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Carillion Plc: Covenant Update

Gazelle Pension Advisory Services

16 January 2013

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Key conclusions

2012 has been a challenging year for Carillion with a marked deterioration in trading conditions, combined with poor cash conversion and a flat outlook on growth over the short-term.

Despite this, the Company was positive on the future in the *Pre-Close Trading Update* to analysts in December 2012 and remains committed to EPS growth and a progressive dividend policy.

Management presented materially worse prospects to Gazelle.

Affordability is dependent upon a number of factors which are materially uncertain at the current time:

- earnings growth;
- cash conversion of reported profits; and
- access to bank credit facilities after 2016.

The key conclusions of our update report are as follows:

- total affordable deficit repair contributions could increase materially (to £52m to £67m p.a.) if Carillion trades in line with analyst forecasts, and the Company would still remain within reduced credit levels
- the existing schedule of deficit contributions would not be cash covered under more pessimistic forecasts but could be met within reduced credit facilities
- higher levels of average debt, working capital movements and reduced liquidity in the current year indicate a higher risk of default.

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Key conclusions

Our view of the **covenant** is tempered by the following considerations:

- the relative disparity on the outlook presented to the City compared to pension stakeholders
- the limited scope for a material improvement in trading over the current valuation cycle in the absence of significant contract wins in the Middle East
- the sustainability of medium / long term profitability in the absence of another major acquisition
- the impact of contract volatility, increased competition and delays in public spending on future revenues
- the increase in embedded debt as a result of the Eaga acquisition in April 2011 and resulting reduction in credit headroom
- the poor return on insolvency and structure of covenant support
- the continued low priority given to pension scheme funding in the Group's capital allocation policy
- the volatility of future pension costs in the absence of derisking strategies.

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Recovery plan considerations

- Management concerns over the trading outlook and access to future credit facilities combined with materially higher levels of average debt indicate an increased risk of default

- This supports the need for higher levels of deficit repair contributions, front-loaded to reflect the lack of earnings visibility and/or additional asset backed security

- “Affordable” recovery plan payments, either at the current level or at the increased level, imply materially longer recovery plans and the schemes bearing a disproportionate share of risk in the business compared to other stakeholders

- Given the Company’s concern about credit headroom and flexibility in capital allocation, the Trustee could consider a proportionate link between the performance of the business and deficit repair, structured around a clearly defined benchmark by which the investment community assesses Carillion, with incremental payments potentially held in an escrow account.

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Recovery plan considerations

Security

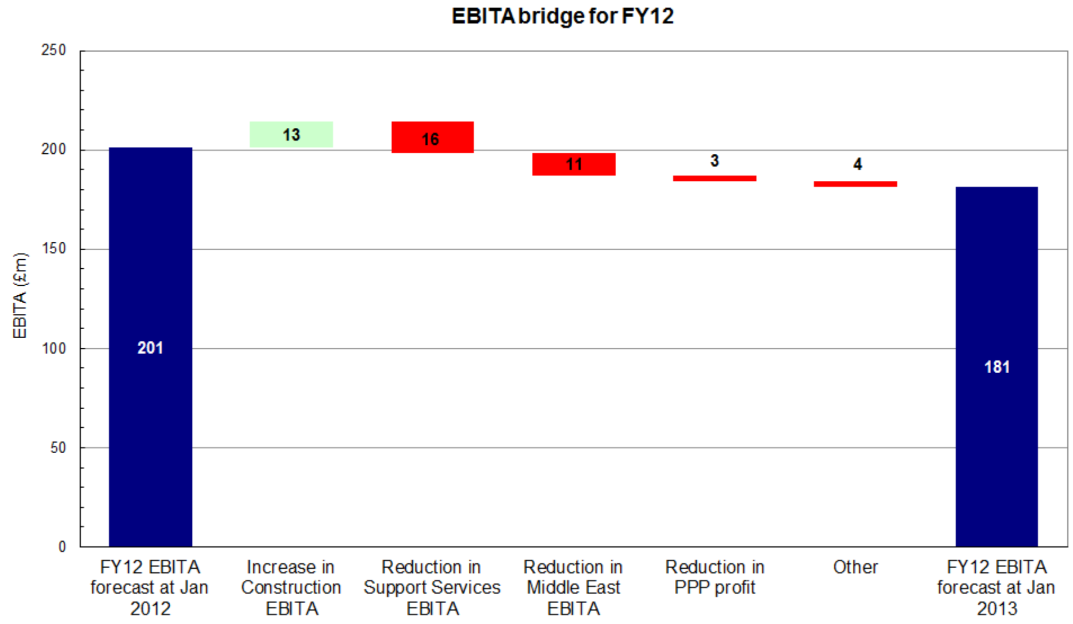
- Given the poor return on insolvency and potential increase in the default risk over an extended recovery plan period, the trustee could seek additional, diversified security for the scheme such as a Letter of Credit or a contingent funding agreement

- The Carillion plc recovery plan guarantees should be updated to be unlimited in value and in duration

- The PPF guarantees should be revisited to ensure they provide incremental security and that the Trustee shares in the benefit of any PPF levy reduction.

Developments since January 2012

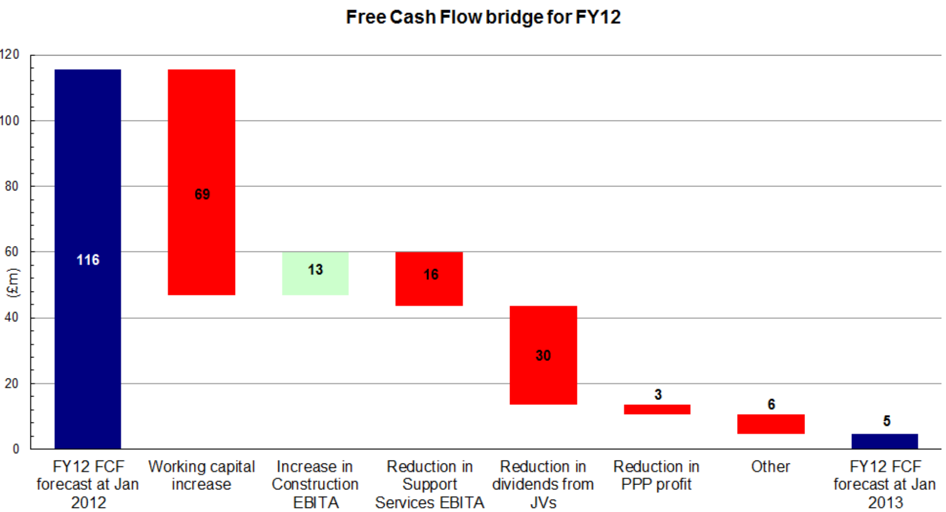
- 2012 EBITA is forecast at 10% below Sensitivity 2 in Gazelle's January 2012 covenant report, and 16% below equity analyst consensus from November 2011.
- UK construction has performed more strongly than expected due to improved, but unsustainable profit margins.
- There are limited short-term pipeline opportunities overseas and across Support Services to improve trading materially over the current valuation cycle.



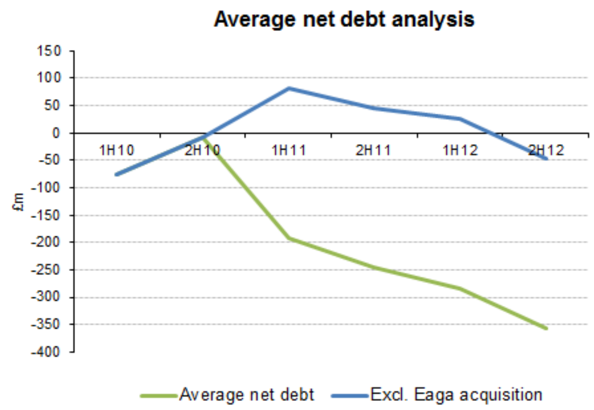
Cash flow analysis

Deterioration in 2012 free cash flow due to:

- stronger-than-anticipated deterioration in working capital, driven by downsizing of UK construction;
- no JV dividends received from the Middle East in 2012; and
- Support Services contract attrition and margin pressure.



- Average net debt increased to over £300m in 2012 versus £42m in 2010, driven by the Eaga acquisition.
- Management anticipate refinancing only £500m of the £737.5m revolving credit facility.
- Management view these factors as providing a major constraint on affordability.
- This is further evidence that the pension schemes continue to be subordinated to other stakeholders in the business.



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Affordability overview

Carillion Plc cash flow		Consensus (adjusted)			New Gazelle forecast		
£m	FY11A	FY12	FY13	FY14	FY12	FY13	FY14
Free cash flow	**191.4**	**29.2**	**103.3**	**133.9**	**4.6**	**48.2**	**65.6**
Pension deficit costs	(36.2)	(35.2)	(35.2)	(35.2)	(35.2)	(35.2)	(35.2)
Dividends	(68.0)	(70.2)	(71.6)	(73.1)	(70.2)	(71.6)	(73.1)
Net debt reduction / (increase)	**(170.9)**	**(57.1)**	**9.2**	**44.6**	**(105.9)**	**(70.6)**	**(54.7)**
Average net debt	(218.9)	(320.0)	(315.4)	(293.1)	(320.0)	(355.3)	(382.6)
Adjusted average net debt		(320.0)	(415.4)	(393.1)	(320.0)	(455.3)	(482.6)

Analysis: Pension deficit payments at 50% of free cash flow from FY13						
£m	FY12	FY13	FY14	FY12	FY13	FY14
Free cash flow (as above)	29.2	103.3	133.9	4.6	48.2	65.6
Pension deficit costs at 2x cover from FY13	(35.2)	(51.6)	(66.9)	(35.2)	(24.1)	(32.8)
(Higher) / lower cumulative recovery plan payments		*(16.4)*	*(48.2)*		*11.1*	*13.5*
Adjusted average net debt	**(320.0)**	**(431.8)**	**(441.3)**	**(320.0)**	**(444.2)**	**(469.2)**

In February 2012, we concluded that total recovery plan payments could increase from £35m to £64m (50% of free cash flow) and remain within acceptable affordability metrics.

- A likely poor recovery on insolvency and questions over profit sustainability suggested that a front-loaded recovery plan best suited the risk profile of the business.

Our new analysis demonstrates that deficit repair contributions could increase to 50% of free cash flow per the analyst forecasts (£52m in 2013 and £67m in 2014), and still allow the Company to retain headroom on its credit facilities.

- In the conservative Gazelle forecasts, the current level of recovery plan payments are not cash covered, but remain affordable, even allowing for a £100m facility ‘buffer’.

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