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BOWER GROUP RETIREMENT BENEFITS SCHEME:
Covenant Assessment Update

PAPER FOR THE TRUSTEE BOARD

APRIL 2016

GAZELLE PENSIONS ADVISORY

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Definitions

The Group/Carillion	*Carillion plc and its subsidiaries*
The Scheme	*Bower Group Retirement Benefits Scheme*
FY15	*Actual results for the full year to 31 December 2015*
FY4	*Actual results for the full year to 31 December 2014*
FY13	*Actual results for the full year to 31 December 2013*
FY12	*Actual results for the full year to 31 December 2012*
FY10	*Actual results for the full year to 31 December 2010*
PEG	*Participating employer group*
RCF	*Revolving Credit Facility*

1. INTRODUCTION

Context and background

Carillion supports a number of defined benefit and defined contribution pension schemes in the UK, Canada and Ireland which arose as a result of the original demerger which formed Carillion, and subsequent acquisitions. The Group is also a member of two major multi-employer schemes, the Railways Pension Scheme and the ESPS scheme. The covenant support available to the Bower Group Retirement Benefits Scheme ("Bower") must be viewed in the context of the Group's wider pension obligations both in terms of the participating employer structure (where key trading entities support a number of schemes), affordability and future growth strategy. Details of the Group's liability to other UK defined benefit schemes are set out in Appendix A.

Bower is closed to new members and future accrual. The scheme is supported by two participating employers:

- Dudley Bower Group plc (principal employer); and
- PME Technical Services Limited.

Dudley Bower Group plc is a dormant intermediate holding company, the parent company of PME Technical Services Limited and PME Partnerships. With the exclusion of the pension scheme, all the assets and liabilities of PME Technical Services Limited were transferred to PME Limited in 2011. Neither of the participating employers trade and together they provide minimal covenant support to the pension scheme.

Under the current Recovery Plan, the Bower Scheme receives deficit repair contributions of £698,490 per annum until 30th June 2023, a 10.5 year recovery plan. A "solvency" basis is used for assessing the scheme liabilities. The valuation results at 31st December 2015 indicate a deficit of £8.0 million compared to £7.8 million at the last valuation[1].

On 17th May 2011, Carillion plc entered into a guarantee with Carillion (DB) Pension Trustee Limited under which it guaranteed the outstanding payment obligations due under the Recovery Plan of the Bower Scheme to 31st December 2017. On 11th February 2014, the guarantee was extended to guarantee payments due to the Bower Scheme under the Recovery Plan to 30th June, 2023.

Corporate activity

Over the last valuation cycle, Carillion has completed the planned contraction of its UK construction business and completed a number of bolt-on acquisitions including:

- **December 2015**: Acquisition of a 67% stake in ASK Real Estate, a partner in an existing property development JV in Manchester, for consideration of £4 million paid in January 2016.
- **May 2015**: Acquisition of Outland Group, a Canadian support services business , for a total capped consideration of £63 million;
- **December 2014**: Acquisition of a 60% interest in Rokstad Power Corporation, a Canadian power transmission and distribution services business for £31 million and a commitment to purchase the outstanding 40% interest in five years;

[1] Mercer Bower Group Retirement Benefits Plan: Valuation as at 31st December 2015 – 19th April 2016

- **October 2013**: Acquisition of John Laing Integrated Services for £17.5 million;
- **December 2012**: Carillion acquitted a 49% equity stake in the Bouchier Group, a Canadian support services business, for consideration of £23.8 million.

On 24th July 2014, Carillion announced that it had entered into preliminary discussions with the Board of Balfour Beatty plc in relation to a possible merger of the two businesses. Carillion's initial offer on 14th August 2014 valued Balfour Beatty at £1,886 million, 56.5% of the merged entity. A revised offer was submitted on 19th August 2014 valued Balfour Beatty at £2,086 million, 58.3% of the merged entity[2]. The improved terms were not accepted by the Balfour Beatty Board and on 20th August 2014, Carillion formally withdrew its offer and confirmed that it was not pursuing the merger.

Our approach

Carillion is a highly integrated business from an operational, management and financial perspective and the PEG has a significant credit exposure to the wider Group via the intercompany loan position. As a result of this and the Carillion guarantee of deficit repair contributions, we have focused our covenant update on the financial position and trading prospects on the Carillion group, considering recourse to the PEG only in the event of insolvency on a group-wide default.

This report is an update to our covenant assessment papers dated 7th February 2012 and 16th January 2013 which were addressed to the trustee directors of Carillion (DB) Pension Trustee Limited, the Trustees of the Carillion Public Sector Pension Scheme and the trustees of the Mowlem (1993) Pension Scheme.

Sources and information flow

Our report has been based upon publicly available information for Carillion plc and draft financial statements of Dudley Bower Group plc and PME Technical services Limited for the year ended 31st December 2015, supplemented by limited discussions with management and our own analysis.

[A copy of this report has been not yet been shared with management for confirmation of factual accuracy.]

[2] Carillion plc RNS announcement 19th August 2014.

2. EXECUTIVE SUMMARY

Following the rescaling of UK construction and restructuring of the Eaga acquisition, trading profitability has stabilised and Carillion returned to positive net cash flow in FY14. Growth prospects and earnings visibility have strengthened but the business continues to experience margin pressures across all operations. There are a number of short to medium term risks including the impact of lower oil prices on Middle East construction markets and the Canadian economy, the costs of mobilising new contract wins and integrating acquisitions, and the ongoing weakness of the Carillion plc balance sheet. Longer term, Carillion remains exposed to significant contract volatility, increased competition and public sector spending cycles in key markets. Carillion continues to be one of the most shorted stocks on the London market indicating a high degree of speculation around the future prospects of the business.

Average net debt has increased materially since the last valuation, reducing the potential return to the pension schemes in the event of any insolvency. However, Carillion retains strong liquidity with an improved maturity and diversified debt profile and undrawn committed facilities of £761m at FY15. The RCF was successfully refinanced and extended for a second time in November 2015 and the drawdown of private placement funding and issue of the convertible bond in December 2014 indicate that credit markets remain open to the Group. Carillion continues to have significant headroom on its financial covenants even when tested using average as opposed to closing net debt figures, indicating a current low risk of corporate default.

The extended liquidity combined with the improved trading results, prospects, mix of business and cash conversion indicate significantly improved Carillion plc affordability metrics over the current valuation cycle even when considered in conjunction with increased deficit commitments to other pension schemes, other operational demands on cash flow and Carillion's progressive dividend policy.

Conclusion and recommendations

Our view of the level of covenant support provided by the Carillion plc guarantee to the Bower Group Retirement Benefits Scheme is tempered by a number of factors:

- strong affordability metrics remain partially dependent upon continued access to extended liquidity and one-off gains;
- higher levels of spot and average net debt which could increase the risk of default and crystallisation of upstream guarantees in the event of deteriorating trading;
- the "de minimis" return from the PEG on any insolvency event;
- Carillion's commitments to other pension schemes and the historically low priority given to pension deficit repair in the corporate capital allocation policy; and
- the viability statement in which the Directors concluded that the degree of confidence that can be placed upon the Group's future revenues diminishes significantly for periods beyond the next three years. This period is materially below the contract and funding maturity profile and recovery plans of the Group's pension schemes.

In view of the continuing concerns over the covenant support, we recommend that the Trustees consider the following:

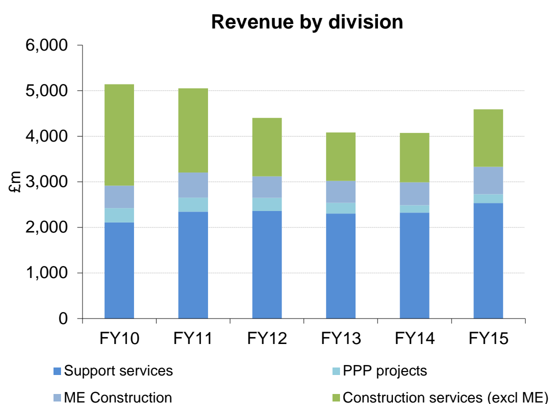
- accelerating the current Recovery Plan to more closely align with the Carillion corporate viability statement timeframe;
- improvements to the formal structure of support available to the Scheme such as contingent security, amendments to the PEG and additional guarantees from other parts of the Group;
- reviewing the investment strategy of the scheme to reflect the Scheme's "solvency" funding basis and Carillion's ability/commitment to repair any under-performance; and
- amendments to the Quarterly Covenant Assessment Update from the Company to provide advance notice of any forecast breach of banking covenants, grant of security or contraction in liquidity.

3. CARILLION PLC TRADING REVIEW AND OUTLOOK

Trading overview

Carillion plc Income Statement £m	**FY10**	**FY11**	**FY12**	**FY13**	**FY14**	**FY15**
Total revenue	**5,139**	**5,051**	**4,403**	**4,081**	**4,072**	**4,587**
Underlying group operating profit	149	167	198	188	192	208
Share of JV profits	46	49	34	27	25	26
Profit from operations/EBITA	**195**	**216**	**232**	**214**	**217**	**234**
Net financial expense	(7)	(4)	(18)	(40)	(48)	(52)
Underlying PBT	**188**	**212**	**215**	**175**	**169**	**182**
Amortisation	(28)	(31)	(31)	(19)	(17)	(20)
Non recurring/non operating items	7	(38)	(4)	(45)	(10)	(7)
Profit before tax	**168**	**143**	**180**	**111**	**143**	**155**
Tax	(15)	(5)	(13)	(4)	(15)	(16)
Net profit	**153**	**138**	**166**	**106**	**128**	**139**
Minority interests	(6)	(3)	(6)	(6)	(7)	(7)
Profit to Carillion shareholders	**147**	**135**	**160**	**100**	**121**	**133**
Dividend (£m)	62.2	70.1	70.4	75.2	75.7	76.8
Dividend cover (net profit)	2.5	2.0	2.4	1.4	1.7	1.8
EBITA margin	3.79%	4.27%	5.28%	5.25%	5.33%	5.10%

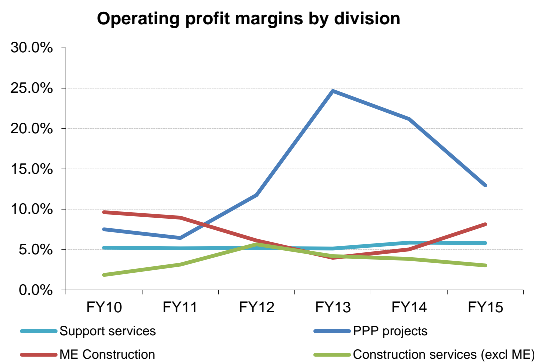
Source: Carillion plc Financial Statements



Revenue has stabilised over the last valuation cycle as the planned contraction of the UK construction business has been partially replaced by growth in the other business areas and incremental revenue from acquisitions.

£3.4bn of revenue was generated by UK operations, a third of which came from UK construction activities. Revenue of £0.5bn was generated in Canada with over 75% coming from support services and PPP projects following strategic acquisitions (Outland and Rokstad) and growth initiatives. Business in the Middle East continues to be focused on construction and various supply chain initiatives and demand management processes have been introduced in response to the sustained low oil price and local economic consequences.

PPP revenue growth continues to be driven by the equity recycling of mature projects and investment in new projects. Revenue grew 19% in FY15 reflecting construction progress on projects won in 2014/15.



Support service margins have stabilised over the valuation cycle supported by a selective approach to contracts and the restructuring and elimination of costs at Carillion Energy Services. Margins remained flat y-o-y at 5.8% despite high contract mobilisation costs.

Construction margins in the Middle East remain under pressure and below the medium-term target of 6%. Local markets remain highly competitive and despite various initiatives, margins fell 0.8% in FY15 to 4.2%. Management have indicated that they expect margins to fall further in 2016.

Net financial expenses have increased materially over the valuation cycle in line with the increases in average net debt, structural bond issues and reduced income from sub-loans to PPP projects.

Non recurring/non-operating items over the period primarily related to the costs of restructuring the Carillion Energy Services (Eaga plc) business (FY13 £42.9m, FY12 £2.6m, FY11 £42.8m) and professional fees, including £9.9m in FY14 incurred on the aborted merger discussions with Balfour Beatty and the acquisition of Rokstad Power Corporation. In FY15, these expenses included a £5m charge on the impairment of the Group's stakeholder loan to the Green Deal Finance Company Limited and £2.5m expenses related to corporate transactions in the year.

Growth prospects and trading outlook

The timing of contract awards and UK General Election meant that the level of new and probable orders fell overall in FY15, particularly in H1. However, the pace of contract awards, new and probable orders accelerated in H2 and is now at 90% revenue visibility[3]. In addition, the Group were also selected for a number of large framework agreements which could generate incremental revenue of £2 billion on top of the probable order book. Carillion secured two major UK support service framework agreements in FY15 which could generate incremental revenue of up to £5.6bn over their lifetime, as well as contracts with Highways England and Network Rail.

Trading outlook **£bn**	**FY11**	**FY12**	**FY13**	**FY14**	**FY15**
Support services	12.9	13.1	13.6	14.1	12.7
PPP projects	2.8	2.2	1.2	1.2	1.2
ME Construction	1.0	0.8	0.9	0.9	0.8
Construction (ex ME)	2.4	2.0	2.3	2.4	2.7
Total order book plus probable orders*	**19.1**	**18.1**	**18.0**	**18.6**	**17.4**
Revenue visibility	***77%***	***75%***	***81%***	***85%***	***84%***
Support services	12.3	11.5	10.4	11.1	12.1
PPP projects	1.0	1.6	3.0	2.5	2.4
ME Construction	11.4	11.4	13.1	15.4	16
Construction (ex ME)	8.4	10.7	11.0	10.2	10.9
Total contract pipeline	**33.1**	**35.2**	**37.5**	**39.2**	**41.4**

[3] Richard Howson, Earnings Call transcript 3rd March 2016

Carillion continues to anticipate growing infrastructure opportunities for support services in the UK, Canada and the Middle East, particularly in the roads, telecoms, power transmission and distribution sectors, as well as increased facilities management opportunities in the UK and ME as public sector services are outsourced. Construction (ex ME) is expected to benefit from PPP projects, particularly in the defence sector. In the ME, low oil prices are impacting customer investment programmes in most sectors but Carillion continues to experience a strong pipeline of opportunities and anticipates significant opportunities from the substantial investment ahead of Expo 2020 (Oman and Dubai).

The latest consensus analyst forecasts for Carillion over the next valuation cycle are set out below. Although these reflect the mobilisation of recent contract wins and stabilising group margins as Carillion works through the "recession" pipeline, most analysts reduced their forecasts following announcement of the FY15 results and the earnings call with management.

Carillion plc Consensus Estimates					
£m	**FY15A**	**FY16E**	**FY17E**	**FY18E**	**FY19E**
Revenue	4,587	4,544	4,735	4,929	5,026
YOY revenue growth	12.6%	-0.9%	4.2%	4.1%	2.0%
EBITDA	259.8	264.0	274.9	284.4	279.0
YOY EBIT growth	6.0%	1.6%	4.1%	3.5%	-1.9%
EBITCA margin	5.7%	5.8%	5.8%	5.8%	5.6%

Source: ThomsonReuters consensus estimates April 2016

Analysts are focused on a number of risks in the Carillion business model:

- limited margin upside potential across the business combined with the inherent earnings volatility of a contracting/construction business;
- the significant cash demands on the business including the costs of mobilising new contract wins, integrating recent acquisitions and funding the pension schemes;
- elevated levels of average working capital if the reverse factoring liability is included;
- deteriorating earnings quality with c33% of FY15 EPS accounted for by one-off gains; and
- the continuing weakness of the Carillion balance sheet and high level of gearing relative to its peers.

Carillion continues to be one of the most shorted stocks on the London market, partially reflecting concerns that "*…the Company lacks the financial firepower to meet its day to day needs and the sums required to start on new support service contracts….*"[4]

[4] Tempus The Times 4th March 2016

Corporate viability

From October 2015, listed corporates are required to make a longer term viability statement as part of their financial reporting under the Corporate Governance Code. This requires the Directors to consider a materially longer term than the current going concern test and to take into account the principal risks to viability and potential mitigation. The governance code requires the board to state that the Company is viable for the foreseeable future and to indicate what timeframe it considers to be "foreseeable".

The Board reviewed the position of Carillion over the next three years – this period was selected because:

- it is the period of the Group Strategic Plan;
- construction programmes associated with significant projects often do not exceed 3 years; and
- the Board considered that the degree of confidence that can be placed upon the Group's future revenues diminishes significantly for periods beyond the next three years.

At FY15, Carillion made the following statement:

"*…….the Directors believe that they have a reasonable expectation that the Company will be able to continue in operation and meet its liabilities as they fall due over the three year period of their assessment.*"

We recommend that the trustees consider the viability statement made by the directors of Carillion at FY15 in the light of the Scheme's reliance upon the covenant and the possibility of reaching full funding by 2018.

4. CARILLION PLC CASHFLOW AND AFFORDABILITY

Carillion plc cashflow £m	FY10	FY11	FY12	FY13	FY14	FY15
Underlying group operating profit	**149**	**179**	**198**	**188**	**192**	**208**
Depreciation and non cash items	32	32	22	21	27	11
Working capital movements*	1	5	(136)	(66)	31	9
JV dividends	48	40	14	18	9	17
Underlying cash flow from operations	**230**	**256**	**98**	**161**	**259**	**245**
Net capital expenditure	(15)	5	(16)	(27)	(22)	(13)
Restructuring costs	(16)	(34)	(29)	(22)	(12)	(6)
Net interest	(2)	(5)	(12)	(20)	(27)	(33)
Taxation	(2)	(4)	3	5	(4)	(8)
Free cash flow	**195**	**217**	**45**	**97**	**194**	**185**
Dividends	(61)	(68)	(79)	(76)	(77)	(80)
Pension deficit contributions	(35)	(36)	(30)	(39)	(46)	(47)
Acquisitions and disposals	2	(277)	(33)	(29)	(35)	(40)
Other	(6)	(7)	(9)	(12)	1	(11)
Net cash flow	**95**	**(171)**	**(105)**	**(59)**	**38**	**7**
Opening net borrowing	25	120	(51)	(156)	(215)	(177)
Closing net borrowing	**120**	**(51)**	**(156)**	**(215)**	**(177)**	**(170)**

Cash conversion rate	**118%**	**112%**	**42%**	**75%**	**119%**	**104%**
Pension scheme % dividend	**57%**	**53%**	**38%**	**52%**	**60%**	**59%**
Pension scheme % FCF	**18%**	**17%**	**67%**	**41%**	**24%**	**26%**

Source: Carillion plc Financial Statements

Cash flow from underlying operations and cash conversion has rebounded strongly over the last valuation cycle on completion of the rescaling of the UK construction business which led to significant working capital outflows in FY12 and FY13. This has been supported by an extension of the reverse factoring facility over this valuation cycle. Working capital movements are now broadly cash neutral and 2015 saw a reduction in both debtor and creditor days.

Free cash flow benefited from reduced capex and lower restructuring costs but this was offset higher interest costs reflecting the level of average net debt and higher tax charges on overseas operations.

Analysts generally anticipate a cash outflow during 2016 as a result of some material cash demands on the business including:

- continuing mobilisation costs in respect of new contract wins;
- higher structural interest costs reflecting the capital structure and higher average levels of debt;
- equity investment in existing and new PPP projects;
- no increase in the level of JV dividends from the Middle East;
- the progressive dividend policy;
- deferred payments in respect of the Outland Group and other acquisition costs.

Affordability

At the last valuation round, affordability of pension deficit repair across all the schemes was constrained by:

- anticipated working capital outflows associated with the contraction of the UK construction business;
- the acquisition and restructuring costs associated with the acquisition of Eaga plc;
- Management concerns over their ability to refinance the RCF at the existing level and the future liquidity available to the business.

As noted above, the working capital position has now stabilised and the restructuring of the Carillion Energy Services business is complete. Most notably, Carillion has amended and extended the RCF twice in the last two years: in December 2013, increasing the quantum from £737.5m to £770m and the maturity from 2016 to March 2018 and in November 2015, when the maturity was extended to November 2020 and the quantum increased to £790m. In addition, group liquidity has been materially increased by a further £80m in bi-lateral facilities, additional private placement funding and the convertible bond issue in December 2014.

The extended liquidity available to Carillion combined with the improved trading position, prospects and cash conversion indicate strong affordability metrics over the current valuation cycle even if average net debt remains at the FY15 level of £539m.

Future affordability		**Analyst estimates***		
£m	**FY15A**	**FY16E**	**FY17E**	**FY18E**
Net operating cashflow	121	189	193	206
Equity dividends	(77)	(82)	(84)	(87)
Pension deficit - Bower	(1)	(1)	(1)	(1)
- Other schemes	(46)	(46)	(45)	(47)
Capex (net)	(29)	(29)	(30)	(31)
Other**	39	(53)	(19)	(17)
Net cash flow	**7**	**(22)**	**14**	**23**

* ThomsonReuters consensus forecasts April 2016

** FY16 includes deferred consideration in respect of Rokstad and Outland

Opening net borrowing	(177)	(170)	(192)	(178)
Net cash flow	7	(22)	14	23
Closing net borrowing	(170)	(192)	(178)	(155)

Group facilities	1,366	1,366	1,351	1,284
Maturing facilities	0	(15)	(67)	(49)
Average net debt**	(539)	(539)	(539)	(539)
Indicative headroom	**827**	**812**	**745**	**696**

** Average net debt kept at FY15 levels despite anticipated net cash flow and debt reduction

5. OVERVIEW OF CAPITAL STRUCTURE AND ASSET BASE

Group Capital structure

Despite a material increase in net and average debt since the last valuation, Carillion retains strong liquidity and an improved maturity profile.

Carillion had undrawn committed facilities of £761 million at FY15.

Carillion plc net borrowing £m	FY12	FY13	FY14	FY15
Cash and cash equivalents	657.1	413.7	472.0	462.2
Bank overdrafts	(4.9)	(3.3)	(6.2)	(6.4)
Net cash and cash equivalents	**652.2**	**410.4**	**465.8**	**455.8**
Bank loans	(466.2)	(292.3)	(145.8)	(118.8)
Finance lease obligations	(34.5)	(29.5)	(26.1)	(17.8)
Other loans	(307.3)	(303.8)	(471.2)	(489.0)
Net borrowing	**(155.8)**	**(215.2)**	**(177.3)**	**(169.8)**
Average net borrowing	**(344.1)**	**(490.6)**	**(450.7)**	**(538.9)**

Over the course of the last valuation cycle, Carillion has continued to access the private placement market to refinance and extend the facilities available to the Group, increasing the total amount of this borrowing from £100 million at FY10 to £325.5 million at FY15. Although Carillion does not have a formal credit rating, the Group's private placements are rated 2- by the NAIC[5]. Management inform us that this is broadly equivalent to a BBB- rating, on the cusp of investment grade.

In December 2014, Carillion issued unsecured convertible bonds to provide additional long term finance and diversify the Group's borrowing sources. These bonds carry a coupon of 2.5% and mature in 2019 when the Group has the option to settle the obligation by the issue of shares[6], payment in cash or a combination of the two.

Debt maturity £m	2016	2017	2018	2019	2020	2021	2022	2023	2024	Total
Private Placements										
US$ 3.85%		17.0								**17.0**
£sterling 4.38%			49.0							**49.0**
£sterling 3.62%				17.5						**17.5**
US$ 4.29%				54.4						**54.4**
£sterling 5.10%						51.0				**51.0**
£sterling 4.19%							17.5			**17.5**
US$ 4.86%							95.3			**95.3**
US$ 5.01%									23.8	**23.8**
Convertible bonds				170.0						**170.0**
Total	-	17.0	49.0	241.9	-	51.0	112.8	-	23.8	**495.5**
Bank facilities	15.0	50.0			805.0					**870.0**
Total available funding	**15.0**	**67.0**	**49.0**	**241.9**	**805.0**	**51.0**	**112.8**	**0.0**	**23.8**	**1,365.5**

In November 2015, Carillion renewed its' main revolving credit facility, extending the maturity from March 2018 to November 2020, improving the pricing and increasing the facility by £20 million.

[5] National Association of Insurance Commissioners which regulate US private placements.

[6] Initial conversion price of £3.9856, 25% premium above the volume weighted average price between launch and offer of the bonds.

Under the terms of its financing documents, Carillion plc remains the borrower and the Group operations continue to be funded by way of intercompany loans and deposits through the corporate structure with a cash pooling arrangement covering all the UK operating subsidiaries. There is strict control over the level of permitted borrowings in subsidiaries which is currently capped at £70 million and partially used to run local overdrafts in Canada and Oman. As a result, the prospect of underlying subsidiaries (such as the PEG to the Scheme) becoming insolvent on a standalone basis is remote but would be linked to a group-wide default under which Carillion plc funders sought to recover intercompany loans through the corporate chain.

The main facilities continue to be unsecured and there are restrictions on security that can be granted in other parts of the Group to avoid subordination of funders subject to a de minimis threshold of £30 million.

Financial covenants

The financial covenants[7] remained in place following the renewal and extension of the RCF:

- Interest cover >3.5x (defined as consolidated trading cash flow to net interest); and
- Net debt to EBITDA<3.5x; and if it exceeds 2.5x, the Group must put in place upstream guarantees from material subsidiaries.

Both the private placement and convertible bondholders have the same covenants as the RCF. Their terms allow them to automatically tighten these restrictions in line with any amendments to the RCF but do not commit them to mirror any relaxation of RCF covenants. In combination with the cross default clauses which govern the Group financing facilities, this means that the financial covenants are unlikely to be relaxed in the short to medium term but may well become tighter.

Breach of the 2.5x gearing threshold would crystallise the commitment to put in place upstream guarantees and could result in the Scheme ranking *pari passu* or becoming structurally subordinated to the external funders. Technically, the Bower Group Retirement Benefits Scheme currently enjoys structural priority to external lenders in respect of the assets of the PEG. However, the only assets of the two employers are intercompany deposits which are unlikely to be recovered under cash pooling arrangements on a group-wide insolvency. The two employers also have significant intercompany borrowings which would rank pari passu to the claim of the scheme.

Management have confirmed that Carillion was fully compliant with all the financial covenants as at FY15. **Our analysis indicates that Group continues to have significant headroom on its financial covenants indicating a low risk of breach under the Group's capital structure and a low risk that upstream guarantees will be put in place, even when tested using average net debt figures.** However, we recommend that the trustees actively monitor actual and forecast compliance with the Group's financial covenants, in particular that net debt to EBITDA remains below 2.5x to ensure that the recovery position of the Scheme is not further reduced by the granting of upstream guarantees.

[7] Tested bi-annually on the on the previous twelve months results

Off balance sheet debt

Carillion continues to utilise reverse factoring facilities to finance its supply chain and optimise the working capital cycle. Management indicate that these facilities total c£300m and most analysts indicate a beneficial impact of £100m on the spot debt position. **UBS calculate "all in" leverage (average net debt + pension + deferred M&A spend + reverse factoring adjustment) at £1,050m, equivalent to 5x EBITDA ex capital gains and state "....*This strikes us as high for a contracting business...*"[8]**

Carillion plc Balance Sheet

Carillion plc Balance Sheet £m	**FY12**	**FY13**	**FY14**	**FY15**
Tangible assets	127	128	141	141
Intangible assets	1,540	1,553	1,611	1,634
Investments	238	159	140	166
Deferred tax (net)	105	102	131	93
Total fixed assets	**2,010**	**1,943**	**2,023**	**2,034**
Inventories	55	49	50	64
Trade debtors	1,109	1,212	1,325	1,271
Cash	657	414	472	462
Other debtors	14	9	3	16
Current assets	**1,835**	**1,683**	**1,850**	**1,813**
Borrowings	(35)	(23)	(35)	(34)
Trade and other creditors	(1,615)	(1,589)	(1,727)	(1,714)
Other financial liabilities	(38)	(51)	(40)	(24)
Net current assets	**146**	**22**	**48**	**42**
Borrowings	(778)	(606)	(614)	(599)
Pension liabilities (net)	(351)	(370)	(510)	(394)
Provisions and other	(19)	(4)	(53)	(67)
Long term liabilities	**(1,147)**	**(981)**	**(1,177)**	**(1,059)**
Net assets	**1,010**	**984**	**895**	**1,017**
Net tangible liabilities	**(531)**	**(569)**	**(716)**	**(617)**
Total debt	**(813)**	**(629)**	**(649)**	**(632)**
Net debt - closing	**(156)**	**(215)**	**(177)**	**(170)**
Net debt - average	**(344)**	**(491)**	**(451)**	**(539)**
Total debt/net assets	**91%**	**70%**	**73%**	**62%**
Net debt/net assets	**17%**	**24%**	**20%**	**17%**
Average net debt/net assets	**38%**	**55%**	**50%**	**53%**

Source: Carillion Financial Statements

Acquisition goodwill of £1,544m (including £43m on the acquisition of Outland Group) continues to exceed the equity value of the Carillion balance sheet. However, the market capitalisation of Carillion plc of £1.25bn appears to support the carrying value of this goodwill in the current trading environment.

[8] UBS Carillion: Walking a Tightrope 15th April 2016

Carillion plc: net asset cover of pension obligations

Improved trading metrics, acquisitions and a stabilised working capital position over the last valuation cycle have increased the Group tangible asset base since the last valuation. However, the tangible asset cover from Carillion plc has declined compared to FY12 as result of higher average net debt and increased aggregate section 75 liabilities across all the pension schemes. Average net debt grew c£90m in FY15 as a result of business acquisitions, investment into PPP contracts and contract mobilisations costs.

Carillion plc Net Asset Cover £m	FY12	FY15
Total tangible assets (exc deferred tax and cash)	**1,543**	**1,658**
Total unsecured creditors (excl borrowings)	(2,023)	(2,198)
Average net debt	(344)	(539)
Less: accounting pension deficit	351	394
Add: s75 deficit Bower Group Scheme	(8)	(8)
Add : s75 deficit other schemes*	(1,316)	(1,703)
Adjusted unsecured creditors	**(3,340)**	**(4,054)**
Net tangible assets/liabilities	**(1,797)**	**(2,396)**

Net asset cover for unsecured creditors	46%	41%
Net asset cover for Bower Group Pension Scheme	3.6	3.4
Shortfall for Bower Group Pension Scheme	**(4.2)**	**(4.9)**

As a result, tangible asset cover for creditors has fallen from 46% to 41% and the illustrative shortfall for the Bower Scheme has increased from £4.2 million to £4.9 million.

This metric is for illustrative purposes only and simply provides an indication of Carillion's ability to meet its aggregate Group liabilities on a continuing basis. Actual recovery for the Scheme on a group-wide default will be limited to the assets of the PEG and is considered overleaf.

Scheme recovery

In the event of a Group default, the Bower Scheme would only have recourse to its participating employer group ("PEG") for recovery of the section 75 deficit. The employers to the Bower Scheme do not trade or provide recourse to non-Group assets and, as a result, the covenant support on both an ongoing and discontinuance basis is minimal.

Purely for illustrative purposes, we have considered the potential recovery from the PEG as at FY15, applying consistent principles and bases with the analysis undertaken in respect of other Carillion schemes. This is only an indication of the Scheme's potential recovery on insolvency – the actual position may well be materially different from our analysis depending upon the chain of events, asset realisation rates achieved and the potential to legally "net" intercompany balances. As we have not received details of the investment value of PME in the Dudley Bower financial statements or the intercompany balances between the two employers, the analysis also contains an element of "double-counting" which means that recovery position may be overstated.

Illustrative recovery from PEG FY15 £m	**Dudley Bower Group**	**PME Technical Services**	**Total**	**Recovery**	
Investment in subsidiaries*	1.3	0.0	1.3	50%	0.7
Intercompany debtors*	1.4	4.4	5.8	20%	1.2
Other debtors***	0.1	0.1	0.2	20%	0.0
Total Assets	**2.8**	**4.5**	**7.3**		**1.9**
Intercompany creditors*	0.0	(28.8)	(28.8)		
Other creditors	0.0	(0.3)	(0.3)		
Pension liability	0.0	(0.5)	(0.5)		
Total Liabilities	**0.0**	**(29.6)**	**(29.6)**		
Net Assets	**2.8**	**(25.1)**	**(22.3)**		

	FY15
Total asset recovery	**1.9**
Total unsecured current liabilities	(29.1)
Bower Scheme s75 deficit**	(8.0)
Recovery for unsecured creditors	**5%**

Bower Group Pension Scheme	**FY15**
Pension scheme recovery (£m)	0.4
Pension scheme shortfall (£m)	(7.6)

Source: Draft financial statementsfor FY15 provided by management.

** Not adjusted for investment in PME and i/c debts within PEG*

*** Solvency deficit as at 31st December 2015 per Mercer paper*

**** Deferred tax*

APPENDIX A: CARILLION PLC: OTHER PENSION SCHEME OBLIGATIONS

Other Pension Scheme Liabilities £m	Latest Solvency Deficit	Deficit repair contributions		
		FY16	FY17	FY18
Carillion Staff Pension Scheme*	328.0	6.1	6.1	12.0
Mowlem Staff Pension Scheme*	550.0	12.4	12.4	13.8
Alfred McAlpine Pension Scheme*	240.0	11.2	11.2	5.8
Carillion B Pension Scheme*	68.0	2.4	2.4	3.4
PME Staff Pension Scheme*	48.0	1.3	1.3	1.2
Mowlem (1993) Pension Scheme**	70.0	2.9	0.7	0.7
Carillion Public Sector Pension Scheme*	104.2	2.7	2.7	2.7
Carillion ESPS*	90.0	2.7	2.7	2.7
Carillion Integrated Services Limited****	1.0	0.1	0.1	0.1
Railways Pension Scheme*	201.2	4.3	4.3	4.3
Permarock Pension Scheme***	2.4	0.1	0.1	0.1
Total	**1,702.8**	**46.2**	**44.0**	**46.8**

** Valuation as at 31st December 2013 (Railways Pension Scheme valuation not yet agreed)*

*** Valuation as at 31st December 2014 (not yet agreed)*

**** Valuation as at 1st January 2014*

***** part of the John Laing Integrated Services acquisition. Valuation as at 31 December 2011*