

Advisory

# *Project Kildonan*

## Comparison of refund guarantee options

*Strictly Private  
and Confidential  
Draft*

*25 July 2019*

***DRAFT***

**pwc**

---

## **Important notice**

SG has set out a proposal to HCC to ‘net settle’ the refund guarantees in respect of 801/2. HCC has set out a counter proposal and has noted that if it is not accepted, HCC will take certain enforcement steps. SG requested during a call at 4.30pm on 24 July 2019 that we set out our comments on these scenarios and this draft document was provided to SG on 25 July 2019.

This is a draft document which has been prepared in accordance with the Contract Award Letter dated 10 December 2018 and our subsequent contract variation dated 13 May 2019, for the purpose of setting out the key advantages and disadvantages of both of the options within this document.

It should be noted that there are more than two potential options, however we have been asked to consider these two options within this document.

The assessment of risks and benefits of each option may differ over time and may be contingent on the actions of other stakeholders.

It is not possible to detail all the possible considerations that exist for each option within this document, we have sought to focus on the key considerations within the context of the discussions currently being undertaken.

More detail on insolvency and solvent solutions is provided in our separate draft “Comparison of Public Ownership Routes” document dated [ ].

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 document, and it may not be provided to anyone else.

## Option 1 - settlement

### Description

A final attempt is made to reach a negotiated settlement with HCCI. If this is unsuccessful, the parties agree to a mutual release to the effect that:

1. CMAL will not call on the refund guarantees;
2. HCCI will not call on FMEL for cash collateral;
3. HCCI will release the escrow cash of ██████ to FMEL for use in continuing the construction of 801 / 802; and
4. HCCI releases its security over the assets of FMEL

This simplifies the position - with HCCI removed from the picture, SG and CBC remain secured creditors, with the ranking of their claims still governed by the inter-creditor. SG still has the option of exercising its right to buy the shares. The option of SG acquiring the FMEL business through a pre-pack administration also remains open, and the prospect of being ransomed by HCCI has been removed.

Advantages	Disadvantages
<ul style="list-style-type: none"><li>• Removes HCCI as first ranking secured creditor leaving SG with priority (for first ██████ of recoveries).</li><li>• Makes a subsequent pre-pack simpler, as SG and not HCCI will be able to make the choice of administrator, and SG can credit-bid up to ██████ for the business &amp; assets, since HCCI will no longer have security.</li><li>• CMAL retains right to cancel the 801/ 802 contracts (expected to trigger an acceptance by the FMEL directors of insolvency of FMEL, should this be required).</li><li>• Share Purchase option is unaffected.</li><li>• Supportive of a solvent solution that may be easier to explain to the public and press.</li></ul>	<ul style="list-style-type: none"><li>• At face value, ██████ of value will have been traded to reduce the uncertainty of the situation and will need to be made up from the public purse. The quantification of benefits will be judgemental as they are intangible and subjective in most cases</li><li>• CMAL may be required to cancel the contract for state aid or procurement reasons as they will not have the benefit of the contractually required guarantee.</li><li>• CBC (or others) may encourage press coverage that argues that SG has mishandled the negotiation and allege that value has been lost for CBC as shareholder, and that this impacts the Fair Value exercise.</li><li>• Questions may be raised with regards to the return received for material fees paid to the sureties.</li></ul>

**Option 1 - settlement**

<b>Advantages (continued)</b>	<b>Disadvantages (continued)</b>
<ul style="list-style-type: none"><li>• Process of taking control may be faster than waiting for enforcement and related process.</li></ul>	<ul style="list-style-type: none"><li>• It is unlikely that the CMAL board will be able to conclude that this is the best option for CMAL and direction from SM may be required.</li></ul>

---

## **Option 2 - enforcement**

### Description

A settlement agreement is not reached with HCC who issue a cash collateral request to FMEL. The directors of FMEL are unable to make such a payment and therefore potentially issue a notice of intention to appoint administrators after 5 days notice to the secured creditors. It is likely that they contact SG as the only party with a potential solvent solution for reassurance before they select this option.

When issuing the cash collateral request, HCC also give the other secured creditors (including SG) the 10 days notice of enforcement action.

There is then a limbo period: of more than 5 days after which the directors of FMEL could appoint administrators; or of more than 10 days after which HCC appoint administrators.

It is likely in either case that the administrator is ultimately the choice of HCC.

The administrator uses funds in hands to mothball the yard whilst seeking a sale of the assets. The value obtained will depend on a number of variables including but not limited to, the existence of other interested parties and the administrator's and HCC's perception of SG's and CMAL's interest in the yard.

In due course SG potentially makes an offer to buy the yard out of administration and seeks to recommence work or it leaves the administrator to realise what value they can.

Alternatively, and the route we would advocate should the enforcement option be chosen or occur, it may be possible to engage with the administrator in waiting in advance of the administration. An offer could be made and the administrator could be encouraged to run a sales process before appointment. At appointment, should SG's offer (including to keep the trade payables whole) be the best offer to maximise value for creditors, the administrator could seek to execute the transaction simultaneously with appointment.

## Option 2 - enforcement

Advantages	Disadvantages
<ul style="list-style-type: none"> <li>• As noted below, CBC as shareholder would have less input to strategy as the business be transacted to a newco.</li> <li>• Other CBC contractual commitments may be severed too</li> <li>• In a worst case, prior to any significant administration / holding costs being incurred, SG could still offer HCC a settlement in line with HCC's latest proposal (if HCC had not moved at all).</li> <li>• [REDACTED]</li> <li>• A potential administrator could highlight a significant funding requirement, the environmental risk and the lack of alternative therefore acting as an independent persuader of HCC to agree a settlement with SG. The administrator may require an indemnity from HCCI which may focus HCCI on resolving matters.</li> <li>• [REDACTED]</li> <li>• From a messaging perspective, CMAL could point to difficulties in using the yard to explain the delay around delivering 801/2 either via moving the vessels to another location (over whatever timescale) or tendering for new vessels. But this does not align with SG objectives re preserving jobs etc</li> </ul>	<ul style="list-style-type: none"> <li>• There will be a loss of control by the introduction of an administrator as a decision maker. While the administrator has a duty to act in the best interests of creditors, they can take account of their ranking and the economic value available. In these circumstances the administrator is likely to consider HCC to have the economic interest and therefore look to HCC for input to strategy. Whilst there is some loss of control to HCC, there will be a greater level of loss to SG and CBC as subordinated secured creditors, to CBC as shareholder, while the powers of the FMEL directors are suspended.</li> <li>• The administrator may seek to dispute CMAL's title to the vessels. Alternatively they may seek to charge CMAL storage costs. They may allow suppliers to enforce RoT and take away components and materials necessary for 801/802.</li> <li>• The funds in hand at appointment will be used to settle statutory, holding costs, (prescribed part), preferential claims and realisation costs (depletion of cash on such costs is clearly not to the benefit of the business or 801/2 and increases the eventual 801/802 funding required from SG).</li> <li>• Should mothballing take place, it significantly increases the risk that trading irrevocably ceases, and even if it can be restarted, there will be significant additional cost due to the delays and disruption (this should not be the case in a prepack)</li> <li>• This route may draw additional press coverage and speculation.</li> </ul>

## Option 2 - enforcement

Advantages (continued)	Advantages (continued)
<ul style="list-style-type: none"><li>• This route reduces the risk that CMAL are criticised for giving away value (as may be the risk in settlement)</li><li>• SG and CMAL could point to HCC as the party that precipitated the insolvency and forced the directors into a position where they had no option but to appt i.e. willing to ransom 350 jobs (with an active Union representation) and Scottish shipbuilding so that they do not incur any loss despite having obtained up to £5m of fees when CBC has lost £25m and SG is losing £45m of loans, [REDACTED] in additional vessel costs via CMAL and an additional ransom payment to HCC, whilst SG were continuing to offer constructive discussions.** In an insolvency SG could select the specific assets and contracts it wished to acquire and, if it wanted, choose not to take any unprofitable (non CMAL) customer contracts and certain other liabilities.</li><li>• Whilst HCC has the economic interest, SG's agreement may be required on certain administration issues (costs, releasing security) so SG will have some influence over strategy. In addition the administrator has a duty to act in the best interests of creditors as a whole, act in good faith and is an officer of the court.</li></ul>	<p>** HCC will have instigated the enforcement action. The initial contact between SG and HCC was 25 June during which there was discussion of the need to extend the guarantees as they were expiring on 31 July and the general financial position of the business. The guarantees were then extended to 31 August to allow discussions on a solution and an NDA was discussed until 19 July. SG submitted its proposal and HCC then submitted a counter proposal with a deadline. When the deadline expired HCC issued its notice.</p> <p><b>Other considerations</b></p> <ul style="list-style-type: none"><li>• If SG were to identify a route to provide the cash collateral with a view to preventing the cash collateral call being the trigger for insolvency, it may not prevent the insolvency in the longer term as the other insolvency factors (contract termination, lack of funds) would remain, and it would not result in any net benefit to SG over and above the settlement scenario.</li><li>• An administrator may seek other bidders for the business. We do not believe anyone would likely to bid, certainly not at a value greater than SG's interest. This would include CBC, who would also have investor and conflict issues to address.</li></ul>



PricewaterhouseCoopers LLP is a limited liability partnership registered in England with registered number OC303525. The registered office of PricewaterhouseCoopers LLP is 1 Embankment Place, London WC2N 6RH. PricewaterhouseCoopers LLP is authorised and regulated by the Financial Conduct Authority for designated investment business.

Project Kildonan  
PwC

Strictly private and confidential  
Draft

25 July 2019  
8