Advisory

Project Poseidon
Phase 2 - monitoring (December 2018 results)

Strictly Private and Confidential
Draft

15 March 2019

pwc

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

[redacted]

PricewaterhouseCoopers LLP

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

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Summary

Production for 801/2 continues to fall further behind both February 2018 budget and September 2018 reforecast.

Management has amended the delivery dates for 801/2 for the third time since February 2018 to October 2019 for 801 and July 2020 for 802.

The current new work in FY19 totals £17m compared to the February 2018 budget which showed a total of £34m.

Management forecasts that cash will run out in June 2019 assuming that the final £5m SG loan drawdown is made. However it confirmed it will take steps earlier if funding is not secured by 31 March 2019.

There is no build plan and therefore any increase in costs and timetable are unknown.

Summary of key points

December 2018 performance

- 801/2 production hours of 29k were ahead of budgeted hours of 25k as contractor levels increased but December revenue was still £3.3m behind February budget and £1m behind September reforecast because material spend was behind budget.
- There were no other significant production activities

801/2

- Year to date revenue was £14.8m behind February budget and £5.4m behind September reforecast.
- Management has amended the delivery dates for the third time since February 2018. 801 is now expected to be delivered in October 2019 and 802 is now expected to be delivered in July 2020. Management notes that due to the ongoing claim dispute, these dates are likely to be revised again.
- SG's operational expert has noted that the delay may be c.6 months beyond the revised delivery dates.

[redacted]

Funding

[redacted]

- The remaining £5m of the SG loan has been requested on 7 March 2019.
- Management has forecast cash will run out in June 2019 unless corrective actions are taken. Management has confirmed that it would take cash preservation steps earlier if funding is not secured by 31 March 2019.

Updated forecasts

- Management has produced a new set of forecasts for 2019 budget. These will be incorporated in the next monitoring report.

[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.

Info. received	Oct-18	Nov-18	Dec-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 December 2018 to the February 2018 budget provided by management, and to the September reforecast.

Profit & loss account: December 2018

£ in ms	Note	Dec Actual	Feb Budget	Variance	Sep Reforecast	Variance
801/2 revenue	1	1.5	4.8	(3.3)	2.5	(1.0)
Other revenue	2	0.3	1.2	(0.9)	0.2	0.1
Gross margin	**3**	**(0.3)**	**(0.1)**	**(0.2)**	**(0.1)**	(0.2)
Selling, general and administrative		(0.1)	(0.1)	0.0	(0.2)	0.1
Addback depreciation		0.1	0.1	-	0.1	-
EBITDA		**(0.3)**	**(0.1)**	**(0.2)**	**(0.2)**	**(0.1)**
Exceptional items		(0.2)	(0.1)	(0.1)	(0.1)	(0.2)
Interest		(0.1)	(0.2)	0.1	(0.3)	0.2
Depreciation		(0.1)	(0.1)	-	(0.1)	-
Net profit		**(0.7)**	**(0.5)**	**(0.2)**	**(0.6)**	**(0.1)**

The original February budget was £7m but this has been reduced to £4.8m to take into account of the 68.1% adjustment as explained on page 9. Note this adjustment has not been reflected in the September reforecasts.

1 – 801/2 revenue is £3.3m behind budget and £1m behind reforecast. Although staff numbers and hours are greater than budget, material spend is behind budget whilst funding arrangements are agreed due to cash constraints.

Actual hours are greater than budget and reforecast (Actual: 29k , Reforecast 28k, Budget 25k).

Staff numbers as at December were:

- Permanent 168 (October: 168)
- Temporary 142 (October: 132)
- Contractors 150 (October: 75)

Management noted a new project manager for 801/2 in November and the previous incumbent then left in December.

[redacted]

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.

Trading is behind budget and reforecast due to delays in production of 801/2 caused by management conserving cash on the 801/2 project whilst funding arrangements are agreed.

Profit & loss account: December 2018 YTD

£ in ms	Note	Actual	Feb Budget	Variance	Sep Reforecast	Variance
801/2 revenue	1	23.7	38.5	(14.8)	29.1	(5.4)
Other revenue	2	2.3	9.6	(7.3)	3.1	(0.8)
Gross margin	**3**	**(1.3)**	**1.5**	**(2.8)**	**(0.5)**	(0.8)
Selling, general and administrative		(2.6)	(2.3)	(0.3)	(2.4)	(0.2)
Addback depreciation		1.0	1.0	-	0.8	0.2
EBITDA		**(2.9)**	**0.2**	**(3.1)**	**(2.1)**	**(0.8)**
Exceptional items		(1.2)	(0.9)	(0.3)	(1.1)	(0.1)
Interest		(2.6)	(2.3)	(0.3)	(3.0)	0.4
Depreciation		(1.0)	(1.0)	-	(0.8)	(0.2)
Net profit		**(7.7)**	**(4.0)**	**(3.7)**	**(6.9)**	**(0.8)**

[redacted]

Management has noted the following:

1. Revenue remains behind both the February budget and September reforecast, due to cash constraints on 801/2 project. [redacted]
2. Other revenue remains behind the February budget which had forecast work wins that are now not expected to materialise until 2019. It is also behind the September reforecast.
3. Gross margin remains behind the February budget and the September reforecast. In net profit terms, trading remains behind the February budget and is now behind the September reforecast.

Management has explained that trading is behind budget and reforecast due to delays in production of 801/2 caused by management conserving cash on the 801/2 project whilst funding arrangements are agreed and due to work wins not being achieved.

Balance sheet

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

The balance sheet is in a net liability position however it does not include the CPI claim.

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

Balance Sheet December 2018

£ in m	Note	Actual	Feb Budget	Variance
Intangible assets		0.3	0.2	**0.1**
Tangible fixed assets		17.8	18.8	**(1.0)**
Total non current assets		**18.1**	**19.0**	**(0.9)**
Inventory		-	-	-
Accounts receivable		0.4	1.4	(1.0)
WIP	1	(8.2)	(10.2)	2.0
Prepayments and other debtors	2	2.6	1.4	1.2
Accounts payable		(5.8)	(5.7)	(0.1)
Accruals & other creditors	3	(20.9)	(31.1)	10.2
Total Net Liabilities (before funding items)		**(13.8)**	**(25.2)**	**11.4**
Cash & cash equivalents		3.3	2.0	1.3
SG loan	4	(35.0)	(17.8)	(17.2)
Cash collateral		4.5	4.5	-
Total Net Liabilities		**(41.0)**	**(36.5)**	**(4.5)**
Capital & Reserves		21.6	22.0	(0.4)
Retained Losses		(62.6)	(58.5)	(4.1)
Total Net Equity		**(41.0)**	**(36.5)**	**(4.5)**

Actual WIP	**£m**
Contract WIP (prepaid costs)	13.7
Deferred revenue	(22.5)
Other WIP	0.6
Total	(8.2)

Deferred revenue	**£m**
Costs to date	93.4
Prepayments	(4.1)
Potential revenue	89.3
@68.1% *	60.8
Billed to date	(83.3)
Deferred revenue	(22.5)

$*68.1\% = \frac{98.6}{98.6+44.3}$

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

1. Contract WIP represents prepayments incurred on 801/2 which have not been released to profit and loss as the work is not complete. The balance remains high as work has been paid for but the schedule is delayed.
2. Prepayment and other debtors relate to £0.3m of prepayments and £2.3m of other debtors which include VAT of £1.9m.

[redacted]

4. The SG loan balance is considerably greater than budget as the February budget does not include the loan.

Medium term cash flow

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

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

Cash flow December 2018 £ in m	Note	Dec Actual	Feb Budget	Variance
EBITDA (excluding exceptionals)		(0.3)	(0.1)	(0.2)
Exceptionals [redacted]				
Cash from trading		**(0.5)**	**(0.2)**	**(0.3)**
Movement in working capital	2	(0.5)	1.4	(1.9)
Operating cash flow		**(1.0)**	**1.2**	**(2.2)**
Purchase of fixed assets		(0.2)	(0.2)	(0.0)
New loans drawn		-	-	-
Increase/(decrease) in cash and cash equivalents		**(1.2)**	**1.0**	**(2.2)**
Opening balance		4.5	1.0	3.5
Closing balance		3.3	2.0	1.3

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

[redacted]

2. The variance in working capital is mainly due to the WIP being less than budget.

Management has provided the latest delivery schedule. Per table below, no cash receipt is expected until October 2019.

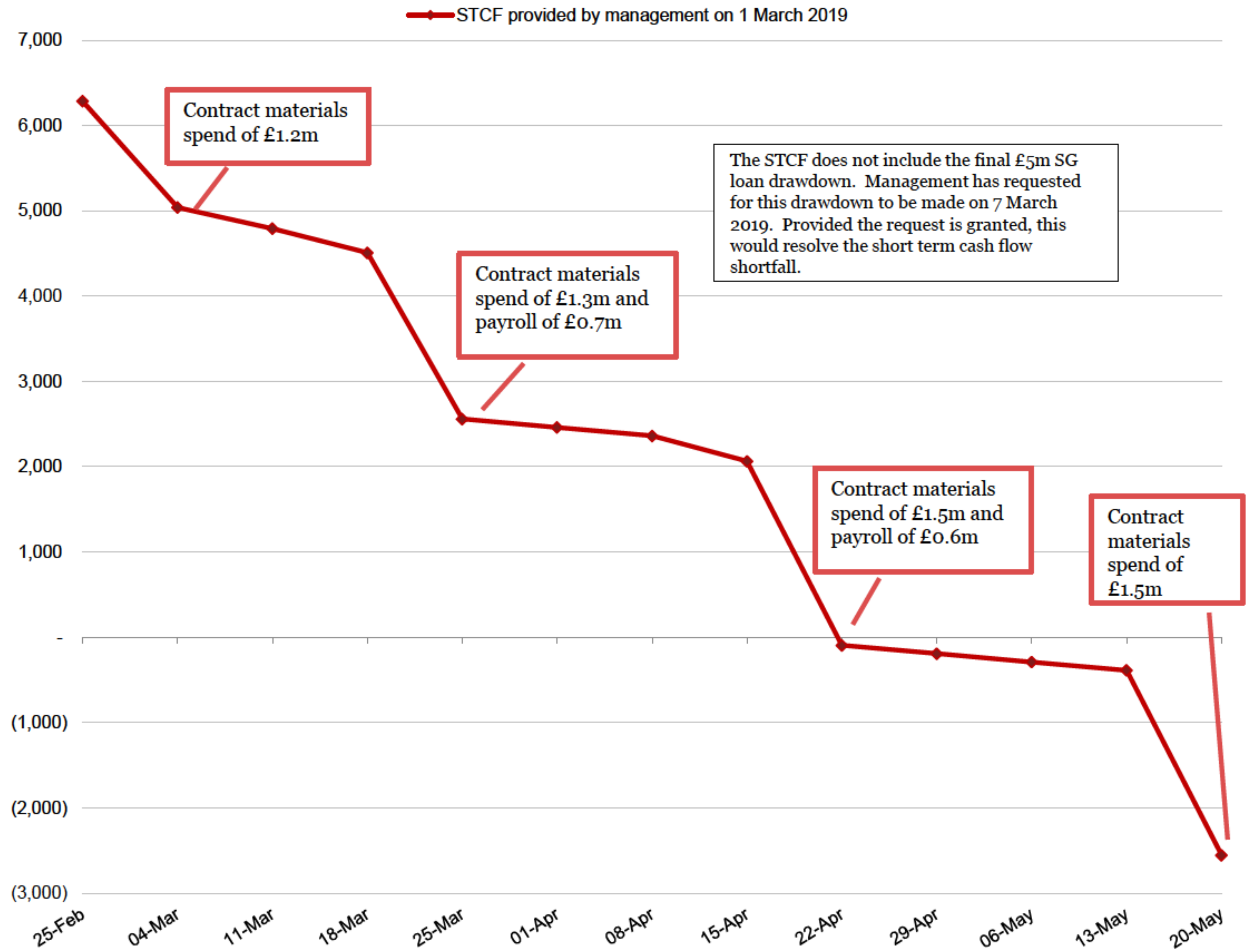
Milestone	Amount (£000)	Per Aug 17 IBR	Per Feb 18 Budget	Per May 18 Reforecast	Per Sep 18 Reforecast	Per Feb 19 Budget
801 Delivery	4,850	Jun-18	Mar-19	Jun-19	Jun-19	Oct-19
802 100% fabrication	1,200	Oct-17	Oct-18	Mar-19	Mar-19	Nov-19
802 Hull inspection prior to paint	1,200	Nov-17	Oct-18	Mar-19	Mar-19	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 1 March 2019).

The STCF does not include the final £5m SG loan drawdown.

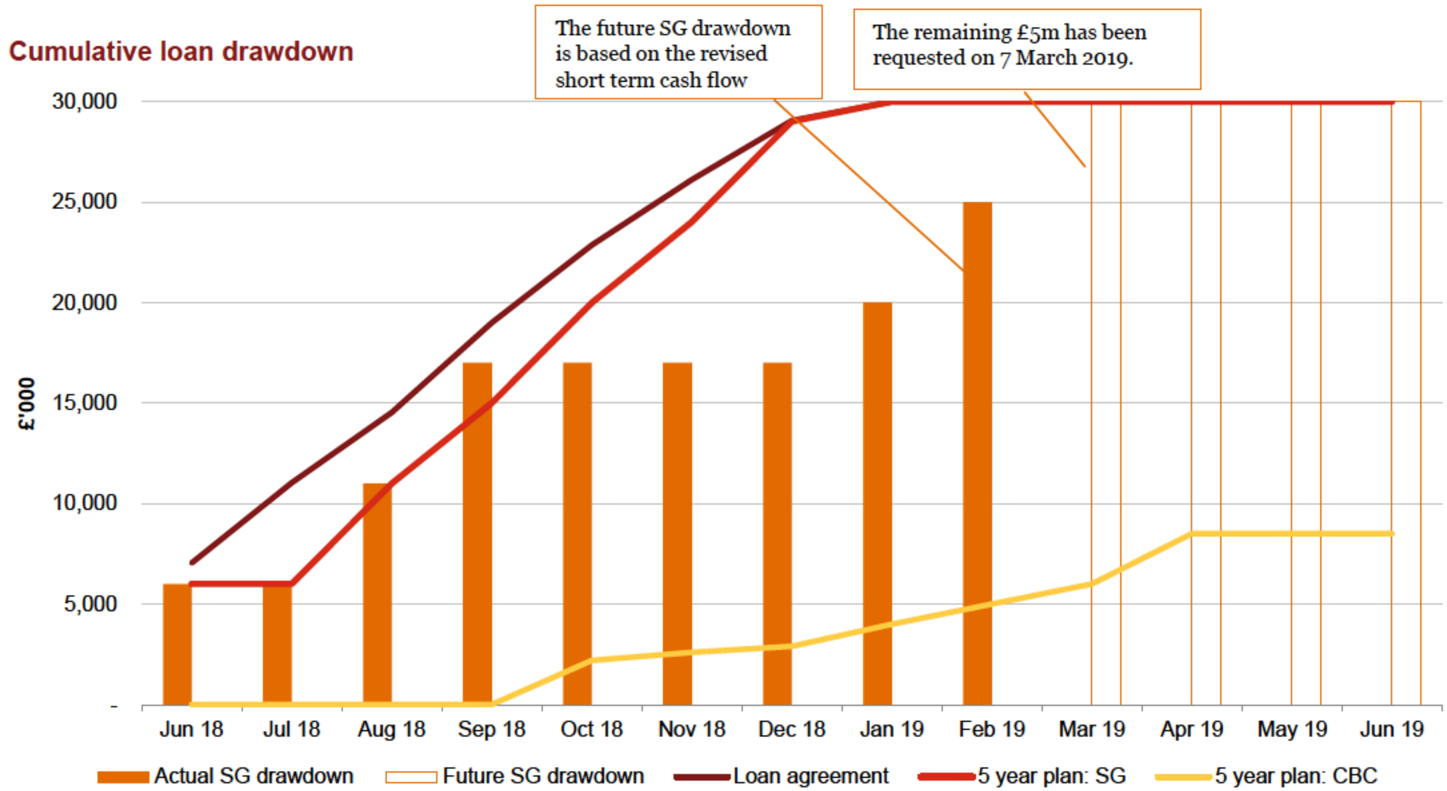
However we understand a request was made on 7 March 2019 to SG for the drawdown.



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 1 March 2019, FMEL had drawn down £25m of the £30m SG loan. This is within the maximum cumulative drawdown limits per the loan agreement.

FMEL had requested on 7 March 2019 for the remaining £5m SG loan to be withdrawn.

[redacted]

801/2 build report

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

The total contract costs have increased by £6.7m which is not reflected in the latest forecasts.

Vessel contract costs £'000	Nov-18 801 total	Nov-18 802 total	Nov-18 801/802	Dec-18 801 total	Dec-18 802 total	Dec-18 801/802	Total Variance
Total contract costs paid to date	59,600	39,300	**98,900**	63,000	41,500	**104,500**	5,600
Total costs to completion	11,600	25,600	**37,200**	12,500	25,800	**38,300**	1,100
Total contract costs	**71,200**	**64,900**	**136,100**	**75,500**	**67,300**	**142,800**	**6,700**
Receipts to date	44,100	39,240	**83,340**	44,044	39,244	**83,288**	(52)
Receipts to completion	5,150	10,010	**15,160**	5,206	10,006	**15,212**	52
Total receipts	**49,250**	**49,250**	**98,500**	**49,250**	**49,250**	**98,500**	**0**
Direct labour hours to date	846	295	**1,141**	860	308	**1,168**	27
Direct labour hours to completion	94	365	**459**	200	417	**617**	158
Total direct labour hours	**940**	**660**	**1,600**	**1,060**	**725**	**1,785**	**185**

801/2 contract costs

The table above shows £5.6m of costs being paid on the 801/2 contract and 27k hours of direct labour hours being booked as discussed in the December P&L (page 6).

Management notes that total contract costs have increased by £6.7m which includes retrospective uplifts to overhead absorption rates in line with the 2016 statutory accounts. This total contract costs increase has yet to be reflected in the latest forecasts.

Management noted a claim for c£60m has been lodged with CMAL. This claim is largely based on increased contract costs but, if agreed, it would represent an increase to the total final receipts which are currently shown as £98.5m.

Direct labour hours

Based on direct labours hours only, 801 is 81% (September 85%) through construction and 802 is 42% (September 40%) through construction with delivery due in June 2019 and March 2020 respectively. The drop in 801 completion percentage is due to an increase in total direct labour hours required for completion, but 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-Nov 18	Dec-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.