Ernst & Young LLP
1 More London Place
London SE1 2AF

Tel: 020 7951 2000
Fax: 020 7951 1345
www.ey.com/uk

Strictly Private & Confidential
Carillion Plc
Birch Street
Wolverhampton
WV1 4HY

14 March 2013

Direct line: 020 7951 2000

Email: tdewar@uk.ey.com

For the attention of J Dawson, Head of Reward

Dear Sirs

Project Spring

DRAFT MEMORANDUM OF FINDINGS IN RELATION TO PAPER FOR PENSION TRUSTEES (CARILLION PENSION PLANS)

We refer to the paper produced by Gazelle for the Trustee board on 16 January 2013 ("the Paper") for the trustee directors of the five pension plans; the Carillion Staff Pension Scheme, the Carillion B Pension Scheme, the Mowlem Staff pension and LA scheme, the PME Staff Pension and Assurance Scheme, the Alfred McAlpine Pension Plan.

1. <u>Overview of document and robustness of analysis</u>

Limitations

The Paper cites a number of limitations in the review conducted in reaching the conclusions contained therein. We believe that there are a number of limitations outlined which may impact the reviewer's ability to draw comprehensive conclusions, namely:

- *The report is based primarily on publically available information for Carillion Plc.*

  Whilst this is a reasonable basis for initial review, we suspect that this means that the reviewer has not had access to information on individual subsidiaries within the Group – which we believe is critical to properly assessing structural covenant support for the respective schemes.

- *Information has been supplemented by discussions with Management.*

  As we do not know what areas have been discussed with Management, or the depth of discussions and questioning – we are unable to comment on whether the breadth of discussion was sufficient to enable the reviewer to draw the conclusions that have been made.

- The Paper also references the fact that that the projections *"involve significant assumptions and subjective judgements which may or may not prove to be correct"*. Whilst limitation is a reasonable point to raise in respect of the forecasts, this limitation should be considered carefully in the context of the conclusions reached in the Paper, particularly in respect of the deemed affordability of pension deficit repair contributions.

2. Arguments made for affordability 'deficit repair contributions' and overview on the Gazelle paper

Arguments made for additional pension deficit repair contributions

The primary arguments put forward (in an evaluation made in January 2012, and also upheld in this Paper) for the Group making pension deficit repair contributions, as outlined, are as follows:

- *Strong affordability of pension deficit repair contributions under the existing recovery plans*

  – however we note that this ignores the recent trading underperformance during FY12, and provides no explanation as to how this conclusion has been reached (i.e. the basis/test on which the reviewer deems additional pension deficit repair contributions affordable).

- *Carillion's historical prioritisation of other demands on cash flow ahead of pension deficit reduction*

  – the company's progressive dividend policy is cited a number of times in the paper and we would agree that more discretionary payments such as these need to be balanced against commitments to improve pension deficit positions. We also note however that the market expectations need also to be considered and unexpected changes to dividend policies may impact the Group's access to capital markets (noting that approx £310m of Group debt is financed through bond issues).

- *Deficiencies in the covenant structure and poor likely recovery on insolvency*

  – the advice to the pension trustees clearly seeks to mitigate these risks by reducing the deficit exposure through higher deficit repair contributions from Group cash flows. However, as we have discussed in further detail below, the covenant structure may indicate that any liabilities in respect of these deficits is ring fenced within individual subsidiaries and therefore not the responsibility of the Group as a whole (supplementary analysis is suggested in this area).

Other observations and arguments against additional pension deficit repair contributions

Trading prospects

- The Paper does not provide a compelling case for affordability of additional payments, and itself cites a marked deterioration in trading across all operations, combined with poor cash conversion metrics and a flat outlook on growth in the short-term. Also noted, is the company's presentations which reflect concerns over future trading and access to credit.
- Recent changes in the mix of business, and the payment terms on which new business is booked has negatively impacted the cash conversion of the business in 2012, and the Paper cites City expectations of fundamental issues facing the business going forward, with limited scope for a material improvement in converting PFI and support service contract wins into revenue and profits.
- Additionally, the Paper also notes that the business has yet to see any incremental growth from the recently acquired energy services business (Eaga), to offset the cost of acquisition and implementation (c£306m), which has materially increased the Group's carrying level of net debt.

Balance sheet position

- As noted in the Paper, the structural increase in embedded debt, combined with the need to refinance the RCF in advance of its maturity in March 2016 is a key consideration in determining the affordability of pension deficit repair contributions – however the Paper does not directly address this point (instead producing analysis which implies that additional pension deficit repair contributions could be serviced within the current facilities, but not comprehensively taking into account the impact of structural changes to the debt structure and balance sheet of the business and the impact on access to future credit).

Other

- The Paper suggests that 'payments to all schemes could increase from £35m to £61m per annum, and remain within acceptable affordability limits'. Notwithstanding the absence of an explanation of the parameters for which the reviewer considers 'acceptable affordability limits', the Paper notes that this increase in payments would result in recovery plans of between 6 to 10 years across a range of forecasts. Our recent practical experience of pension deficit repair schedules agreed in other situations we see would place this range at the short end of the recovery plan timeframe.
- The Paper cites deficiencies in the covenant structure supporting the five pension plans under review. As noted below, we would suggest that this should be an area of further review, however our initial observations in respect of this are:
  - The paper's reference to a poor expected recovery for the pension plans in an insolvency event, suggest that each of the pension plans has claims only against the individual entities within the group (i.e. no cross guarantees). As such, a review of affordability of the Group against the aggregation of pension deficits is not necessarily appropriate.
  - Dependent upon the trading and balance sheet profile of individual subsidiaries, the affordability of additional pension deficit repair contributions in individual entities could be materially different and significantly less that any deemed affordability for the Group.
- The review appears to have been undertaken for the benefit of five pension plans, the Carillion Staff Pension Scheme, the Carillion B Pension Scheme, the Mowlem Staff pension and LA scheme, the PME Staff Pension and Assurance Scheme, the Alfred McAlpine Pension Plan. We would note that there appear to be a further seven defined benefit pension schemes which have not been considered, but who may also seek to capture additional pension deficit repair contributions should additional payments be agreed with the five schemes under review.

3. Supplementary analysis suggested

- A [full] review of the covenant structure supporting the respective pension schemes, and accompanying legal based entity analysis is recommended to determine the strength of trustee claims for deficit repair contributions and the responsibility of the Group (as opposed to individual subsidiaries) for addressing these deficits.
- A review of the ongoing current pension costs (excluding any deficit repair contributions) borne by the business and whether these costs are likely to increase in the near term, thereby putting further pressure on cash.
- Review the position and likely requirements from the other seven defined benefit pension schemes, should any additional deficit repair contributions be agreed.
- Discuss with Management and review the inter- and intra- month working capital movements and cash requirements of the Group (and where appropriate individual entities), to determine minimum level of headroom within the current RCF facilities.

4. Conclusions

- Given the limitations around the projections as outlined in the Paper (and referenced in section 1, above), it would seem imprudent to draw down on facilities, thereby reducing the level of available headroom which has been put in place for the very purpose of covering such uncertainty in the timing of short term cash flows/liquidity requirements.

- Furthermore, we expect that a further increase in the reported net debt (and nearer term obligations) utilised to fund the much longer term liabilities of the Group, would increase the risk of default, reduce the Group's credit rating and therefore access to debt and liquidity funding –moving the Group closer to a constrained situation. Therefore we strongly question the rationale of the proposal which effectively reduces the business' access to liquidity under the current situation.

- In our more recent experience with each of the institutions providing the current RCF financing to the Group, we have seen a that number of these institutions investigate carefully, the cash flows and uses of cash by the business in the context of draw downs, and note the perspective of these lenders:
  - There is a strong negative view taken in respect of businesses which are drawing down on revolving credit facilities to fund payments of long term liability and/or dividends, given the purpose of the RCF is to fund cyclical swings in the business' working capital
  - The RCF is not a replacement for long term debt; and
  - We have recently seen moves by these lenders to reduce the level of headroom / RCF provided to businesses (particularly those with projected trading uncertainty), in order to minimise their own risk exposure and the capital cost of carrying unutilised customer credit lines.

- The advice outlined in the Paper and provided to the pension trustees, clearly seeks to mitigate the risks of deficiencies in the covenant structure by reducing the deficit exposure through higher contributions from Group cash flows. However, as we have previously discussed, the covenant structure may indicate that any liabilities in respect of these deficits are ring fenced within individual subsidiaries and not the responsibility of the Group as a whole. Furthermore we have not seen anything in this paper which seeks to address the structural covenant deficiency by other means.

Yours faithfully

T D G Dewar
Partner