Advisory

Project Poseidon
Phase 2 - monitoring (March 2019 results)

Strictly Private and Confidential

16 May 2019

pwc

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

[redacted]

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.

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

[redacted]

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Summary

Production hours for 801/2 in March are behind budget.

No further new work has been won .

As previously advised, 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.

[redacted]

Summary of key points

801/2

- Based on direct labour hours only, 801 is 88% through construction and 802 is 46%. Total contract costs to date are £111.4m, relative to the original budget of £98.5m.
- Management confirmed on 1 May 2019 that 801 is now expected to be delivered in Q2 2020; 802 is expected to be delivered in Q4 2020.
- Management has caveated that the above dates are subject to an agreement being reached with SG in early course to provide funding to FMEL.

March 2019 performance

- Due to cash constraints and uncertainty to the future of the company, management notes 801/2 production hours of 17k were behind budget by 5k hours and budgeted material spend has been delayed.

[redacted]

- Management explained that production activity has slowed down significantly and is unlikely to recover until a long term solution can be agreed with SG.

[redacted]

Other work

- Management has not won new work since December 2018.

[redacted]

Funding

- 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.
- The SG loan has been fully drawn down.

Updated forecasts

- Management has not yet provided indirect cash flow or balance sheet forecasts to support the revised projections provided on 26 February 2019. These projections are based on previous delivery dates and build plans.
- An updated 801/2 build plan from FMEL has been requested by SG, but is yet to be received.

[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 does not include a budget for the balance sheet and cash flow, which has been requested but have yet to be presented to us.

Info. received	Jan-19	Feb-19	Mar-19
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	N*	N*	N*
CF comparison v budget	N*	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. Balance sheet and cash flows are important as they support the integrity of the projections model and as they set out the status of the business and how it uses it cash.

Profit and loss account

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

Profit and loss account: March 2019

£ in ms	Note	Mar 19 Actual	Feb 19 Budget	Variance
801/2 revenue	1	1.3	2.4	(1.1)
Other revenue	2	0.5	1.5	(1.0)
Gross margin	**3**	**(0.3)**	**0.2**	**(0.5)**
Selling, general and administrative		(0.3)	(0.3)	-
Add back depreciation		0.1	0.1	-
EBITDA excluding exceptionals		**(0.5)**	**(0.1)**	**(0.4)**
Exceptional items		(0.1)	(0.1)	-
Interest		(0.3)	(0.2)	(0.1)
Depreciation		(0.1)	(0.1)	-
Net profit		**(1.0)**	**(0.5)**	**(0.5)**

1 801/2 revenue – is behind the 2019 budget despite only being presented in February. The variance is driven by lower production hours than forecasted (Actual 17k , Budget 22k, January 25k) and a delay in material spending due to cash constraints. Management explained that production activity has slowed down significantly and is unlikely to recover until a long term solution can be agreed with SG. We have not been provided with a amended build plan. We believe that an amended build plan may reflect a higher number of production hours and therefore a higher cost.

2 Other revenue - is £1.0m behind budget due to reduction in production hours on other ships (Actual 9k, Budget 16k) and a delay in material spending (£0.7m). Management notes that work on other vessels have been pushed back because of external design delays and cash constraints.

3 Gross Margin – should be £nil reflecting there being no margin in 801/02. Management explained that an under recovery of overheads resulting in a gross margin shortfall of c£0.3m was due to:

- reduction in booked hours;
- low staff morale reducing productivity;

[redacted]

- time recording improvements to reflect the true proportion of labour activities i.e. greater indirect hours are now recorded.

Management stressed that whilst the new method of recording hours would help identify improvements to productivity over the long term, the uncertainty of the yard's future would continue to reduce productivity relative to budget in the short term.

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: March 2019 YTD

£ in ms	Note	Mar 19 Actual	Feb 19 Budget	Variance
801/2 revenue	1	3.0	5.1	(2.1)
Other revenue	2	2.8	4.2	(1.4)
Gross margin		**(0.6)**	**0.2**	**(0.8)**
Selling, general and administrative		(0.7)	(0.6)	(0.1)
Addback depreciation		0.3	0.3	-
EBITDA excluding exceptionals		**(1.0)**	**(0.1)**	**(0.9)**
Exceptional items		(0.2)	(0.3)	0.1
Interest		(0.7)	(0.7)	-
Depreciation		(0.3)	(0.3)	-
Net profit		**(2.2)**	**(1.4)**	**(0.8)**

1. 801/2 revenue is behind the 2019 budget despite being presented in February 2019.
2. Other revenue remains behind the 2019 budget because of cash constraints and 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.

Staff numbers as at March were:

Headcount	Feb-19	Mar-19
Direct	93	90
Indirect	74	73
Permanent total	**167**	**163**
Direct	109	109
Indirect	29	29
Temporary total	**138**	**138**
Total FMEL headcount	**305**	**301**
Trade contractors	50	41
Contractor consultants	18	18
Total headcount	**373**	**360**

[redacted]

Balance sheet

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

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

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Balance Sheet March 2019 £ in m	**Note**	**Mar Actual**	**Feb Actual**
Intangible assets		0.4	0.4
Tangible fixed assets		17.7	17.6
Total non current assets		**18.1**	**18.0**
Accounts receivable		0.9	0.2
WIP	1	(7.7)	(7.9)
Prepayments and other debtors		1.4	1.4
Accounts payable		(2.5)	(2.3)
Accruals & other creditors	2	(19.9)	(20.7)
Total Net Liabilities (before funding items)		**(9.7)**	**(11.3)**
Cash & cash equivalents		5.3	7.5
SG loan	3	(46.8)	(46.5)
Cash collateral		4.6	4.5
Total Net Liabilities		**(46.6)**	**(45.8)**
Capital & Reserves		21.6	21.6
Retained Losses		(68.3)	(67.3)
Total Net Equity		**(46.7)**	**(45.7)**
WIP			
Contract WIP (prepaid costs)		12.8	13.7
Deferred revenue		(21.4)	(22.4)
Other WIP		0.9	0.8
Total		**(7.7)**	**(7.9)**
Deferred revenue			
Costs to date		111.4	109.6
Prepayments		(12.4)	(13.6)
Potential revenue		99.0	96.1
@65.8%		**65.2**	**63.2**
Billed to date		(83.3)	(83.3)
Other deferred revenue		(3.3)	(2.4)
Deferred revenue		**(21.4)**	**(22.4)**
		Apr-00	Apr-00
		98.5+51.3	98.5+51.3
		=65.8%	=65.8%

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 £19.9m accruals and other creditors is the £17m contract provision (Feb: £17.6m).
3. The final drawdown of £5m was made in April.

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 March 2019.

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

Cash flow £ in m	Note	Mar 19 Actual	Feb 19 Actual	Variance
Net profit		**(1.0)**	**(0.5)**	**(0.5)**
Less exceptionals		0.1	0.1	-
Less interest		0.3	0.2	0.1
Less depreciation		0.1	0.1	-
EBITDA (excluding exceptionals)		**(0.5)**	**(0.1)**	**(0.4)**
Exceptionals [redacted]				
Cash from trading		**(0.6)**	**(0.2)**	**(0.4)**
Movement in working capital	2	(1.5)	(4.8)	3.3
Operating cash flow		**(2.1)**	**(5.0)**	**2.9**
Purchase of fixed assets		(0.1)	(0.1)	-
New loans drawn		-	8.3	(8.3)
Increase/(decrease) in cash and cash equivalents		**(2.2)**	**3.2**	**(5.4)**
Opening balance		7.5	4.3	
Closing balance		5.3	7.5	

[redacted]

The latest milestones schedule based on 26 February 2019 budget is shown below. Management outlined in a letter to SG on 2 May 2019 that 801 is now expected to be completed in Q2 2020 and 802 is expected to be completed in Q4 2020 however a build schedule with more detailed breakdown has yet to be provided.

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 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

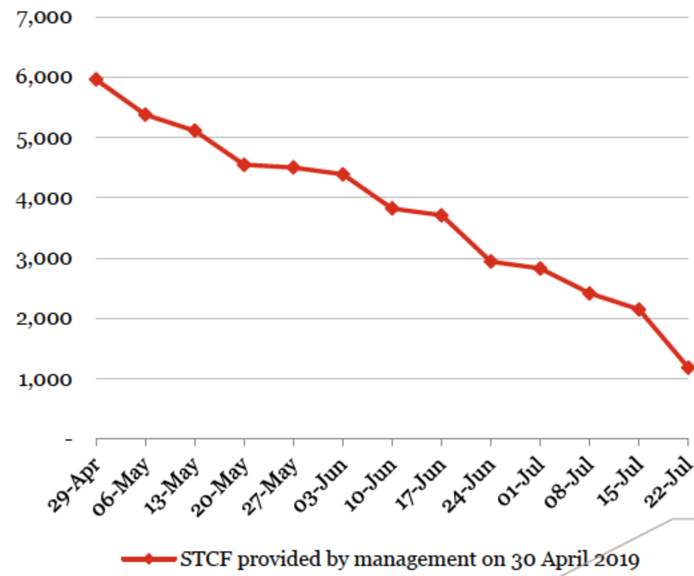
*Note: Jun 19 and Mar 20 are the last agreed delivery dates with CMAL.

Short term cash flow forecast

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

Management 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 excluding £1.8m ring fenced for Hyseas III and other vessels i.e. 804 and 805.

There are no more further SG loan drawdowns.



The STCF is forecasting a cash balance of £1.2m excluding £1.8m ring fenced at the end of the week commencing 22 July 2019.

[redacted]

[redacted]

801/2 build report

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

Contract Statement

Vessel contract costs £'000	Feb-19 801 total	Feb-19 802 total	Feb-19 801/802 Total	Mar-19 801 total	Mar-19 802 total	Mar-19 801/802 Total	Total Variance
Total contract costs paid to date	65,000	42,800	**107,800**	67,007	44,412	**111,419**	3,619
Total costs to completion	14,100	27,900	**42,000**	12,093	26,288	**38,381**	(3,619)
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	886	326	**1,212**	896	332	**1,228**	16
Direct labour hours to completion	134	395	**529**	124	389	**513**	(16)
Total direct labour hours	**1,020**	**721**	**1,741**	**1,020**	**721**	**1,741**	**-**

801/2 contract costs

The table above shows £3.6m of costs being paid on the 801/2 contract and 16k hours of direct labour hours being booked as discussed in the March profit and loss account* (page 6).

[redacted]

Direct labour hours

Based on direct labour hours only, 801 is 88% (February 87%) through construction and 802 is 46% (February 45%) through construction with delivery due in Q2 2020 and Q4 2020 respectively. We have not been provided with an amended build plan therefore we believe that the final total direct labour hours will be greater.

*Note small variance due to immaterial rounding variance.

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	Jun-18	Jul-Dec 18	Jan-19	Feb-19	Mar-19
Personnel changes	Y	*	*	N	Y	Y	Y	Y	Y	Y	Y
Profit and loss	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Balance sheet	Y	Y	N	*	*	*	*	Y	Y	Y	Y
Cash flow statement	Y	Y	N	N	Y	*	*	Y	Y	Y	Y
P&L comparison v budget	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
BS comparison v budget	*	N	N	N	*	*	*	Y	N	N	N
CF comparison v budget	*	N	N	N	*	*	Y	Y	N	N	N
801/2 build report	Y	*	*	N	*	Y	Y	Y	Y	Y	Y
801/2 cost over runs	N	*	*	N	*	Y	Y	Y	Y	Y	Y
Permitted fees	Y	Y	N	N	Y	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.