Rt. Hon. Frank Field, MP  
Chair, Work and Pensions Committee

Rachel Reeves, MP  
Chair, Business, Energy and Industrial Strategy Committee 

House of Commons  
London  
SW1A 0AA

March 23, 2018

Dear Mr. Field and Ms. Reeves

**Carillion**

Thank you for your letter of 15 March 2018 relating to your Committees’ inquiries into the Carillion liquidation.

We have recently published a report on aspects of Carillion’s insolvency, *Carillion’s Demise: What’s At Stake* (Report), which I attach. As we did not rate Carillion, our Report is based on public information as well as on *The Collapse of Carillion* (House of Commons Library Briefing Paper (Number 8206, 14 March 2018)) (the Commons Briefing).

The Report offers our analysis of what we believe are the likely contributing causes to the Carillion insolvency and covers several of the questions in your letter. Please note that as our answers below only summarize relevant aspects of the Report, your respective Committees should consider its contents as a whole. We would be pleased to assist you further by providing additional views or commentaries that we may publish.

As a credit rating agency registered with the European Securities and Markets Authority (ESMA), S&P Global Ratings is prohibited by regulation from making policy recommendations. Nevertheless, we hope that the Report’s analysis may offer your Committees some perspective on the issues leading to Carillion’s insolvency.

**Overview:**

Several factors, in our view, likely contributed to Carillion’s insolvency including its (i) declining profitability margins (suggesting that new contracts were less profitable, or that
existing contracts were underperforming), (ii) poor risk management practices (as evidenced by the large write-down of PFI and project construction contracts in the UK and elsewhere), (iii) debt-funded dividend distributions at a time when Carillion was exposed to underfunded pension liabilities, (iv) significant working capital outflows and negative operating cash flow, and (v) aggressive leverage exacerbated by an increase in Carillion’s pension deficit in 2016.

We further believe that the lack of transparency concerning Carillion’s reverse factoring practices likely obscured its weak balance sheet and cash flow position.

Committee Questions:

Q.1: Did Standard & Poor’s have an official credit rating for any of Carillion’s debt? If not, was there an indicative rating?

A: S&P Global Ratings neither maintained a public rating on any debt of Carillion nor its affiliates, nor a public indicative rating outcome. We do, however, maintain ratings on several project financings in which Carillion was a construction contractor or services provider. One rating (Aberdeen Roads (Finance) Plc) has already been affected by the Carillion insolvency (See: U.K. operational projects remain resilient while construction suffers, on p. 13 of the Report; and Aberdeen Roads (Finance) Downgraded To ‘BBB-‘ On Security Package And Construction Uncertainty; Stays On Watch Negative Feb 23, 2018 (attached)).

Q.2: Could you comment on how Carillion’s reverse-factoring facility would have affected its credit rating had the scale of the associated liabilities and cash flow implications been known fully?

A: Based on our reading of the Commons Briefing, we believe that Carillion appears to have made extensive use of reverse factoring (supply chain financing) as a funding source. We estimate that reverse factoring amounts approximated £500 million by end-2016, calculated as the increase in “other creditors” over 2012-2016. We also believe that lack of transparency concerning Carillion’s reverse factoring practices obscured both its weak operating cash flow and a substantial part of its debt. (See: Charts 5 (Carillion Cash Flow From Operations 2012-2016) and 6 (Carillion Debt to EBITDA 2012-2016) of the Report. See also: Carillion’s modest increase of reported working capital in 2012-2016 masks significant working capital growth and weak operating cash flow generation when adjusted for reverse factoring; on p. 6 of the Report. See also: Carillion’s financial leverage would have been high when adjusted for pension liabilities and reverse factoring... on p. 10 of the Report).

Reverse factoring can have the effect of understating debt (and overstating operating cash flow because increases can be recorded as working capital inflows). For this reason, although S&P Global Ratings did not maintain a public rating on Carillion, our criteria contemplates treating amounts subject to reverse factoring as debt (or at least those amounts we consider to exceed usual trade payable payment terms). As a matter of rating practice, we try to understand the nature and extent of a company’s reverse factoring practices. Without such an understanding, we
believe there is an increased risk that the company’s cash position, as well as its operating cash flow and debt, could be misunderstood. For this reason, when we rate a company that reverse factors, we try to get a detailed picture from management of how the practice works. (See: Companies should consider more transparency about their reverse factoring practices when necessary to achieve a fair presentation of financial statements, on p. 9 of the Report).

From a credit rating perspective, the effect of reverse factoring on Carillion’s operating cash flow and adjusted debt would have been material. Again, we note that reverse factoring is not a cause in itself but, absent appropriate transparency about the practice, can obscure cash flow and balance sheet weaknesses.

Q.3: Could this information have been obtained from published accounts?

A: While it appears that Carillion disclosed its use of reverse factoring as an "early payment facility" in the strategic report at the front of its annual report, it also appears that Carillion did not quantify the extent to which it used reverse factoring or the effect of the practice on its financial statements. The Report states that had the strategic report been clearer about Carillion’s reverse factoring practices, the effect on its working capital might have been seen to be several times higher than the £101 million Carillion reported (See: Carillion's modest increase of reported working capital in 2012-2016 masks significant working capital growth and weak operating cash flow generation when adjusted for reverse factoring, on p. 6 of the Report).

Q.4: How widespread is the use of reverse-factoring facilities?

A: Due in part to a U.K. government initiative (See: Supply Chain Finance (Reverse Factoring) on p. 9 of the Report) several companies appear to have participated in reverse factoring schemes in the U.K. Reverse factoring and similar arrangements are also employed in other countries. In Spain, for instance, we have come across similar mechanisms used by project construction companies that feature delayed payment terms by suppliers. Further, we have observed that these companies with sizable swings in working capital may use reverse factoring to ease suppliers’ payment.

We believe that the standards of transparency about the use of reverse factoring, and the extent of financing obtained thereby, could be improved.

Q.5: Compared to similar companies, was there anything unusual about Carillion’s use of this facility?

A: As noted in our response to Q.2, when we rate a company employing reverse factoring, we seek to identify how the company uses it as well as the implications of its use in our discussions with management. When we find instances of reverse factoring materially extending trade payable days (well beyond what we consider as normal terms for the company), we will account for the amounts in question in calculating the credit metrics on which our ratings are based.

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Do please let us know if we can be of further assistance.

Yours sincerely,

[Signature]

Alexandra Dimitrijevic
Managing Director and Lead Analytical Manager, Corporates

Attachment: Carillion’s Liquidation: There’s More At Stake Than The Known Flaws of the U.K. PFI Market