carillion

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News

10th July 2017

2017 first-half trading update
Strategic review and management changes

H1 revenue expected to be similar to that in 2016 at approximately £2.5bn.

- H1 operating profit lower than expectations primarily due to phasing of Public Private Partnerships (PPP) equity disposals, which are now expected to be in H2.
- Strong work-winning performance, with £2.6bn of new work secured in H1 - £2.1bn in support services.
- Progress made against strategic objectives set at full year results, with cost reduction underway and disposal of 50 per cent of the economic interest in the Group's business in Oman, Carillion Alawi, for an immediate cash consideration of £12.8m.
- Deterioration in cash flows on a select number of construction contracts led the Board to undertake an enhanced review of all of the Group's material contracts, with the support of KPMG and its contracts specialists, as part of the new Group Finance Director's wider balance sheet review.
- This review has resulted in an expected contract provision of £845m at 30 June 2017, of which £375m relates to the UK (majority three PPP projects) and £470m to overseas markets, the majority of which relates to exiting markets in the Middle East and Canada. The associated future net cash outflows in respect of these contracts is £100m-£150m (primarily in 2017 and 2018).
- As a result of the enhanced contracts review and the strategic actions below, reflecting difficult markets and exits from certain territories, Carillion is issuing revised full-year guidance, with revenue now expected to be between £4.8bn and £5.0bn and overall performance expected to be below management's previous expectations.

Actions to reduce net borrowing

- Deterioration in cash flows on construction contracts, combined with a working capital outflow due to a higher than normal number of construction contracts completing and not being replaced by new contract starts, means H1 average net borrowing is now expected to be £695m (Full year: 2016: £586.5m).
- The actions the Board put in place in March 2017 to reduce net borrowing have been accelerated and further actions are being taken to reduce net borrowing including:
  - Disposals to exit non-core markets and geographies to raise up to a further £125m[1] in the next 12 months.
  - Further annual cost savings to be quantified as part of the strategic and operational review.
  - Maximising the recovery of receivables.
  - 2017 dividends suspended resulting in a cash saving of approximately £80m.

Strategic and operational review

- The Board announces today that it is undertaking a comprehensive review of the business and the capital structure, with all options to optimise value for the benefit of shareholders under consideration. An update on the Board's review of the business and capital structure will be provided at the Group's interim results, in September.
- Significant actions already taken to reposition the business.
- Exit from construction PPP projects.
- Exit from construction markets in Qatar, the Kingdom of Saudi Arabia and Egypt.
- Only undertaking future construction work on a highly selective basis and via lower-risk procurement routes.

[1] Includes £12.8m immediate cash consideration from the sale of Carillion Alawi

Philip Green, Non-Executive Chairman said,
"Despite making progress against the strategic priorities we set out in our 2016 results announcement in March, average net borrowing has increased above the level we expected, which means that we will no longer be able to meet our target of reducing leverage for the full year.

"We have therefore concluded that we must take immediate action to accelerate the reduction in average net borrowing and are announcing a comprehensive programme of measures to address that, aimed at generating significant cashflow in the short-term.

"In addition, we are also announcing that we are undertaking a thorough review of the business and the capital structure, and the options available to optimise value for the benefit of shareholders. We will update the market on the progress of the review at our interim results in September.

"Richard Howson has stepped down as Group Chief Executive and from the Board with immediate effect and Keith Cochrane, previously our Senior Independent Non-Executive Director, will take over as interim Group Chief Executive, while a search is underway for a new Group Chief Executive. We are fortunate to have had Keith as a Non-Executive member of our Board as he has considerable plc CEO experience. Richard will stay with the Group for up to one year to support the transition."

A presentation for institutional investors and analysts will be held today at etc.venues St Paul's, 200 Aldersgate, London EC1A 4HD starting at 08:30 today. The presentation will be webcast live on www.carillionplc.com and subsequently available on demand. A dial-in facility is also available on 0808 109 0700 (UK Toll Free) or +44 (0) 20 3003 2666 (Standard International Access) with a participant pin code of 110717. A replay facility will be available for 7 days on +44 (0) 20 8196 1998 with an access code of 9946232

The announcement contains inside information. The person responsible for the release of this announcement on behalf of Carillion plc is Zafar Khan, Group Finance Director.

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Managing positions in challenging markets and on difficult contracts

Carillion has continued to focus on delivering its revised strategy and the priorities it set out at the time of its 2016 full-year results announcement. Although progress has been made against these priorities, the Group has experienced deteriorating cashflows across a number of significant contracts during the first half of 2017. Of these contracts, there are four material contracts where the financial position has worsened significantly, of which three are construction contracts for PPP projects in the UK, and the other is a mixed use construction contract in Qatar.

Enhanced Contracts review

In line with the Group's stated priority of managing its positions in challenging markets and on difficult contracts, and in response to the deterioration in the cashflows on four major construction contracts, the Board initiated an enhanced review of all the Group's material contracts as part of a wider balance sheet review already being carried out by the new Group Finance Director.

Given the significance of the enhanced review, the Audit Committee asked the Group's auditors, KPMG, to accelerate certain year-end audit procedures in respect of the Group's contracts, which included a "deep dive" review by KPMG's contracting specialists, and to report on those procedures as part of its independent half-year review.

Scope

The enhanced contract review covered both continuing and completed contracts and considered:

- Contracts impacted by the Company's decisions to exit certain territories as a result of geo-political and macro-economic deterioration, in Canada, Egypt, the Kingdom of Saudi Arabia, Qatar and the Caribbean;
- Existing contracts impacted by the increased selectivity imposed on bidding for construction contracts in Canada;
- Contracts in the UK where there has been a notable deterioration during 2017 that would indicate potential risk of impairment;
- All contracts with material contentious receivables where there was a wide range of potential outcomes, as identified by management and KPMG; and
- All continuing contracts contributing revenues greater than £20m in the period to 31 May 2017 and all contracts with receivable balances in excess of £20m as at 31 May 2017.

The selection process identified 58 contracts for enhanced review, including 20 completed contracts and 38 continuing contracts. These 58 contracts accounted for £1.58bn or 73 per cent of total receivables on the Group's balance sheet as at 31 May 2017. Of the 38 continuing contracts reviewed, 13 are support services contracts and 25 are construction contracts (out of a total of 83 continuing construction contracts). The 38 continuing contracts accounted for 46 per cent of the Group's revenue at 31 May 2017.

The enhanced review was designed to consider whether all important relevant information and evidence had been identified and appropriately considered in arriving at revenue, costs and margin recognised to date and whether appropriate account had been taken of likely revenue, costs and margin to completion.

Consequently, the enhanced review considered whether the resulting adjustments had any impact on the Company's half year or prior year results or carrying value of the Company's balance sheet and concluded that no prior year adjustments were necessary.

Outcome

The enhanced review identified issues relating to construction contracts, including continuing contracts, where cashflows have deteriorated and where the commercial assessment of final account settlements are, or could be, potentially below previous estimates. In light of this review, the Board expects to take an estimated provision of £845m at 30 June 2017. Of the expected provision, approximately half relates to the cost of completing challenging contracts and half to the cost of exiting non-core construction markets in Canada and the Middle East.

These contracts represented £927m of receivables on the Group's balance sheet at 31 May 2017. The expected provision includes £599m against receivables and the remainder is for future costs, with the estimated future net cash outflows for these contracts of between £100m-£150m mainly in 2017 and 2018, based on estimated receivables of £328m net of estimated payables of £443m. Notwithstanding the provision, the Group also intends to continue vigorously pursuing the recovery of receivables on all these contracts.

The four challenging construction contracts described above (three in the UK and one in Qatar) are at an advanced stage with good visibility on the timeline to completion, within the next 18 months. Following this provision, the Group expects to have tax losses of £810m, with a potential associated cash benefit to the Group of £110m.

There is a high level of uncertainty and judgement involved in assessing the assumptions underlying the expected £845m provision, with a potentially broad range of outcomes. The Board believes that the provision represents a prudent estimate of the likely outcome, based on the information currently available.

Strategic and operational review

The full year 2016 results announcement identified certain markets and sectors in which the Group was operating that were considered to be no longer attractive, including its construction markets in the Caribbean, Canada and the Middle East, and set out plans to exit these markets.

The enhanced contract review has provided the Board with a better understanding of why problems have arisen under certain of the Group's construction contracts. In particular, construction for PPP contracts and construction in the Middle East and Canada have been the markets where the significant majority of issues have occurred and a number of the issues are common to these contracts. These include accepting tenders with a high degree of uncertainty around key assumptions, undertaking contracts where success has been contingent on the performance of others not under our control and agreeing design changes without agreeing incremental costs and value.

As a result, the Group has begun the process of fully exiting from the construction markets in Qatar, the Kingdom of Saudi Arabia and Egypt. In future, the Group will focus its Middle East joint venture operations selectively on the UAE and Oman, where it has local partners, and only where it can do so with the support of UK Export Finance.

The Board has also concluded that the Group will exit the business of delivering construction for PPP projects, and after the delivery of ongoing projects it will no longer bid for this type of work.

After the completion of ongoing construction contracts, any future construction work that the Group undertakes will be focused on lower-risk procurement routes and increasingly aligned with its support services businesses. Currently the Group estimates that approximately 67 per cent of its construction order book has been procured through these lower risk routes.

In addition to the actions that were previously underway or are now being taken, the Board has concluded that it will also undertake a comprehensive strategic and operational review of the business and the capital structure, with all options to optimise value for the benefit of shareholders under consideration.

A further update on the Board's review of the business and capital structure will be provided at the Group's interim results, in September.

Management changes

- In order to strengthen management controls a number of leadership changes have been made or are in the process of being made.
- Richard Howson has stepped down as Group Chief Executive Officer and from the Board with immediate effect. He will stay with the Group for up to a one year transitional period. Keith Cochrane, previously Senior Independent Non-Executive Director, will take over as interim Group Chief Executive Officer with immediate effect.
- The Managing Director of the UK Building business has left the Group and changes have been made to strengthen the management team.
- Three of five Business Unit Finance Directors have also been replaced since Zafar Khan took over as Group Finance Director in January 2017.
- Baroness Sally Morgan, previously an Independent Non-Executive Director, has been appointed as the Senior independent Non-Executive Director with immediate effect.

Reducing leverage

Average net borrowing in the first half of 2017 is expected to be £695m (31 December 2016: £586.5m) with net borrowing at 30 June 2017 expected to be £536m[2] (31 December 2016: £183.1m[3]), with both being

[2] Includes the £39m (31 December 2016: £35.8m) benefit of the Group's FX derivative instruments

[3] Includes the £39m (31 December 2016: £35.8m) benefit of the Group's FX derivative instruments

higher than expected at the time of the Group's 2016 full-year results announcement. The Group remains well within its 3.5 times net debt to EBITDA covenant at 30 June 2017.

As explained, the increase in net debt has arisen as a result of the impact of the cash outflow associated with onerous contracts, together with the cash outflows caused by a high number of UK construction contracts reaching completion and not being replaced by any new material contract starts, and an increasingly challenging trading environment in the Middle East affecting the collection of receivables.

Full-year average net borrowing, before the application of any disposal proceeds, is now expected to be between £775m and £800m. However, the Group expects net borrowing at 31 December 2017 to be slightly lower than at 30 June 2017. The Board has concluded that average net borrowing must be reduced and has announced a comprehensive programme of measures to accelerate this, including new management incentives linked to deleveraging.

Disposals of non-core businesses
The Group has today announced the disposal of 50 per cent of its economic interest in in its construction and support services business in Oman, Carillion Alawi, for immediate cash consideration of £12.8m.

The Board has also identified a number of other non-core businesses for disposal, and from which its target is to raise approximately £125m[4] in the next 12 months. Sale processes for three business disposals are currently in progress. The timing and amount to be raised from any disposals remains subject to the successful conclusion of the sale processes.

Further cost efficiencies
The Group's current cost reduction programmes, as announced at the full year 2016 results, are targeting a gross £50m of cost savings in 2017. The Group will now target further cost savings the quantum and timing of which will be a key element of the strategic review.

Maximising recoveries
Management will continue to focus on the recovery of receivables, including in respect of the underperforming contracts against which a provision has been taken.

Pension fund deficit payments
At 30 June 2017, the pension deficit is expected to reduce by £76m to around £587m (31 December 2016: £663.2m).

Dividend
The Board has decided that it would be inappropriate to pay dividends until the Group's leverage position and cash generation has improved. Therefore, the Board has suspended the payment of any dividends in the financial year 2017, resulting in a cash saving of approximately £80m, and will review the dividend policy in 2018.

Covenants and Liquidity
The Group remains within its covenant limits and continues to maintain substantial liquidity, with no loan maturities in the short term.

Trading update
The Group has continued to focus on delivering its strategy and the priorities it set out at the time of its 2016 full-year results announcement. Although progress has been made against these priorities, the Group has experienced deteriorating cashflows across a number of significant contracts during the first half of 2017. This, coupled with more challenging market conditions, is expected to result in the Group's overall performance for the full year 2017 now being below management's previous expectations.

First-half work winning in 2017
Work winning in the first six months of the year has been healthy, with new orders and probable orders in the first half worth a total of £2.6bn, despite the slower pace of new contract awards in the UK, due to political uncertainty as a result of Brexit and the UK General Election, and the ongoing difficult market conditions in the Middle East.

[4] Includes £12.8m immediate cash consideration from the sale of Carillion Alawi

At 30 June 2017, total orders plus probable orders of some £16bn (2016: £16.0bn), giving full-year revenue visibility of 92 per cent (2016: 97 per cent). The Group's pipeline of specific contract opportunities, for which it is either bidding or planning to bid, has also remained relatively strong at £32bn (31 December 2016: £41.6bn), after being adjusted to reflect greater selectivity in, or withdrawal from, certain construction markets.

The Group's order book and pipeline reflects the good positions it has in a number of infrastructure and property services markets. In infrastructure, these include the rail and highways markets in the UK and power transmission and distribution market in Canada. In property services, the Group has a leading position in the UK Defence sector and a strong position on the UK Crown Commercial Service framework for the provision of facilities management services.

First-half trading in 2017

Total first-half revenue is expected to be similar to that reported for the first half of 2016. Underlying operating profit is expected to be lower than 2016, mainly due to a reduction in profit from PPP projects reflecting the phasing of planned equity disposals, which are now expected in the second half of the year.

As indicated above, the Group's average net borrowing in the first half of 2017 will be higher than expected at the time of the Group's 2016 full-year results in March 2017, at around £695m (31 December 2016: £586.5m). Net borrowing at 30 June 2017 is also expected to be higher than expected at some £536m[5] (31 December 2016: £183.1m[6]).

Business segment analysis and outlook

The Board believes that it is appropriate to provide an updated outlook for its business segments and the Group as a whole. This revised guidance replaces all previous forward-looking statements made by the Group.

Group

The Group now expects full-year revenue in 2017 (including joint ventures) to be between £4.8bn and £5.0bn.

Support services

First-half revenue is expected to be slightly above the level in the first half of 2016 and in line with expectations, despite the strong comparable period performance in 2016. First-half operating margin is expected to be slightly ahead of the margin in the first half of 2016, as this business segment has seen some benefit from the cost savings programme announced in March 2017, albeit that the bottom line impact of these savings is expected to be lower than originally planned.

The value of orders and probable orders at 30 June 2017 for support services, is expected to be slightly ahead of the £12.2bn reported at the end of 2016. At 30 June 2017, the pipeline of contract opportunities in this segment is expected to be approximately £13bn (31 December 2016: £11.1bn), which reflects healthy growth opportunities across a number of our support services markets.

Full-year revenue is expected to be between £2.6bn to £2.8bn. As previously disclosed, in the second half of 2016 the Group benefited from certain licensing profits of some £20m**.** While the Group had targeted securing revenue growth and cost savings to replace this licensing profit, it now believes that it is unlikely to replace the majority of this profit in the current year, due to a number of reasons.

Revenue growth is now likely to be lower than expected at the start of 2017, mainly because the award and mobilisation of a number of large UK Government contracts has been delayed due to the purdah period ahead of the UK General Election and the uncertainty created by its outcome. The phasing of cost savings targeted in 2017 are now expected to be weighted towards the end of the year and their net benefit to margins is also likely to be less than originally expected, as a greater proportion of these savings are being used to mitigate additional cost pressures due to a later than planned exit from a major facilities management contract during the first half. However, overall we are pleased with the underlying operational performance of this business segment, as it continues to focus on markets with good growth fundamentals and in which it has a leading or strong position.

[5] Includes the £39m (31 December 2016: £35.8m) benefit of the Group's FX derivative instruments

[6] Includes the £39m (31 December 2016: £35.8m) benefit of the Group's FX derivative instruments

PPP projects

First-half revenue is expected to be broadly similar to that in 2016, as a small decline in revenue as a result of Royal Liverpool University Hospital moving towards completion was offset by the contribution from a new project, Irish Schools Bundle 5, on which we achieved financial close in 2016. Operating profit is expected to reduce significantly, with profit from PPP equity sales lower than in the first half of 2016, due to the timing of these sales being deferred to the second half of 2017. First-half equity sales in 2017 generated proceeds of £1.5m (2016: £48.2m), but continued to represent a discount rate of approximately seven per cent. At 30 June 2017, we had a portfolio of 15 financially closed projects in which we have invested £27m of equity and into which we have commitments to invest a further £52m of equity. At 30 June 2017, the Directors' valuation of the portfolio based on a nine per cent discount rate was £46m; at a seven per cent discount rate the valuation was £65m.

Total orders plus probable orders at 30 June 2017 amounted to £0.7bn (31 December 2016: £0.8bn). Full-year revenue is expected to reduce compared with 2016 to between £225m and £275m, as construction volumes reduce, notably as a number of PPP contracts move towards completion. Underlying operating profit is expected to be around 15-20 per cent lower, mainly because no projects are expected to reach financial close in 2017 and therefore no associated success fees are expected.

Middle East construction services

We expect first-half revenue to be lower, due to a number of projects approaching completion and not being replaced, in line with our revised strategy for Middle East construction of focusing on contracts supported by UK Export Finance. However, we expect the benefits of this strategy to be evident in the first half underlying operating margin and underlying operating profit, with both of these increasing as a result of putting UK Export Finance arrangements in place for one new project in the first half and securing the associated fee.

The value of orders plus probable orders at 30 June amounted to £0.5bn (31 December 2016: £0.5bn). Full-year revenue is expected to be lower than in 2016 at between £520m and £570m, reflecting the sale of 50 per cent of our business in the Oman and our more selective strategy in the Middle East of bidding for contracts only with the support of UK Export Finance. Our pipeline of contract opportunities in the Middle East has also reduced to around £1.5bn (31 December 2016: £15.0bn) for the same reasons. However, we expect to maintain the operating margin at or around 4 per cent, as a result of securing further projects with the support of UK Export Finance.

The Group has disposed of 50 per cent of its economic interest in its subsidiary business that operates in the Oman, Carillion Alawi, to the Al Zawawi family. Carillion Alawi operates in Oman and carries out all types of civil engineering works. The Group owned 49 per cent of this business with the remaining 51 per cent owned by its partner, the Al Zawawi family. Prior to the disposal, the Group had benefited from a 100 per cent economic interest, controlled the board and day to day operations and had therefore consolidated Carillion Alawi into its accounts. As part of the disposal, the Group has entered into new arrangements with the Al Zawawi family, such that both parties will equally share the economic interests and control of Carillion Alawi. In exchange, the Group will receive an immediate cash consideration of £12.8m, with a deferred cash consideration of up to a further £29.0m depending on the performance of the business. For the 2016 financial year, Carillion Alawi contributed £281.6m of revenue with a loss before tax of £(3.6)m and gross assets of £323m as at 31 December 2016. The disposal proceeds will be applied to reducing the Group's overall leverage position and following the disposal Carillion Alawi will be deconsolidated in the Group accounts and Carillion Alawi will now operate as an incorporated Joint Venture in which the Group has a 50 per cent economic interest.

Construction services (excluding the Middle East)

Revenue in the first-half is expected to increase slightly. First-half underlying operating margin and underlying operating profit are expected to reduce, because of the impact on margins of the provisions taken in respect of the onerous contracts, as described above.

The value of orders plus probable orders at 30 June was £2.0bn (31 December 2016: £2.5bn), giving revenue visibility for the full-year of 87 per cent (2016: 100 per cent) on full year revenue expectations of approximately £1.2bn to £1.4bn (2016: £1.5bn). Full-year revenue is expected to be lower, because a number of projects are nearing completion and have not been replaced by any new material construction contracts starts, as a result of a general slowdown in the pace of contract awards due to the general political uncertainty caused by Brexit, the purdah period ahead of the UK General Election and the uncertainty created by its outcome. The pipeline of contract opportunities at 30 June was worth £13.0bn (31 December 2016: £12.5bn). The underlying operating margin is expected to be lower than in 2016, principally due to trading the onerous contracts described above at zero margin. The Group's developments business continues to perform well and in line with expectations.

IFRS 15 – Revenue on contracts with customers
A review of the effects of adopting IFRS 15 is underway and an update on this will be provided with the Group's 2017 half-year results.

Summary
The Board believes that, despite the problems experienced in the first half, the underlying business benefits from a good order book and pipeline and leadership positions in key support services markets, which are expected to benefit from structural growth. The Board is committed to progressing its target of reducing financial leverage and will provide an update on its operational and strategic review at the time of its interim results in September.