruals & other creditors	2	(20.7)	(22.0)	(20.9)
Total Net Liabilities (before funding items)		**(11.3)**	**(15.7)**	**(13.8)**
Cash & cash equivalents		7.5	4.3	3.3
SG loan	3	(46.5)	(38.2)	(35.0)
Cash collateral		4.5	4.5	4.5
Total Net Liabilities		**(45.8)**	**(45.1)**	**(41.0)**
Capital & Reserves		21.6	21.6	21.6
Retained Losses		(67.3)	(66.7)	(62.6)
Total Net Equity		**(45.7)**	**(45.1)**	**(41.0)**

WIP			
Contract WIP (prepaid costs)	13.7	14.2	13.7
Deferred revenue	(22.4)	(24.4)	(22.5)
Other WIP	0.8	0.6	0.6
Total	**(7.9)**	**(9.6)**	**(8.2)**
Deferred revenue			
Costs to date	109.6	107.7	93.4
Prepayments	(13.6)	(11.0)	(4.1)
Potential revenue	96.1	96.7	89.3
@65.8%/68.1%*	**63.2**	**65.9**	**60.8**
Billed to date	(83.3)	(83.3)	(83.3)
Other deferred revenue	(2.4)	(7.0)	-
Deferred revenue	**(22.4)**	**(24.4)**	**(22.5)**
	98.5 / 98.5+51.3 =65.8%	98.5 / 98.5+44.3 =68.1%	98.5 / 98.5+44.3 =68.1%

1. WIP is a combination of contract WIP (prepayments incurred on 801/2 which have not been released to profit and loss as the work is not complete) and deferred revenue (billed to date revenue less potential revenue).
2. Included in the £20.7m accruals and other creditors is £17.6m which has been booked to take account of the [redacted]

Other deferred revenue relates to the 2016 statutory account adjustments. We have asked management for further explanation for these differences.

The adjustment calculation is based on the original contract cost over the total contract cost. This adjustment to the deferred revenue recognises that not all of the contract cost will be recovered.

Medium term cash flow

The table opposite summarises the cash flow of FMEL for January and February 2019. Cash flow for December 2018 has also been provided for reference.

Cash flow £ in m	Note	Feb 19 Actual	Jan 19 Actual	Variance	Dec 18 Actual	Variance
EBITDA (excluding exceptionals)		(0.1)	(0.4)	0.3	(0.3)	(0.1)
Exceptionals	[redacted]					
Cash from						
Movement in working capital	2	(4.8)	1.5	(6.3)	(0.5)	2.0
Operating cash flow		**(5.0)**	**1.1**	**(6.1)**	**(1.0)**	**2.1**
Purchase of fixed assets		(0.1)	-	(0.1)	(0.2)	0.2
New loans drawn		8.3	-	8.3	-	-
Increase/(decrease) in cash and cash equivalents		**3.2**	**1.1**	**2.1**	**(1.3)**	**2.4**
Opening balance		4.3	3.2		4.5	
Closing balance		7.5	4.3		3.2	

[redacted]

3. The new loans drawn down were received over two receipts, £2m on 3 April 2019 and £3m on 4 April. These are now fully drawn.

As set out below, management provided new delivery dates on 26 February 2019 in the February 2019 budget.

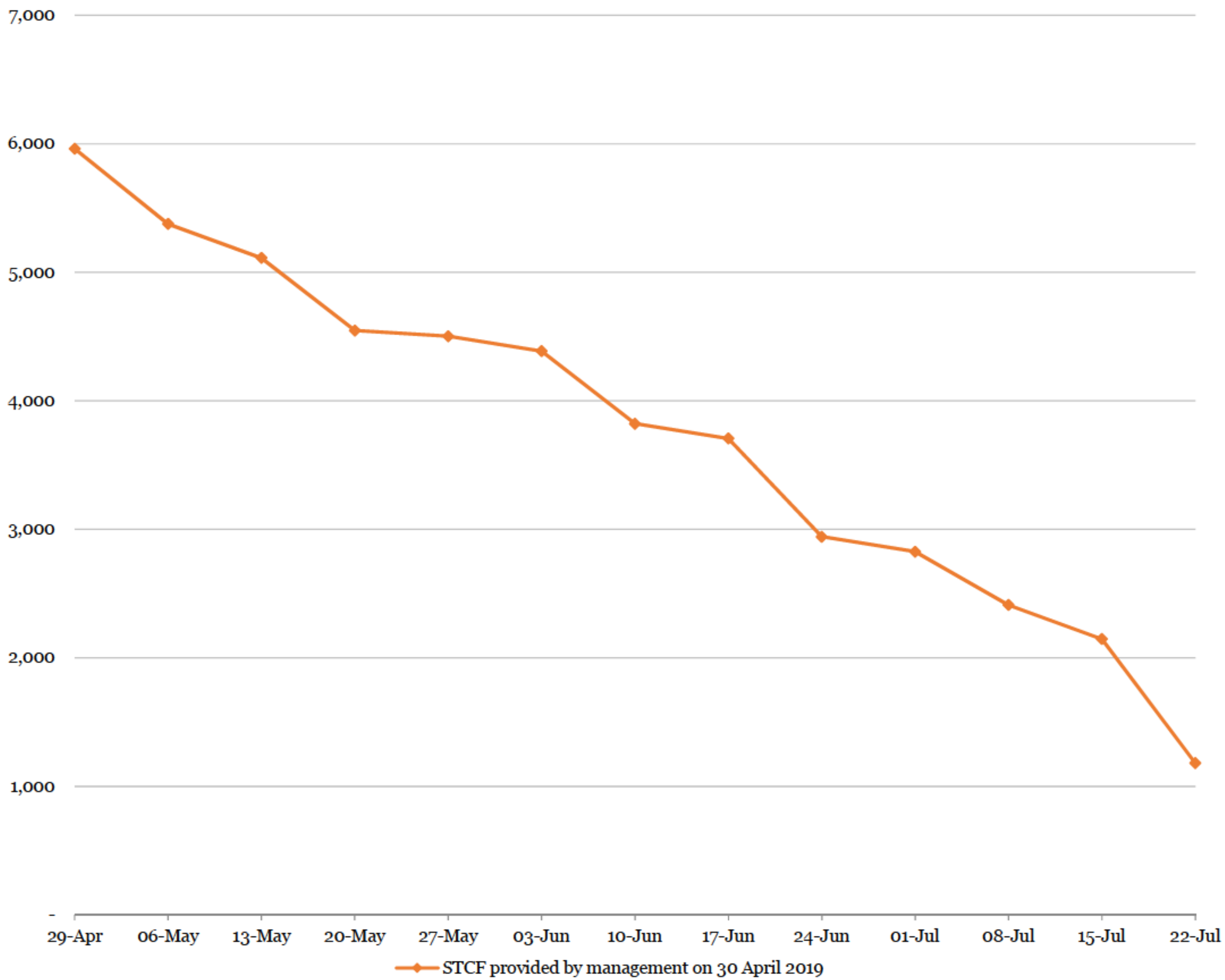
Milestone	Amount (£000)	Per Aug 17 IBR	Per Feb 18 Budget	Per May 18 Reforecast	Per Sep 18 Reforecast	Per Feb 19 Budget
801 Delivery	4,850	Jun-18	Mar-19	Jun-19	Jun-19	Oct-19
802 100% fabrication	1,200	Oct-17	Oct-18	Mar-19	Mar-19	Nov-19
802 Hull inspection prior to paint	1,200	Nov-17	Oct-18	Mar-19	Mar-19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

Short term cash flow forecast

The graph shows the short term cash flow forecast (provided by management on 30 April 2019).

Management forecasts there to be a positive cash balance to the week commencing 22 July 2019. This does not include £1.8m of ring-fenced cash.

There are no more further SG loan drawdowns.



[redacted]

801/2 build report - January

The table opposite compares the contract costs in January 2019 and December 2018.

Vessel contract costs £'000	Dec-18 801 total	Dec-18 802 total	Dec-18 801/802 Total	Jan-19 801 total	Jan-19 802 total	Jan-19 801/802 Total	Total Variance
Total contract costs paid to date	63,000	41,500	**104,500**	65,000	42,800	**107,800**	3,300
Total costs to completion	12,500	25,800	**38,300**	14,100	27,900	**42,000**	3,700
Total contract costs	**75,500**	**67,300**	**142,800**	**79,100**	**70,700**	**149,800**	**7,000**
Paid to date	44,044	39,244	**83,288**	44,044	39,244	**83,288**	-
Payments to completion	5,206	10,006	**15,212**	5,206	10,006	**15,212**	-
Total payments	**49,250**	**49,250**	**98,500**	**49,250**	**49,250**	**98,500**	**-**
Direct labour hours to date	860	308	**1,168**	872	315	**1,187**	19
Direct labour hours to completion	200	417	**617**	148	406	**554**	(63)
Total direct labour hours	**1,060**	**725**	**1,785**	**1,020**	**721**	**1,741**	**(44)**

801/2 contract costs

The table above shows an £3.3m increase of total contract costs paid to date on the 801/2 contract. Contract costs paid to date relate to cash payment, not revenue recognised therefore there will not match exactly to the monthly profit and loss account due to timing differences.

Overall, management notes that total contract costs have increased by £7m of retrospective uplifts to overhead absorption rates, which is in line with the 2016 statutory accounts submitted late in December 2018.

Direct labour hours

Based on direct labours hours only, 801 is 84% (December: 81%) through construction and 802 is 43% (December: 42%) through construction with delivery scheduled in October 2019 and July 2020 respectively. Direct labour hours to completion has decreased which is driven by replanning of production activities. We have not been provided with a final build schedule therefore we believe that the final total direct labour hours will be greater.

801/2 build report - February

The table opposite compares the contract costs in February 2019 and January 2019.

Vessel contract costs £'000	**Jan-19 801 total**	**802 total**	**801/802 Total**	**Feb-19 801 total**	**802 total**	**801/802 Total**	**Total Variance**
Total contract costs paid to date	65,000	42,800	**107,800**	65,800	43,800	**109,600**	1,800
Total costs to completion	14,100	27,900	**42,000**	13,300	26,900	**40,200**	(1,800)
Total contract costs	**79,100**	**70,700**	**149,800**	**79,100**	**70,700**	**149,800**	**-**
Paid to date	44,044	39,244	**83,288**	44,044	39,244	**83,288**	-
Payments to completion	5,206	10,006	**15,212**	5,206	10,006	**15,212**	-
Total receipts	**49,250**	**49,250**	**98,500**	**49,250**	**49,250**	**98,500**	**-**
Direct labour hours to date	872	315	**1,187**	886	326	**1,212**	25
Direct labour hours to completion	148	406	**554**	134	395	**529**	(25)
Total direct labour hours	**1,020**	**721**	**1,741**	**1,020**	**721**	**1,741**	**-**

801/2 contract costs

The table above shows 25k of hours of direct labour hours being booked, which has been offset by a delay in materials recognised in the profit and loss as discussed on page 7.

[redacted]

Direct labour hours

Based on direct labour hours only, 801 is 87% (January: 84%) through construction and 802 is 45% (January: 43%) through construction with delivery due in October 2019 and July 2020 respectively. We have not been provided with a final build schedule therefore we believe that the final total direct labour hours will be greater.

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-Dec 18	Jan-19	Feb-19
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	N	N
CF comparison v budget	*	N	N	N	*	*	Y	Y	N	N
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.