

Kiltearn Partners LLP

Exchange Place 3
3 Semple Street
Edinburgh
EH3 8BL
Telephone 0131 460 1040
Facsimile 0131 202 0661

2 February 2018

Rt Hon Frank Field MP
Work and Pensions Committee
14 Tothill Street
London, SW1H 9NB

Rt Hon Rachel Reeves MP
Business, Energy and Industrial Strategy Committee
14 Tothill Street
London, SW1H 9NB

Dear Mr. Field and Ms. Reeves,

Please note this letter contains information regarding the business of Kiltearn Partners LLP ("**Kiltearn**") and its clients. Kiltearn has consented to the publication of this letter as part of the Work and Pensions Committee and the Business, Energy and Industrial Strategy Committee's joint enquiry into the collapse of Carillion Plc ("**Carillion**"). This letter should not be published for any other purpose without Kiltearn's prior written consent.

Re: Carillion

In response to your letter, dated 26 January 2018, regarding Kiltearn engagement with Carillion following the publication of Carillion's 2016 Annual Report and Accounts and its interim financial results for 2017, please find the requested information below.

Background on Kiltearn

Kiltearn is an Edinburgh-based investment manager established in 2011 by myself, Murdoch Murchison, and four other founding partners. Kiltearn is a limited liability partnership. Kiltearn is majority-owned by its founding partners and employees through their ownership of Kiltearn Limited, Kiltearn's corporate partner. Kiltearn has 20 members of staff, including eight investment professionals. Kiltearn offers a single global equity programme, managed with a disciplined value investment philosophy, to institutional investors. Kiltearn: (i) manages two US-based commingled funds; (ii) acts as the delegated investment manager for a Dublin-based UCITS vehicle; and (iii) manages accounts on behalf of three large institutional clients. The majority of investors in Kiltearn's commingled funds are US foundations, endowments and pension plans. Kiltearn currently manages ~GBP9.7 billion (~USD13.7 billion) of assets on behalf of its clients. Kiltearn is authorised and regulated by the FCA in the UK and is registered as an investment adviser with the US Securities and Exchange Commission.

*Registered Office: Exchange Place 3, 3 Semple Street, Edinburgh, EH3 8BL
Partnership Registration Number: SO303158*

Authorised and regulated by the Financial Conduct Authority

Kiltearn manages portfolios invested in 50 to 90 global publicly-traded equity securities on behalf of its clients. The typical weighting of a security in the portfolios is 1% to 3%.

All of Kiltearn's clients held positions in Carillion in their portfolios in early 2017.

Kiltearn's Public Holding Disclosure on 2 February 2017

On 31 January 2017, as a result of inflows into Kiltearn's commingled funds, Kiltearn purchased further shares in Carillion on behalf of the commingled funds to maintain the weighting of Carillion in their portfolios. As a result of the purchases, Kiltearn's clients owned 10% of Carillion's outstanding shares on 31 January 2017. As required by the FCA's Handbook, on 2 February 2017 Kiltearn disclosed that its clients held 10% of Carillion's outstanding shares to the FCA and Carillion.

Carillion's 2016 Annual Report

Carillion's 2016 Annual Report was published on 1 March 2017.

Nothing in Carillion's 2016 Annual Report indicated to Kiltearn that Carillion was likely to announce a significant provision within the next six months. It is worth noting that the phrase "*Underlying profit from operations fully cash-backed*" is included on the first page of the document under the sub-heading "*Performance in line with expectations*".

Kiltearn's clients owned in excess of 10% of Carillion's outstanding shares on 1 March 2017. Kiltearn continued to purchase shares in Carillion on behalf of its clients, to maintain the weighting of Carillion in their portfolios following inflows, until early July 2017.

Carillion's 2017 Annual General Meeting ("AGM")

Carillion's 2017 AGM took place on 3 May 2017 – after Carillion's 2016 Annual Report and Accounts had been published but before Carillion had announced the ~GBP845 million provision to the market. At the meeting Kiltearn voted all of the shares under its voting control against the non-binding resolution to approve Carillion's Remuneration Report. Kiltearn voted against the resolution on the basis that – while disclosure of key performance indicators was much improved compared to previous years – it believed that the Chief Executive Officer's (the "**CEO**") proposed level of remuneration was excessive for the 2016 financial year. Richard Howson was Carillion's CEO at the time of the meeting. Mr. Howson's proposed total remuneration was set to increase by 17.7% relative to the prior financial year, whilst Carillion's net income had fallen ~7% over the same period. Carillion's justification for the increase in remuneration relied heavily on Mr. Howson meeting a number of non-financial targets. Kiltearn did not find Carillion's explanation for the proposed increase in Mr. Howson's remuneration reasonable. The non-binding resolution passed with ~80% of the votes cast.

Kiltearn's clients owned in excess of 10% of Carillion's outstanding shares on 3 May 2017.

Announcement of the Provision

On 10 July 2017 Carillion announced a ~GBP845 million provision to the market relating to receivables on its construction business, notably in the Middle East. Kiltearn had no prior knowledge whatsoever of the provision. Carillion's share price declined significantly in the subsequent months as a result of the provision, with the majority of the drop in price coming immediately after the public announcement (it fell ~39% on 10 July and by the close of business on 12 July it had fallen ~70%).

Kiltearn's clients continued to own in excess of 10% of Carillion's outstanding shares on 10 July 2017.

Mr. Howson resigned from his position as Carillion's CEO on 10 July 2017.

Kiltearn's Initial Analysis of the Provision

On 14 July 2017, following Carillion's announcement of the ~GBP845 million provision, Kiltearn carried out analysis on Carillion's financial situation. On the basis of this analysis, Kiltearn determined that Carillion had a significant funding deficit, in the region of GBP600 million, and it was unclear how Carillion would close this funding gap. In order to understand how Carillion proposed it would close the funding gap, Kiltearn had a meeting with Carillion's interim CEO, Keith Cochrane, on 17 July 2017.

Meeting of 17 July 2017

Four members of Kiltearn's investment team, Colin Armstrong, Khaled Mohamed, Anya Serdyuk and Craig Watson, met with Mr. Cochrane, and a representative from Carillion's Investor Relations department, John Denning, on 17 July 2017. During the meeting, the issues discussed were: (i) the ~GBP845 million provision; (ii) Carillion's balance sheet; and (iii) Carillion's future outlook.

As part of these discussions, Carillion's representatives asserted that the first indications of issues with four of the large contracts subject to impairment arose around the time of the AGM. Further, Carillion's representatives acknowledged that the ~GBP600 million impairment to receivables was large, asserting that the company would do everything possible to recover its receivables – even suggesting that Mr. Howson may be retained to collect them.

Mr. Cochrane stated that it was difficult for him to comment on worst-case debt scenarios as he had only been in the job a week. Mr. Cochrane noted that the GBP800 million net debt guidance was the Chief Financial Officer's target and Mr. Cochrane was still to go through the numbers. Mr. Cochrane confirmed that the GBP800 million net debt guidance did include a GBP50 million cash contribution to the pension fund and discussions were ongoing with the pension trustees surrounding the appropriate level of contributions. It was noted that Ernst and Young had been retained to examine cost-control, cash contributions and reducing net debt.

Mr. Cochrane concluded the meeting by stating that he was not interested in becoming Carillion's permanent CEO.

During the course of the meeting, no material non-public information about the company was shared with Kiltearn. Further, in Kiltearn's opinion, Mr. Cochrane did not provide any meaningful information on how Carillion intended to close the funding gap.

Kiltearn's clients continued to own in excess of 10% of Carillion's outstanding shares on 17 July 2017.

Decision to Sell

Kiltearn's original decision to invest its clients' assets in Carillion was based on the company's stated capital base and its apparent consistency of cash flows. Following the announcement of the ~GBP845 million provision, Kiltearn had material reservations about both Carillion's capital base and its cash flows. Kiltearn was of the opinion that the ~GBP845 million provision effectively destroyed Carillion's capital base. Kiltearn believed the company had become impossible to value as it was not clear what future cash flows would be as there was no concrete information on critical factors. Further, Carillion's published information, including its historic annual reports, could no longer be considered reliable and consequently no effective assessment of its finances could be made.

Kiltearn determined that the higher level of debt, lower profits and minimal capital meant that a recovery in Carillion's fortunes was unlikely and a restructuring involving a debt-for-equity swap to raise at least ~GBP600 million on unknown terms had become highly probable.

After further consideration, Kiltearn concluded that the investment in Carillion was highly speculative as it was no longer based on sound fundamentals – which are an essential component of Kiltearn's value investment philosophy.

It is worth noting that Kiltearn ordinarily invests its clients' assets in companies with a market capitalisation of no less than USD1 billion. By 3 August 2017 Carillion's market capitalisation had fallen to ~GBP247 million (~USD325 million). Further, by 3 August 2017 Carillion's weighting in our clients' portfolios had fallen to 0.27%. As noted above, the typical weighting of a security in Kiltearn's clients' portfolios is 1% to 3%. Kiltearn consequently needed to either increase the weighting of Carillion in its clients' portfolios by purchasing more Carillion shares or sell out of the position completely. Based on the uncertainty introduced by the ~GBP845 million provision it was clear Kiltearn could not increase the weighting of Carillion in its clients' portfolios. Kiltearn was consequently left with little option but to sell out of the positions.

On 3 August 2017 Kiltearn took the decision to steadily exit the investment in Carillion on behalf of its clients as Kiltearn believed it was in their best interests to do so. Kiltearn began selling its clients' shares in Carillion on 3 August 2017.

Kiltearn's Public Holding Disclosure on 8 August 2017

On 7 August 2017, as a result of the continuing sale of Carillion's shares on behalf of its clients, Kiltearn's clients' ownership of Carillion's outstanding shares went below 10% for the first time since 31 January 2017. As required by the FCA's Handbook, on 8 August 2017 Kiltearn disclosed that its clients held less than 10% of Carillion's outstanding shares to the FCA and Carillion.

Meeting of 13 October 2017

Kiltearn's clients continued to own in excess of 5% of Carillion's outstanding shares on 13 October 2017.

A member of Kiltearn's investment team, Colin Armstrong, met with Mr. Cochrane on 13 October 2017. During the meeting, the issues discussed were Carillion's: (i) balance sheet; (ii) cash flow; (iii) UK support services; and (iv) future outlook.

Mr. Cochrane opened the meeting by re-iterating that he would not be taking the position of CEO on a permanent basis.

Despite being a former non-executive director and being in the position of interim CEO for three months, Mr. Cochrane could only provide responses that Kiltearn considered limited and vague to fairly fundamental questions about Carillion, including questions about Carillion's worst-case debt scenarios.

Mr. Cochrane noted that the additional GBP140 million in secured liquidity given by Carillion's lenders *should* avert any immediate covenant concerns but the company's issues were not behind it – just over a month later, on 17 November 2017, Carillion's shares dropped in excess of 30% in price when Carillion announced it was going to breach those covenants.

At the meeting, Mr. Cochrane stated that the disposal target had been increased from GBP125 million to GBP300 million. These disposals needed to be achieved to get Carillion's net debt to management's target level. Mr. Cochrane stated that it was difficult to estimate the post-disposal funding gap, but a number of external analysts considered the gap to be around GBP500 million, relative to a market capitalisation of ~GBP191 million on 13 October 2017.

Mr. Cochrane stated there would be little point trying to raise significant debt or issue equity until: (i) cost reductions and disposals had been delivered; (ii) Carillion had shifted its focus to its core business, namely UK support services; and (iii) a permanent CEO had been recruited, as potential investors would need a clear idea of what they would be investing in.

Mr. Cochrane stated that a further ~GBP200 million impairment to support services would have a minimal cash impact. Mr. Cochrane provided limited details of Carillion's support services sales and margins, noting that sales were growing albeit at low margins.

Mr. Cochrane concluded the meeting by stating that in the future he expected Carillion's business to be nearly entirely UK-based and focused on its core businesses, namely UK support services and UK construction.

No material non-public information about the company was shared with Kiltarn at the meeting.

Mr. Cochrane's responses at the October meeting reinforced Kiltarn's established concerns regarding Carillion's financial condition. The fact that the interim CEO could not give answers that Kiltarn considered satisfactory to relatively straightforward questions, particularly on Carillion's balance sheet, meant that it was all but impossible for an external party, such as Kiltarn, to arrive at a true understanding of what the assets, liabilities and cash generation of the business were. Absent this information, Kiltarn determined that it could only continue to sell out of its clients' positions in Carillion.

Kiltarn's Public Holding Disclosure on 8 December 2017

On 7 December 2017, as a result of the continuing sale of Carillion's shares on behalf of its clients, Kiltarn's clients' ownership of Carillion's outstanding shares went below 5%. As required by the FCA's Handbook, on 8 December 2017 Kiltarn disclosed that its clients held less than 5% of Carillion's outstanding shares to the FCA and Carillion.

Final Disposal and Selling Strategy

Kiltarn continue to liquidate its clients' positions in Carillion throughout the rest of 2017, finally selling out of Carillion completely on 4 January 2018. Disposing the positions over a prolonged period of time was consistent with Kiltarn's standard investment and trading strategy; Kiltarn looks to dispose positions in companies without having a significant market impact. Due to the size of the holding prior to the announcement of the ~GBP845 million provision and the relatively illiquid nature of the stock, it took Kiltarn ~five months to exit the positions in Carillion on behalf of its clients.

Stewardship Code

Given Kiltarn's size, structure and the straightforward nature of its investment programme, to keep its business simple, Kiltarn is not a signatory to the Financial Reporting Council's Stewardship Code. Nevertheless, in accordance with COBS 2.2.3 of the FCA's Handbook, Kiltarn publicly discloses, by way of its website (www.kiltarnpartners.com), its commitment to the Stewardship Code.

As noted above, Kiltarn had no knowledge whatsoever of the ~GBP845 million provision prior to its announcement by Carillion on 10 July 2017. In certain circumstances Kiltarn may deem it appropriate to engage a company's management and/or board with a view to influencing the company's governance or business practices. However, in the case of the announcement of the ~GBP845 million provision, given the materiality of the issue by the time it was announced, Kiltarn's analysis and discussions with Carillion in mid-July focused on determining whether Carillion remained a viable investment. As noted above, Kiltarn determined that it was not. From that point on, Kiltarn sought to liquidate the positions in Carillion on behalf of clients. The meeting with Mr. Cochrane in October reinforced Kiltarn's view; an investment in a company cannot be viewed as anything other than highly speculative if the company cannot answer straightforward questions about its balance sheet.

Until the announcement of the ~GBP845 million in July 2017, Kiltarn had relied in good faith on Carillion's published information, including its annual reports. The published information had given Kiltarn no indication that there were financial issues with Carillion that were of such a material nature. During its research of Carillion's balance sheet Kiltarn did note that the company's debt and its pension scheme deficit was large; however, the published information suggested that cash generation was sufficiently strong to allow Carillion to service those liabilities. The level of Carillion's debt was higher than is typical for companies in our clients' portfolios, but Kiltarn took comfort from Carillion's level of stated cash generation and potential long-term growth.

In order to maintain the integrity of the market and ensure that institutional investors can effectively discharge their stewardship responsibility, a listed company should *promptly* make the market and its participants aware of all facts that the market and its participants would consider material. Where material issues are not disclosed in a prompt manner by a company, they may develop and may eventually result in an irredeemable situation. Kiltarn believes that is what happened in the case of Carillion. Further, if a company cannot give answers to simple questions about the company's finances, such as its balance sheet, it is not feasible for institutional investors to engage with the company's management and/or board in any meaningful way to influence the company's financial decisions.

Kiltarn believes that its actions both prior to and following the announcement of the ~GBP845 million provision were consistent with the principles of the Stewardship Code (notably, Principle 3, which requires an investment firm must monitor their investee companies with respect to material issues) and its overarching fiduciary duty to act in the best interests of its clients. Kiltarn voted against the non-binding resolution to approve Carillion's Remuneration Report at Carillion's 2017 AGM when it had concerns about Mr. Howson's level of remuneration relative to the company's level of net income. Once the ~GBP845 million provision was announced, Kiltarn engaged – by means of the meeting in July and the meeting in October – with Carillion to understand the scale of the problem and whether Carillion had a reasonable strategy to address its financial issues. Carillion did not adequately quantify the extent of the financial issues it faced or articulate how Carillion intended to address them at either meeting with Kiltarn.

Conduct of Carillion Prior to the July Announcement and Redress

Given the nature, materiality and timing of the issue, Kiltarn believes that there are clear grounds for an investigation into whether Carillion's management knew, or should have known, about the need for a ~GBP845 million provision due to receivables on its construction business earlier than July 2017 (possibly stretching back to prior reporting periods). If management did know this, or should have known this, then a disclosure relating to the provision should have been included in published information earlier than July 2017 and the omission of the disclosure from published information, including the 2016 Annual Report, may have amounted to a dishonest concealment of a material fact by persons discharging managerial responsibilities within Carillion.

As noted above, on the first page of Carillion's 2016 Annual Report, published on 1 March 2017, it is stated that *"Underlying profit from operations [is] fully cash-backed"*. In contrast, as part of Carillion's Q2 2017 Earnings Call, published on 29 September 2017, a little over two months after Carillion's announcement of the ~GBP845 million provision, Mr. Cochrane stated *"Historically, underlying earnings have not been cash-backed with an over-reliance on one-offs to support operating profit and cash flow"*.

We note that at Carillion's AGM, on 3 May 2017, Mr. Howson stated *"trading conditions across the group's markets have remained largely unchanged since we announced our 2016 full-year results in March"*. He went on to say *"we have made an encouraging start to the year in terms of winning new business in our chosen markets, with new orders and probable orders worth approximately GBP1.3 billion, which has increased revenue visibility for 2017 to over 85%"*. Less than six weeks later, Carillion announced the GBP845 million provision to the market, inclusive of a ~GBP600 million impairment to receivables. Impairments to receivables on this scale do not typically occur overnight.

Kiltearn notes that if Carillion had not gone into liquidation, Kiltearn would have considered participation in civil legal action against Carillion with a view to recovering a proportion of its clients' crystallised losses.

On 9 January 2018 Kiltearn enquired whether Innsworth, a funder of shareholder litigation, was monitoring the situation with a view to bringing a claim against Carillion under Section 90A and Schedule 10A, Part 2 of the Financial Services and Markets Act 2000. On 12 January 2018 Innsworth confirmed that it was monitoring the situation. On 15 January 2018 Carillion entered liquidation.

Kiltearn is currently monitoring the Financial Reporting Council's investigation into whether KPMG breached any rules, including the ethical and technical standards for auditors, when it acted as Carillion's auditors. Further, Kiltearn is watching with interest to see if any of Carillion's other former advisers become the subject of similar investigations.

We would be happy to answer any additional questions that you may have.

Sincerely,

A handwritten signature in dark ink, appearing to read 'Murdoch Murchison', written in a cursive style.

Murdoch Murchison
Chief Executive Officer
Kiltearn Partners LLP