

Advisory

Project Poseidon

Phase 2 - monitoring (October and November 2018 results)

*Strictly Private
and Confidential*
Draft

8 February 2019



**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

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

The production for 801/2 year to date has fallen further behind both February budget and September reforecast.

Management has yet to amend the delivery dates for 801/2.

New work is behind schedule although management have made progress on winning work.

By way of illustration the new orders that have been, or management believes are likely to be, won in early course total £17m compared to the February 2018 budget figure for FY19 which showed a total of £34m.

Summary of key points

October 2018 performance

- 801/2 production was behind target, month to date revenue was £1.5m behind February budget and £1.1m behind September reforecast.
- Management has stated that it has reduced labour spend to conserve cash whilst funding arrangements are agreed.
- There were no other significant production activities.

November 2018 performance

- 801/2 production increased significantly as contractor levels increased but month to date revenue was still £0.6m behind February budget and £1.5m behind September reforecast.
- There were no other significant production activities.
- The November management accounts includes the £44.3m loss provision for 801/2 that was recognised in the 2016 statutory accounts. These are non-cash adjustments.

801/2

- Year to date revenue was £11.5m behind February budget and £4.4m behind September reforecast.
- Management is still retaining the stated delivery dates. Transport Scotland (TS) notes Caledonian Maritime Assets Ltd (CMAL) is less confident on the delivery dates being met. Scottish Government's (SG) operational expert notes that there may be 3-4 months of slippage in delivery dates.

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	Sept-18	Oct-18	Nov-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 October 2018 to both the February 2018 budget provided by management, and the September reforecast.

Profit & loss account: October 2018

£ in ms	Note	Oct Actual	Feb budget	Variance	Reforecast	Variance
801/2 revenue	1	1.1	2.6	(1.5)	2.2	(1.1)
Other revenue	2	0.1	1.4	(1.3)	0.4	(0.4)
Gross margin	3	-	0.3	(0.3)	0.1	(0.1)
Selling, general and administrative		(0.3)	(0.2)	(0.1)	(0.2)	(0.1)
Add back depreciation		0.1	0.1	0.0	0.1	0.0
EBITDA		(0.2)	0.2	(0.4)	0.0	(0.2)
Exceptional items		(0.1)	(0.1)	0.0	(0.1)	(0.1)
Interest		(0.2)	(0.2)	0.0	(0.3)	0.1
Depreciation		(0.1)	(0.1)	-	(0.1)	(0.0)
Net profit		(0.6)	(0.2)	(0.4)	(0.4)	(0.2)

1 – 801/2 revenue was £1.5m behind budget and £1.1m behind reforecast as management has not been able to recruit sufficient labour for production. Actual hours show a shortfall against budget and reforecast (Actual: 31k, Reforecast 42k, Budget 51k).

Actual hours shows a nominal increase of 5k from the figure reported in September (26k). This is in line with the nominal increase in contractors.

Management did not note any significant key staff movements in October.

Profit and loss account

The table opposite compares the actual profit and loss account for November 2018 to the February 2018 budget provided by management, and to the September reforecast.

Profit & loss account: November 2018

£ in ms	Note	Nov	Feb	Variance	Reforecast	Variance
		Actual	Budget			
801/2 revenue	1	1.5	2.1	(0.6)	3.0	(1.5)
Other revenue	2	0.1	1.3	(1.2)	0.2	(0.1)
Gross margin	3	0.1	0.5	(0.4)	0.3	(0.2)
Selling, general and administrative		(0.4)	(0.2)	(0.2)	(0.2)	(0.2)
Add back depreciation		(0.0)	-	(0.0)	0.1	(0.1)
EBITDA		(0.3)	0.3	(0.6)	0.2	(0.5)
Exceptional items		0.1	-	0.1	(0.1)	0.2
Interest		(0.3)	(0.2)	(0.1)	(0.3)	0.0
Depreciation		-	-	-	(0.1)	0.1
Net profit		(0.5)	0.1	(0.6)	(0.3)	(0.2)

The original February budget was £3.1m but this has been reduced to £2.1m to take into account of the 68.1% adjustment as explained on page 9. Note this adjustment has not been reflected in the October MI pack and the September reforecasts.

1 – 801/2 revenue is £0.6m behind budget and £1.5m behind reforecast. Although labour levels and hours have increased, these are still below forecasted figures. Actual hours show a shortfall against budget and reforecast (Actual: 52k, Reforecast 55k, Budget 63k).

Staff numbers as at December were:

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

Management has not produced a summary of these figures for November. This reflects the increase noted in our September report but the extra contractors' work have not continued into 2019 due to management conserving cash whilst funding arrangement are made.

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

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: November 2018 YTD

£ in ms	Note	Feb		Variance	Reforecast	Variance
		Actual	Budget			
801/2 revenue	1	22.2	33.7	(11.5)	26.6	(4.4)
Other revenue	2	2.0	8.4	(6.4)	2.9	(0.9)
Gross margin	3	(1.0)	1.6	(2.6)	(0.5)	(0.5)
Selling, general and administrative		(2.5)	(2.2)	(0.3)	(2.2)	(0.3)
Add back depreciation		0.9	0.9	-	0.8	0.1
EBITDA		(2.6)	0.3	(2.9)	(1.8)	(0.8)
Exceptional items		(1.0)	(0.8)	(0.2)	(1.0)	0.0
Interest		(2.5)	(2.1)	(0.4)	(2.7)	0.2
Depreciation		(0.9)	(0.9)	-	(0.8)	(0.1)
Net profit	4	(7.0)	(3.5)	(3.5)	(6.3)	(0.7)

Management has noted it is working on an up to date reforecast. This will be presented at a board meeting on 11 February 2019.

1. Revenue remains behind both the February budget and September reforecast, due to cash constraints on 801/2 project. In addition, management have ring fenced cash for wages and other projects.
2. Other revenue remains behind the February budget which had expected greater work wins, but has now also fallen behind the September 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 November 2018 to the 2018 budget provided by management.

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

Balance Sheet November 2018

£ in 000s	Note	Actual	Budget	Movement
Intangible assets		0.3	0.2	0.1
Tangible fixed assets	1	17.7	18.7	(1.0)
Total non current assets		18.0	18.9	(0.9)
Inventory		-	-	-
Accounts receivable		1.1	0.2	0.9
WIP	2	(9.7)	6.6	(16.3)
Prepayments and other debtors		2.1	1.4	0.7
Accounts payable		(4.1)	(3.4)	(0.7)
Accruals & other creditors	3	(22.0)	(2.5)	(19.5)
Total Net Assets (before funding items)		(14.6)	21.2	(35.8)
Cash & cash equivalents		4.5	1.0	3.5
SG loan	4	(34.8)	(17.6)	(17.2)
Cash collateral		4.5	4.5	-
Total Net Assets		(40.4)	9.1	(49.5)
Capital & Reserves		22.0	22.0	-
Retained Losses		(62.4)	(12.9)	(49.5)
Total Net Equity		(40.4)	9.1	(49.5)

Note: The retained losses have increased from £15.9m in September 2018 to £62.4m in November 2018 due to the loss provision adjustment relating to FY16 audited statutory accounts.

WIP	£m
Contract WIP (prepaid costs)	13.7
Deferred revenue	(24.0)
Other WIP	0.6
Total	(9.7)

Deferred revenue	£m
Costs to date	98.9
Prepayments	(13.0)
Potential revenue @68.1% [*]	85.9
Billed to date	(83.3)
Misc	0.8
Deferred revenue	(24.0)

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

- Accounts receivable mainly relates to the air cushion barge contract.
- Contract WIP is related to prepayments incurred on 801/2 which have not been released to the profit and loss account as the work is not complete. The balance remains high as work has been paid for but the production schedule is delayed.
- [REDACTED]
- The SG loan balance is considerably greater than budget as this does not include the second SG loan.

Medium term cash flow

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

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

Cash flow October 2018

£ in 000s	Note	Oct Actual	Feb budget	Variance
EBITDA (excluding exceptionals)		(0.2)	0.2	(0.4)
Exceptionals				
Cash from trading		(0.3)	0.2	(0.5)
Movement in working capital	2	(1.6)	(0.6)	(1.0)
Operating cash flow		(1.9)	(0.4)	(1.5)
Purchase of fixed assets		0.0	(0.2)	0.2
New loans drawn		-	-	-
Increase/(decrease) in cash and cash equivalents		(1.9)	(0.6)	(1.3)
Opening balance		9.5	2.2	7.3
Closing balance		7.6	1.6	6.0

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

- The variance in working capital is mainly due to the WIP being greater than budget, i.e. greater costs have been prepaid than was budget as the work is behind budget.

Medium term cash flow

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

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

Cash flow November 2018 £ in 000s	Note	Nov Actual	Feb Budget	Variance
EBITDA (excluding exceptionals)		(0.3)	0.4	(0.7)
Exceptionals				
Cash from trading		(0.2)	0.3	(0.5)
Movement in working capital	2	(2.9)	(0.8)	(2.1)
Operating cash flow		(3.1)	(0.5)	(2.6)
Purchase of fixed assets		0.0	(0.1)	0.1
New loans drawn		-	-	-
Increase/(decrease) in cash and cash equivalents		(3.1)	(0.6)	(2.5)
Opening balance		7.6	1.6	6.0
Closing balance		4.5	1.0	3.5

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

2. As discussed in the October cash flow, the variance in working capital is mainly due to the WIP being greater than budget, i.e. greater costs have been prepaid than was budget as the work is behind budget.

As set out below no significant 801/2 income is expected until at least March 2019.

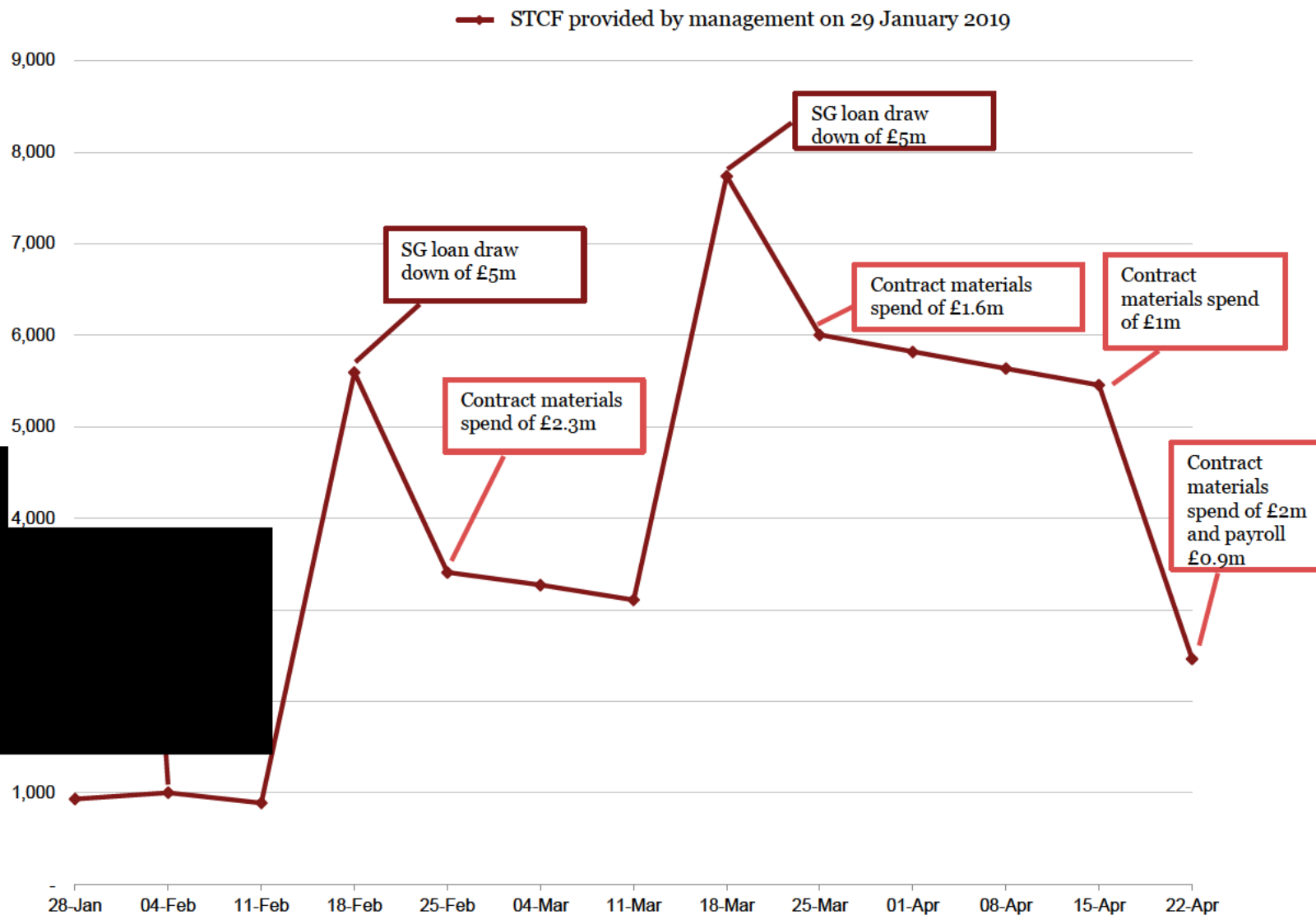
Milestone	Amount (£000)	Per Aug 17 IBR	Per Feb 18 Budget	Per May 18 Reforecast	Per Sep 18 Reforecast*
801 Delivery	4,850	Jun-18	Mar-19	Jun-19	Jun-19
802 100% fabrication	1,200	Oct-17	Oct-18	Mar-19	Mar-19
802 Hull inspection prior to paint	1,200	Nov-17	Oct-18	Mar-19	Mar-19
802 Berth join up	1,200	Nov-17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

Short term cash flow forecast

The graph shows the short term cash flow forecast (provided by management on 29 January 2019).

Management are forecast to make two further drawdowns in the period of the short term cash flow: £5m in the week ending 18 February and £5m in the week ending 18

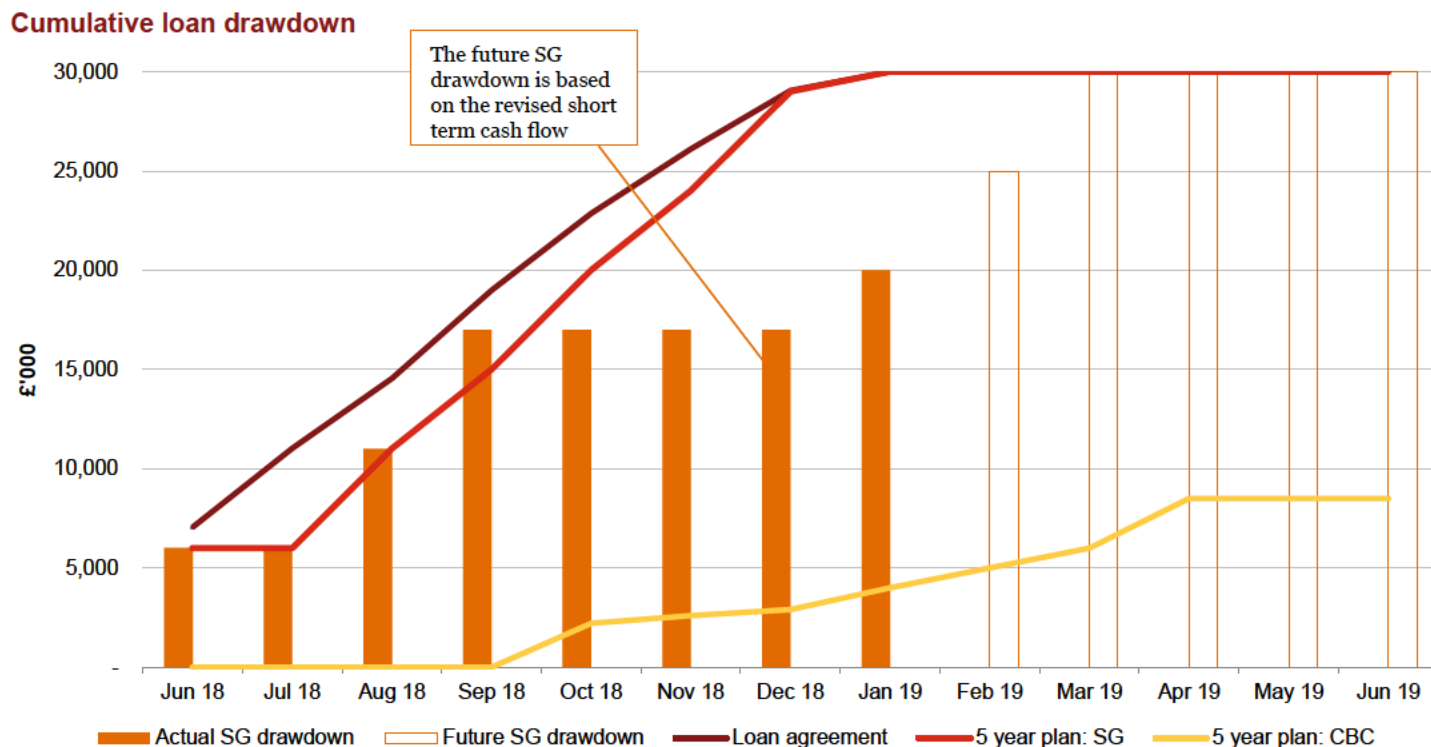
The opening balance does not include ring fenced funds of £2.8



Cumulative loan drawdown

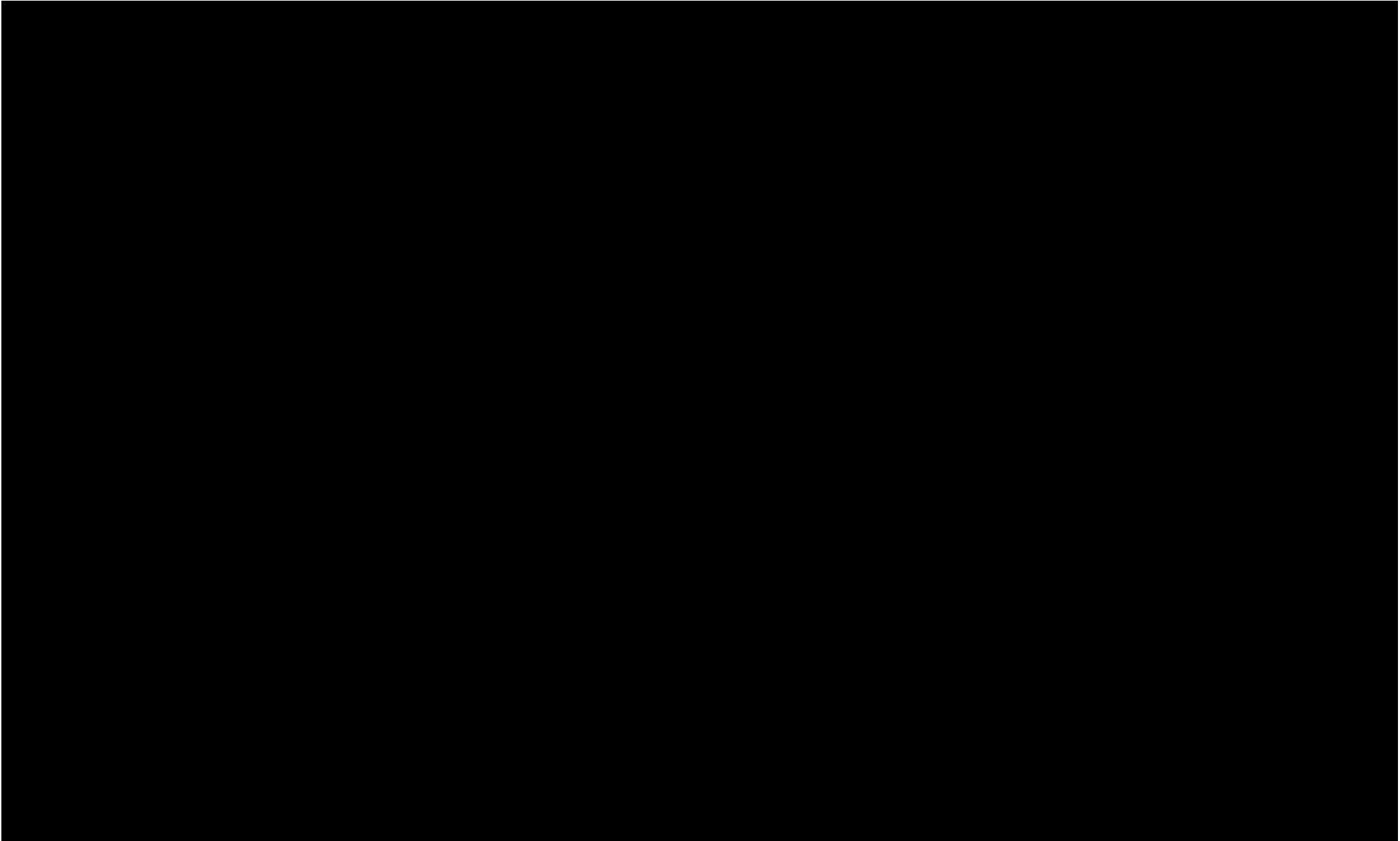
The graph shows the cumulative loan drawdown as projected in the loan agreement together with those forecast in the latest five year management projection.

The projections show the funding to be below the maximum per the loan agreement.



As at 31 January 2019, FMEL had drawn down £20m of the £30m SG loan. This is within the maximum cumulative drawdown limits per the loan agreement.

SG agreed to release £3m of funding in January 2019 to allow some of 801/2 production to progress.



801/2 build report

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

Vessel contract costs £'000	Oct-18			Nov-18			Total Variance
	801 total	802 total	801/802	801 total	802 total	801/802	
Total contract costs paid to date	57,800	37,400	95,200	59,600	39,300	98,900	3,700
Total costs to completion	13,400	27,500	40,900	11,600	25,600	37,200	(3,700)
Total contract costs	71,200	64,900	136,100	71,200	64,900	136,100	(0)
Paid to date	44,100	39,300	83,400	44,100	39,300	83,400	-
Payments to completion	5,200	10,000	15,200	5,200	10,000	15,200	-
Total payments	49,300	49,300	98,600	49,300	49,300	98,600	-
Direct labour hours to date	818	272	1,090	846	295	1,141	51
Direct labour hours to completion	122	388	510	94	365	459	51
Total direct labour hours	940	660	1,600	940	660	1,600	-

801/2 contract costs

The table above shows £3.7m of costs being paid on the 801/2 contract and 51k hours of direct labour hours being booked as discussed in the November P&L (page 7).

Management noted that a further delay would be expected following production slowing down, but this has not yet been quantified. SG's operational expert noted this may be c.3-4months and is likely to be almost entirely due to cash constraints in 801/2 projects rather than inappropriate action by FMEL.

Direct labour hours

Based on direct labours hours only, 801 is 90% (September 85%) through construction and 802 is 45% (September: 40%) through construction with delivery due in June 2019 and March 2020 respectively (see page 11).

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- Oct 18	Nov- 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.