Advisory

Project Poseidon
Phase 2 - monitoring (July 2018 results)

Strictly Private and Confidential

20 September 2018

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 27 November 2017.

This report has been prepared in connection with the 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

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Summary

July 2018 was behind forecast due to the cash constraints which meant that materials were not on site, staffing levels were low and productivity was lower than expected.

Management has presented a reforecast for the costs to complete 801/2 which highlight a further £6.9m cash cost compared to the May 2018 reforecast.

Summary of key points

July 2018 performance

- Revenue is £5.2m behind forecast for July and Gross Margin is £0.6m behind forecast. These are largely explained as delays resulting from the cash pressures experienced by the business during the summer months.
- The above included a delay in materials being installed/costs not yet incurred (£4.5m) and significantly fewer man hours (23k) being booked due to staffing remaining behind forecast.

Other matters

[redacted]

- Management noted that it was incurring significant costs and spending significant time preparing a detailed claim against CMAL for a potential cost price increase for 801/2. Further investigation would be carried out over the coming months but management has not yet set out what action would be taken thereafter.

Revised cash flow forecast presented in September 2018

- This monitoring report is based on the MI provided which compares performance against the budget provided in February 2018, rather than the cash reforecast provided in May 2018 or the revised forecasts provided at the meeting of 12 September 2018. We have requested this model but it has not yet been provided.
- The revised model is forecasting an additional cash cost of £6.9m to the 801/2 build costs compared to the May 2018 reforecast. We have not reviewed these forecasts. We recommend that the work plan should be reviewed by your operational expert.
- The September 2018 reforecast also notes a specific delivery month for 802 of March 2020, whereas previously it had been noted as H1 2020.
- The revised September 2018 model assumes draw downs of the SG facility totalling £30m by January 2019 and [redacted] Management forecasts a negligible cash shortfall in H2 of 2019 if new work is won but a shortfall greater than £6m from October 2019 onwards if new work is not won. However, management consider this could be mitigated and would reduce to zero on receipt of 802 final delivery payments in 2020.
- At the meeting of 12 September 2018, management set out an updated list of potential new orders which it believed were imminent and/or likely to be confirmed over the coming months. We agreed that management has made progress in securing certain orders but would caveat their optimism by noting such statements have been made on previous occasions and the value of orders expected to convert into work in the coming months remain lower than planned by FMEL.

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	May-18	June-18	July-18
Personnel changes	Y	Y	Y
Profit & loss	Y	Y	Y
Balance sheet	*	Y	Y
Cash flow statement	*	Y	Y
P&L comparison v budget	Y	Y	Y
BS comparison v budget	*	Y	Y
CF comparison v budget	*	Y	Y
801/2 build report	Y	Y	Y
801/2 cost over runs	Y	Y	Y
Permitted fees	Y	Y	Y

* Please see the relevant monthly report for our comments on the differences between the information requested and the information received.

Profit and loss account

The table opposite compares the actual profit and loss account for July 2018 to the February 2018 build forecast provided by management

Profit & loss account: July 2018

£ in 000s	Note	Actual	Forecast	Variance
801/2 revenue	1	700	5,940	(5,240)
Other revenue	2	80	1,740	(1,660)
Gross margin	3	**(299)**	**320**	**(619)**
Selling, general and administrative		(200)	(200)	-
Addback depreciation		100	80	20
EBITDA		**(399)**	**200**	**(599)**
Exceptional items		(200)	(60)	(140)
Interest		(300)	(170)	(130)
Depreciation		(100)	(80)	(20)
Net profit		**(999)**	**(110)**	**(889)**

1. Revenue – is significantly behind target due to both (a) a delay in materials being installed/costs not yet incurred (£4.5m) and (b) 23k fewer hours (June 19k) being booked booked (£0.8m) as staffing has been behind forecast.

Management has noted current staff numbers are 372 (June: 290) which can be analysed: permanent 167, temporary 130, contractors 75.

[redacted]

3. Gross margin – Management states that, due to the reduction in booked hours as discussed above, there has been an under recovery of overheads resulting in a gross margin short fall of c.£0.6m. Management notes this largely arises from an under-recovery of production overhead, i.e. staff could not work efficiently in this period as there were not materials for them to work with and their costs could not be avoided.

4. Other – We have asked management to provide its interest calculation.

Balance sheet

The table opposite compares the actual balance sheet for July 2018 to the February 2018 forecast provided by management.

Balance sheet: July 2018

£ in 000s	Note	Actual	Forecast	Variance
Intangible assets		300	154	146
Tangible fixed assets	1	17,900	18,500	(600)
Total non current assets		**18,200**	**18,654**	**(454)**
Inventory		38	-	38
Accounts receivable		300	170	130
WIP	2	5,800	6,500	(700)
Prepayments and other debtors	3	1,900	1,430	470
Accounts payable	4	(5,300)	(3,700)	(1,600)
Accruals & other creditors	5	(2,100)	(2,695)	595
Total Net Assets (before funding items)		**18,838**	**20,359**	**(1,522)**
Cash & cash equivalents		6,200	570	5,630
SG loan	6	(23,000)	(16,700)	(6,300)
Cash collateral		4,900	4,500	400
Total Net Assets		**6,938**	**8,729**	**(1,792)**

1. **Tangible fixed assets –** Spend on fixed assets is £0.6m behind budget (June: £0.5m) due to cash constraints**.**
2. **WIP** – £0.7m less than forecast as less work has been carried out than was forecast.
3. **Prepayments and other debtors –** £0.5m greater than forecast mainly due to an increase in VAT recoverable.
4. **Accounts payable** – £1.6m greater than forecast due to significant cash constraints. Further commentary is provided on page 9.
5. **Accruals and other creditors** – The budget accruals are based on the November 2017 accruals. The actual balance is behind forecast due to less than budgeted overtime hours as a result of the continued delay of the launch of 802.
6. **SG loan** – The forecast did not account for the loan drawdown of £6.0m at the end of June 2018 and the associated interest.

Medium term cash flow

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

Cash flow July 2018

£ in 000s	Note	Actual	Budget
[redacted]			
Cash from trading		**(560)**	**125**
Movement in working capital	2	(1,013)	(3,049)
Operating cash flow		**(1,573)**	**(2,924)**
Purchase of fixed assets		(60)	(167)
New loans drawn	3	-	-
Increase/(decrease) in cash and cash equivalents		**(1,633)**	**(3,091)**
Opening balance		7,800	3,700
Closing balance	4	6,167	609

1. **EBITDA/Exceptionals** – The numbers provided by management do not tie to the P/L. We have asked for a reason for the difference.
2. **Movement in working capital** – net effect of the variances set out on the balance sheet page of this report.
3. **New loans drawn** – No additional funds were drawn down in July.

[redacted]

Summary of milestones not achieved

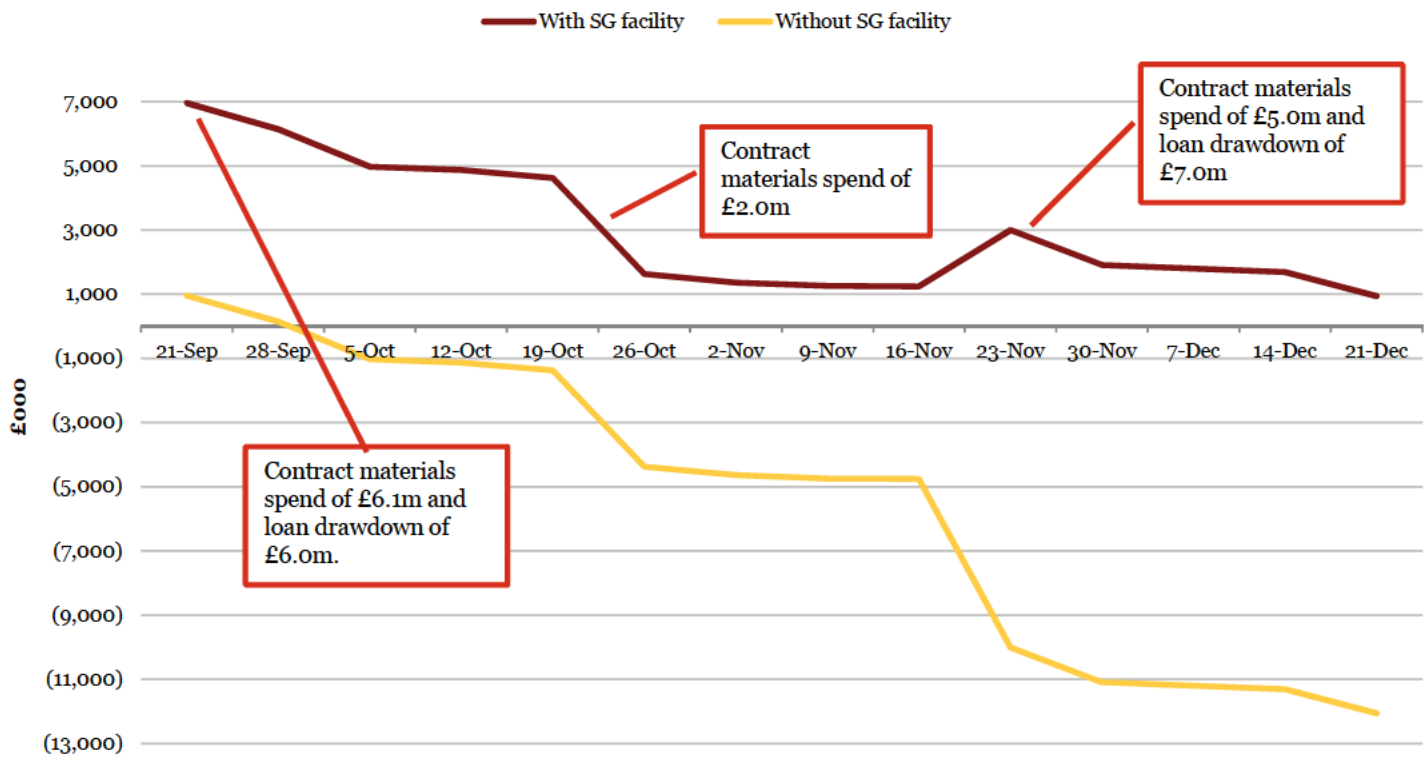
Milestone	Amount (£000)	Original milestone date*	Revised milestone date**	Received per cash flow
801 Launch	4,850	N/A	June-19	N/A
802 Hull inspection prior to paint	1,200	Nov-17	Mar-19	N/A
802 100% fabrication	1,200	Nov-17	Mar-19	N/A
802 Berth join up	1,200	Nov-17	May-19	N/A
802 major items	625	Oct-17	June-18	N
Total	**9,075**			

* Original milestone date – as per the IBR of August 2017

** Revised milestone date – are based on FMEL's projection provided on 11 May 2018. We are not aware of these having been pushed back further.

Short term cash flow forecast

The graph shows the short term cash flow forecast provided by management on 12 September 2018, with a comparative against the cash balance should SG not have provided a further loan facility.



Management forecasts to make two further drawdowns in the period of the short term cash flow: £6.0m and £7.0m in w/c 21 September 2018 and w/c 23 November 2018 respectively.

These drawdowns allow the business to retain a positive cash balance in the forecast period.

The “without SG loan facility line” does include the first £6.0m drawdown on 27 June 2018 and therefore, without any SG funding, the business would be in a significantly worse cash position than this line shows.

[redacted]

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-18
Personnel changes	Y	*	*	N	Y	Y	Y	Y
Profit & loss	Y	Y	Y	Y	Y	Y	Y	Y
Balance sheet	Y	Y	N	*	*	*	*	Y
Cash flow statement	Y	Y	N	N	Y	*	*	Y
P&L comparison v budget	Y	Y	Y	Y	Y	Y	Y	Y
BS comparison v budget	*	N	N	N	*	*	*	Y
CF comparison v budget	*	N	N	N	*	*	Y	Y
801/2 build report	Y	*	*	N	*	Y	Y	Y
801/2 cost over runs	N	*	*	N	*	Y	Y	Y
Permitted fees	Y	Y	N	N	Y	Y	Y	Y

* Please see the relevant monthly report for our comments on the differences between the information requested and the information received.