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STRICTLY PRIVATE AND CONFIDENTIAL

Carillion (DB) Pension Trustee Limited
COVENANT REPORT (Stage 1)

FOR THE 22nd MAY TRUSTEE BOARD

Gazelle Corporate Finance Limited
41 Devonshire Street London W1G 7AJ
www.gazellegroup.co.uk
T+44 (0)20 7182 7220

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1 Purpose of this Report

1.1 Context and basis of approach

This Report focuses on the projected profitability, balance sheet and cash flow of the sponsor in order to advance discussions with Management regarding the 2016 valuation noting that "Advice from Gazelle on affordability will be a key lever for the Trustee in negotiations" (Mercer, March 2017).

The purpose of this Report is to assist the Trustee in relation to the December 2016 Triennial valuations of the following schemes (the" Schemes"):

- PME
- Mowlem Staff
- AMPP
- Carillion B
- Carillion Staff

This report has been prepared by Gazelle for the Trustee of the Schemes and is based on the information set out in 1.2 below. **The Report has been shared with Management for factual accuracy and to build an agreed basis and understanding for the discussions.**

Gazelle previously submitted papers to the Trustee dated 11th January 2012 and 16th January 2013. Whilst the 2012 paper indicated that affordability was "strong" with scope for increased recovery plan contributions, by January 2013 poor trading and reduced cash conversion, in part resulting from the Eaga acquisition, had eliminated cash cover of contributions. Both papers highlighted deficiencies in the covenant structure supporting the Schemes as well as the high probability that the Schemes' substantial Section 75 debts would not be recovered in a worse case insolvency context. Gazelle has not undertaken independent covenant monitoring for the Schemes since January 2013.

Covenant characteristics: January 2012

The key covenant characteristics identified were as follows:

- Strong affordability of existing pension deficit contributions with material liquidity headroom;
- Historic prioritisation of other demands on cash flow ahead of pension deficit repair;
- Deficiencies in covenant structure and poor recovery on an insolvency event offset by low risk of default; and
- Higher than average volatility as a result of investment strategy.

Covenant Update: January 2013

Carillion experienced difficult trading conditions during 2012 as the market deteriorated but provided positive future guidance to analysts. The Company presented a significantly more negative outlook and forecasts to Gazelle and identified specific concerns over the trading outlook and cash conversion, the working capital impact of downsizing the UK construction activites, the integration of Eaga and access to future credit facilities.

Key conclusions from the covenant update:

- "Affordable" deficit repair could increase to £67m pa if Carillion traded in line with analyst forecasts and the Company could remain within reduced credit limits;
- The existing schedule of deficit contributions would not be cash covered under sensitised pessimistic forecasts but could be met within credit facilities;
- Higher levels of average net debt, working capital movements and reduced liquidity in 2012 indicated a higher risk of default.

This Report focuses on affordability at Carillion group level of overall deficit repair contributions over the 3 years to the next Triennial valuations in December 2019, but because the length of individual scheme recovery plans will extend well beyond 2019, we also comment, in so far as is possible, on the sponsor's medium and longer-term prospects (noting that the sponsor's viability statement only extends for 3 years). The Report also analyses group liquidity and financing risks for the period to the next Triennial valuations and comments on the payment risks attaching to the Scheme's recovery plans.

This Report examines Carillion plc's ability to support the individual Schemes in aggregate and assumes that the parent company will extend the current guarantee to cover the recovery plan schedules of contributions of the individual Schemes. Without this assumption considerable additional work will be required to examine the position of the individual Schemes and a material additional adjustment for funding prudence would likely need to follow.

In assessing the affordability of new recovery plans for the Schemes it is important to take account of Carillion's other defined benefit schemes which are not within the scope of this report. We have not investigated the risks presented by these schemes or likely changes in their recovery plans but have collated what information is readily available for these schemes.

1.2 Sources and bases

In addition to publically available information on Carillion plc, we have reviewed the following information provided by the Company:

- 2017 RF1 and 2018 & 2019 Business Plan cash flow forecasts (*based on the June 2016 Business Plan adjusted for the 2016 closing position)*

- Full year 2016 Going Concern and Viability review
- The Appendix 1 supporting the adoption of the Going Concern and Viability Review
- Company responses to Gazelle's questions (which are set out in Appendix 1)

In additional we have reviewed actuarial and investment information for the Schemes from the following Mercer papers *(which were obtained subject to signature of a non-reliance agreement with Mercer)*:

- 31 December 2016 Valuations Preliminary Results Summary
- Reviewing investment strategy: February 2017
- Key issues to consider and investment strategy: March 2017

1.3 Regulatory context

Since the last valuation The Pensions Regulator has issued a revised Code[1] and Guidance[2] which will apply to this valuation. Key developments are:

- Formal incorporation of its new "**sustainable growth**" objective: the need for Trustee to understand employer investment plans and any constraints these might place on funding targets;

- The promotion of a more **collaborative approach** between Trustee and sponsors, for instance noting that covenant assessment is not designed to be a critique of an employer's business but an assessment of the employer's strength relative to the scheme;

- A "proportionate **integrated approach** to risk management when developing an appropriate scheme funding solution": the interplay between covenant, funding and investment risks is now firmly emphasised;

- Looking at covenant risk over the **short, medium and also longer term**: Trustee should understand the extent of the scheme's reliance on the employer covenant over time on the basis of a range of plausible future scenarios. The Code does not propose significant changes to the scope of the assessment, but allows more flexibility in approach, noting that it should be "proportionate" to the circumstances, focused on those areas where the Trustee are not already confident of the position for example.

Although this Report does not constitute a full covenant assessment, we have sought to reflect these developments in this Report.

[1] TPR Code on scheme funding 03
[2] TPR Guidance August 2015

2 Executive summary

2.1 Conclusions

Affordability

The sponsor's 3 year plan indicates scope for additional annual deficit repair contributions of £21.1 million which on a pro-rated basis with the other pension schemes would allow the Schemes £16 million of additional recovery plan contributions for the 2016 valuation plans.

Payment risk on contributions

Whilst credit and debt markets remain positive about management's strategy and execution to rebalance the business towards Support Services, reduction in the scale of UK Construction and the acquisition of Eaga have placed pressures on Carillion's balance sheet which have not so far proved possible to reverse through improved operating performance.

Management have not yet communicated a chosen option to deliver a "step-down" in average net debt. Until clear action is delivered, the sponsor, in our view, is not currently in robust condition to counter material financial shocks or disappointments and would be very exposed to a deterioration in debt and credit market confidence.

For this reason we would advise the Trustee that it should not extend recovery plan length as we consider that there is currently increased payment risk attaching to deficit repair contributions. We are further unsure how management can reduce debt materially in the short-term without cutting the dividend. If the dividend were cut we would view this very positively from a pension covenant standpoint.

Medium and longer term support

We consider that the sponsor may be in a position to offer the Schemes increasing support after 2020 due to growth in Support Services and with a return to normalised uses of cash flow.

However given that the Schemes' aggregate deficits are now equivalent to Carillion's entire stock market valuation, we are concerned that the Schemes' unhedged asset and liability exposures need to be contained to ensure the Schemes are prevented from becoming an even heavier financial burden on the sponsor.

2.2 Recommendations

2016 valuation

The sponsor covenant presents two principal constraints on agreeing a new schedule of contributions for the Schemes. These constraints are evaluated and described in this Report. Firstly an affordability constraint limits available additional deficit repair contributions, and secondly assessed payment risk on contributions and the increasing probability of structural scheme underfunding places limits on acceptable recovery plan lengths.

In Section 6 we illustrate how the combination of these two constraints will make agreement on new recovery plans for the Schemes a challenge. A combination of recovery plan outperformance assumptions, valuation assumptions and investment policy options will be needed to create a valuation outcome that can work within these sponsor constraints.

We appreciate that the sponsor constraints set out in this Report may potentially stretch actuarial assumptions beyond what is prudent, reasonable or acceptable if an accommodation is to be reached for the 2016 Valuation.

From the sponsor standpoint additional deficit repair contributions of £21.1 million eradicates any possibility of achieving a material reduction in debt by 2020 without taking action.

Gazelle's view is that only if the sponsor cuts the dividend or produces an alternative plan to reduce debt will the sponsor constraints be eased or relaxed. If the Trustee are unable to find an accommodation then ultimately the sponsor may be forced to take action to reduce debt to enable agreement on the 2016 Valuation.

Risk budget

Our report indicates potential for some improvement in sponsor affordability from 2020. We are however very concerned that further deterioration in the sizeable liabilities of the Schemes would quickly negate this. In particular the additional economic uncertainties presented by Brexit mean that neither the sponsor nor the Trustee should be relying on continuing low inflation and an expectation of rising rates.

Our strong recommendation to the Trustee, and sponsor, is therefore to specifically review whether the current combination of longevity, inflation, rate hedging and increasing focus on "mid-risk" assets is sufficient to contain liability expansion between this valuation and the next. If insufficient an increase in the "risk budget" for these should be considered as part of the 2016 valuation discussions.

3 Affordability: Carillion plc's cash flow forecasts 2017-2019

3.1 Context

Carillion have provided Gazelle with their summary "Business Plan and Cash Flow" forecasts. These are for 2017, 2018 and 2019 which cover the financial period until the next Triennial valuations in December 2019 when deficit repair plans for the Schemes will be reviewed and reset.

These forecasts are based on the June 2016 business plan updated for the 2016 closing position. The forecasts form the basis for Carillion's viability statement and this 3 year period is deemed by the sponsor to be the appropriate period over which to make a group viability statement. The 3 years until the next Triennial valuations provide an appropriate period for evaluating the affordability of new recovery plans.

In Section 4 we consider the payment risk attaching to new recovery plans and how this may influence decisions regarding recovery plan length.

Section 5 looks beyond the forecasting period to December 2019 and considers longer-term influences on sponsor affordability of deficit repair relative to the size and risks presented by the Schemes.

3.2 Overview of forecasts and conclusions regarding affordability of deficit repair

Carillion's 2017-2019 forecasts compared to 2016 actuals, with the 2016 actuals excluding exchange rate movements to better show comparatives, are set out in Table 1 below. The main conclusions we would draw from Table 1 are the following:

- There is scope for **maximum additional deficit repair contributions financed from net cash flow in the order of £21.1 million per annum.** This covers all the deficit repair requirements for all Carillion DB schemes over the 3 years to 2019. (£21.1million is the 3 year average of the annual maximum affordable deficit repair contributions).
- Net operating cash flow reflects solid progress in improving EBITDA tempered by lower JV dividends in 2018 and 2019
- Free cash flow presents a less favourable development reflecting increased requirements for Capex and restructuring costs in 2017 and a step-up in committed merger and acquisition expenditure in 2018 and 2019. Together these increased requirements are using approximately £68 million of operating cash flow over the 3 year period or on average £22 million per annum.

- Increasing dividend payments in fact reflect only a 1% annual increase in shareholder dividends but increased dividends to minorities.

Table 1

Carillion

Cash flow available to pay pension contributions 2017-2019

(excluding forex movements)

Year ended December 31st	**2016** *Actual* £m	**2017** *RF1* £m	**2018** *Plan* £m	**2019** *Plan* £m
EBITDA	226.3	248.8	263.1	284.2
% change		*9.9%*	*5.7%*	*8.0%*
JV dividends	11.8	31.2	21.4	22.2
Operating cash flow	**238.1**	**280.0**	**284.5**	**306.4**
% change		*17.6%*	*1.6%*	*7.7%*
Interest	-37.1	-38.3	-35.5	-35.2
Tax	-4.2	-4.8	-13.0	-15.0
Sub-total	-41.3	-43.1	-48.5	-50.2
Net operating cash flow	**196.8**	**236.9**	**236.0**	**256.2**
% change		*20.4%*	*-0.4%*	*8.6%*
Used by business:				
Working capital release (incl.PPP)	39.0	9.4	18.4	5.7
Net capital expenditure	-23.5	-35.0	-27.0	-27.5
Restructuring costs/disc.ops	-27.8	-18.1	-3.5	-3.5
Committed net M&A	-36.1	-42.0	-62.0	-66.0
Sub-total	-48.4	-85.7	-74.1	-91.3
% change		*77.1%*	*-13.5%*	*23.2%*
Free cash flow	**148.4**	**151.2**	**161.9**	**164.9**
% change		*1.9%*	*7.1%*	*1.9%*
Stakeholders distributions:				
Dividends (incl. minorities)	-82.7	-88.2	-92.0	-94.7
Max. DR contributions	**65.7**	**63.0**	**69.9**	**70.2**
Actual DR contributions	46.6	*46.6*	*46.6*	*46.6*
Additional DR contributions	***19.1***	***16.4***	***23.3***	***23.6***

Source: Carillion Business Plan & Free Cash Flow

3.3 Competing uses of net operating cash flow

The payment of deficit repair contributions to the Carillion Schemes "compete" with other corporate uses of net operating cash flow. These are principally:

- The operating needs of the business
- Distributions to shareholders; and
- The financial needs of the business in terms of reducing net debt

We consider these in turn.

Operating needs of the business

Capital expenditure: increased capex over the period reflects Project Rio which is expected to deliver significant benefits for Support Services (£10-12m bottom line improvement post-2020). The annual costs associated with Project Rio are expected to be:

2017	£20.9 million
2018	£13.4 million
2019	£13.9 million

This high level of capital expenditure is clearly targeting the sustained growth of the core Support services business. Longer term the underlying capital expenditure requirement of the group is likely to be approximately £25 million per annum.

Restructuring: costs associated with restructuring of £15.2 million are planned for 2017 but no additional restructuring is currently planned for 2018 and 2019 and no cover for any need to scale back UK or Middle East Construction operations is provided for.

Committed net acquisitions: the Company has indicated that this comprises up to £25 million of PPP investments per annum and up to £15 million per annum of committed acquisition payments in Canada totalling £40 million per annum. We would therefore conclude that discretionary acquisitions costing £22 million in 2018 and £26 million in 2019 have been included in the cash flow projections. This could **provide additional capacity to pay deficit repair contributions if absolutely required in 2018 and 2019** providing some headroom in excess of the maximum deficit repair contributions of £21.1 million per annum indicated above. If these discretionary acquisitions were to be foregone then there would however be a loss of operating cash flow from acquisitions planned but not yet committed which we would estimate of perhaps £4.5 million in 2019 and £9 million in 2020.

Shareholder distributions

We would distinguish between shareholder dividends which are in principle discretionary and dividends to minority interests which may be contractual. **Importantly the forecasts include an assumption of only 1% per annum growth in dividends to shareholders over the 3 year period and it is dividends to minorities which are driving up distributions to shareholders as a total.**

Dividends to minority interests are payable in relation to Canadian businesses Carillion have acquired. There are two businesses which are consolidated but not owned 100% - these are Bouchier (49% owned) and Rokstad (60% owned). The business plan assumes that Carillion pays dividends based on the level of profits in the previous year, in reality the directors of those businesses will determine what the dividend will be.

For public listed companies it can be argued that the payment of dividends reflect in part the cost of continuing access to equity markets which is important to the longer-term future of the Company. However in the current context of Carillion's share price and very high dividend yield the cost of new equity financing is arguable prohibitive and the shareholder base is also potentially currently not conducive to a rights issue.

Carillion is currently paying shareholder distributions at a level which is higher than the total operating needs of the business and from the perspective of other stakeholders this is resulting in shorter-term financial constraints on affordability and intense competition between competing uses of funds.

Debt reduction

Management have publically stated that a material reduction in average net debt is now a key target for the business but have yet to explain to markets how this will be achieved quickly. "Currently the Board has chosen to pursue a number of actions focused on accelerating the rebalancing of the business into markets where we can achieve good margins and cash flows, the tighter management of working capital across all our contracts and cost reduction programmes". Brokerage analysts suggest that a material reduction in average net debt would only be achieved by cutting the dividend or potentially disposing of Carillion's Middle East construction interests. A rights issue or other equity issue is another possibility but as indicated above would, without a cut in dividends, leads to even higher shareholder distributions.

If management are unwilling to take action or believe that adequate debt reduction can be achieved over time within the current business plan, the repair of Carillion Schemes' increasing pension deficits is placed in direct conflict with Carillion stated target of achieving a material reduction in average net debt. We consider this to be the most important issue facing the sponsor and Trustee. Further analysis is set out below.

3.4 Access to additional financial resources to pay deficit repair contributions

In Section 4 below we conclude that there is very limited scope currently to draw on Carillion's balance sheet to supplement cash flow generation to fund competing uses of net operating cash flow.

Carillion has confirmed that Gazelle would be "broadly correct" to assume that the Carillion group has reached a point where it is now pretty well capital constrained at maximum uncommitted facilities.

3.5 Ability of sponsor to repair Value at Risk

It is now standard practise to consider, as part of evaluating the affordability of deficit repair plans, whether the sponsor would be able to repair Value at Risk measures. This can provide important perspective for setting an appropriate investment policy alongside and consistent with funding plans.

Using the cash flow projections analysed above we can examine the likely scope to repair Value at Risk arising from adverse asset liability developments when funding is next reviewed in December 2019.

Assuming that deficit repair contributions are set at the maximum affordable level, we could envisage that if cash flow forecasts were extended to 2020 on an underlying basis, incremental free cash flow available to repair VaR might reasonably be illustrated as follows:

Operating cash flow +5%	+ £15 million
Project Rio benefits	+ £10 million
Normalised capital expenditure	+ £5 million
No discretionary acquisition spend	+ £20 million
Total additional cash flow available to repair VaR	+ £50 million
VaR repaired assuming 8 year plan	**+ £400 million**
VaR repaired assuming 10 year plan	**+ £500 million**

We do not have an overall estimate of 3 year VaR for the Schemes and the schemes outside the scope. Mercer's March 2017 investment strategy paper indicates 1 year VaR for the Carillion Staff, Mowlem Staff and McAlpine schemes to be £350 million based on the current investment strategy. These VaR estimates however reflect current contribution rates.

The £500 million indication of sponsor ability to repair VaR at the next Triennial valuation provides a useful indication for calibrating investment policy, contributions and sponsor support within a consistent integrated framework. Some additional work may however be required to determine an estimate for Value at Risk for all the Carillion DB schemes. We would normally expect the impact value and probability of strategic pension risk in a sponsor viability statement to reflect an ALM-based risk measure.

3.6 Impact of maximum contributions on sponsor debt reduction forecasts

If higher contributions are required to repair the deficits of the Schemes for the 2016 valuation and these contributions are the maximum DR contributions shown above then the reduction in Net Debt targeted by management will not be achieved.

This can be simply illustrated as follows:

Year ended 31 December	**2017**	**2018**	**2019**
Forecast Net Debt (£m)	210.0	190.0	170.0
Max. additional DR (£m)	21.1	21.1	21.1
Adjusted closing Net Debt (£m)	231.1	232.1	233.2

In terms of affordability this places additional deficit repair contributions directly into conflict with the achievement of management's debt reduction forecasts. A reduction in debt may diminish payment risk but is unlikely to generate any additional recovery of Section 75 debt for the Schemes. The implication of this is that management would not be able to achieve any debt reduction through operational cash flow and cost savings if additional annual deficit repair contributions of £21.1 million are paid.

There is potential headroom to reduce or eliminate cumulative new acquisition expenditure for 2018 and 2019 which could reduce net debt by £40-50 million by 2020, the remaining options to reduce debt are key strategic decisions regarding cutting the dividend, selling Middle East construction or an equity issue.

3.7 Comparison of Company forecasts with stock market forecasts

The purpose of the Company providing Gazelle with its own internal forecasts is to reduce scope for disagreement about prospects and stock market estimates which will normally reflect a "funnel of uncertainty" around future company performance.

The result of doing this is that the Trustee are basing decisions on an apparently deterministic set of forecasts presented by management who undoubtedly have superior information on which to base their forecasts and assumptions. This does not however eliminate uncertainty regarding Company forecasts both on the upside and downside.

We note that management have based the 3 year public viability statement on these forecasts and therefore we consider that the Trustee can justifiably rely on them. We have not therefore applied any additional sensitivities.

The table below sets out current analysts' consensus cash flow forecasts. Comparison of the consensus analysts' forecasts indicate that the stock market is expecting better EBITDA performance in 2017 and 2018 but marginally less free cash flow over the period.

With respect to pension costs analysts have seen the December 2016 deficit of £663 million but estimates on ongoing deficit repair costs range from £46 million up to £60 million. The Company's Business Plan presents ongoing pension contributions of only £45 million per annum in line with the current plans.

Comparative forecasts	FY16	FY17	FY18	FY19
EBITDA consensus	280.9	268.5	275.3	283.2
EBITDA RF1 & Plan		248.8	263.1	284.2
Free cash flow consensus	148.8	151.5	148.7	161.3
Free cash flow RF1 & Plan		151.2	161.9	164.9

Source: Thomson Reuters Eikon 11 May, 2017

4 Payment risk: Carillion plc's liquidity and financial strength

4.1 Review of viability statement

Sight of the group viability statement and the supporting Appendix 1 has been invaluable in understanding and coming to a judgement on the level of payment risk which will attach to revised recovery plans for the Schemes.

The viability statement provides satisfactory comfort that the group has ample room to work within its existing debt covenants over the period 2017-19.

The viability statement highlights that the principal debt refinancing requirement is renewal of the group's main c. £800 million banking facilities by November 2020. We consider that renewal on satisfactory terms and without tighter covenants depends both on management demonstrating progress with reducing overall debt commitments and continued confidence in the group's credit status.

We are not surprised that the group's current high levels of average debt carry some risk of potential liquidity issues, especially around April 2019. Based on analysis of Strategic Risk 3. Pension Liabilities, we have some concerns that enough prudence is reflected in the value attributed to strategic risks. Strategic Risk 3 has a value of £25 million and probability of 50% and therefore a risk value of £12.5million. Other premium listed companies have quantified pension risk in terms of ALM modelling and we would assume that this would generate a much higher impact value and probably elevate pension risk up the rankings. Carillion have agreed to share their basis for the impact value of pension risk.

The overall impression gained is of a group, dependent on accurate management of a very complex set of financial inter-relationships, which is close to becoming capital constrained but still able to opportunistically exploit pockets of additional or replacement finance from capital markets.

We are concerned at this time that management has yet to communicate a plan to equity and debt markets to address this capital constraint relatively quickly. This places the group in a particularly exposed position to financial shocks or events that would impact financial confidence in the group's creditworthiness even though banking covenants currently look comfortable. Customers also need to be confident in Carillion's financial strength and robustness and the current levels of borrowings, combined with unfamiliar financing such as reverse factoring, (which can be construed as reducing perceived borrowing levels or reducing clarity on borrowing levels), are providing ammunition to some commentators to build a case that the group is financially stretched. The viability statement further points towards April 2019 as being the point in time with the narrowest margin for error.

The Trustee must take a creditor viewpoint of payment risk on pension deficit repair contributions. At the current time and without a clear management plan to reduce debt, a degree of caution looks to be justified. With appropriate management action the issue could quickly be addressed and the additional caution we would currently advise Trustee to adopt rendered unnecessary.

4.2 Headroom on debt and private placement covenants

The viability statement concludes that "the covenant calculations for the Group based on Company forecasts show that the covenants will not be breached. [We are awaiting the covenant calculations in Appendix 6 of the Company's viability statement to complete the tables below.]

The principal facilities are unsecured and the two main financial covenants are for each 12 month financial period:

Trading Cash flow/ Consolidated Net Interest> 3.5x

	2017	2018	2019
Trading cash flow			
Consolidated net interest			
Covenant ratio			

Net Borrowings (period end)/EBITDA< 3.5x

	2017	2018	2019
EBITDA			
Net borrowings			
Covenant ratio			

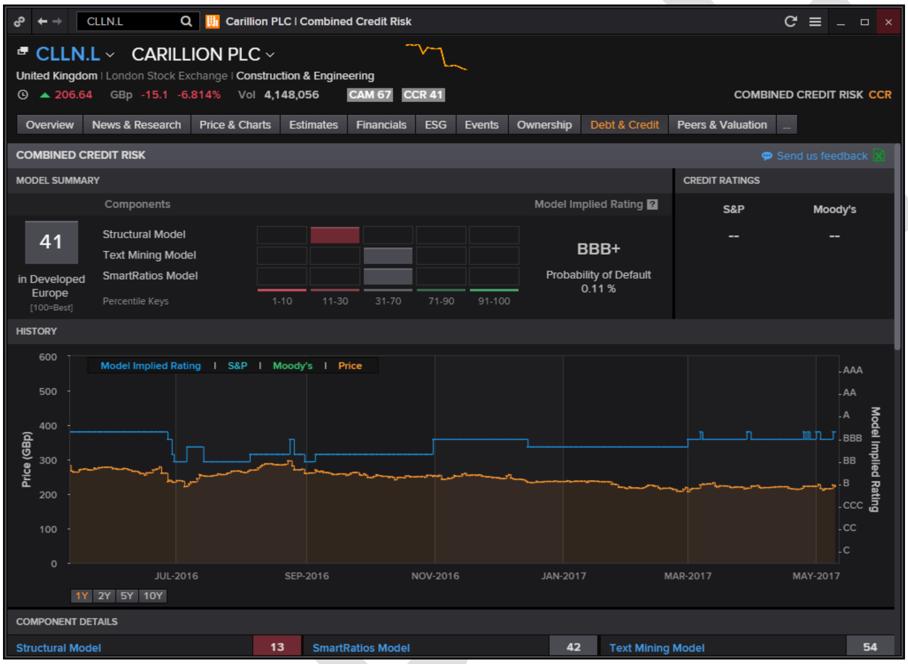
4.3 Debt refinancing requirements

The new Schuldschein European market funding has effectively re-financing the US and £sterling private placements and Lloyds facility maturing in 2017 and 2018. This leaves the £170 million convertible capital bond to re-finance (if not converted into equity) by December 2019 and then then main £790 million revolving credit bank facility by November 2020. So Carillion is currently in a good position as there are no immediate re-financing requirements or re-financing risk and ample time to re-finance the bond and RCF.

Of perhaps greater concern at the present time is therefore the continued availability of bank bond facilities which are important for the construction business. The group viability statement identifies pressures on bank bond facilities and highlights that they are uncommitted. However "having reviewed the Group pipeline of works over the next 3 years based on facilities currently available at full year exchange rates, we anticipate having adequate cover for the bonding requirements of future projects".

4.4 Carillion's credit strength and payment risk on contributions

There are no credit rating agency issuer ratings for Carillion. Thomson Reuters does however provide a credit rating model which provides some insight into how credit markets currently view Carillion as varying between BB+ and BBB+. These are surprisingly strong ratings for a group approaching maximum leverage.



Cumulative annual default probabilities for this band of credit ratings are set out below (based on Moody's historic default data). In approximate terms one might conclude from this data that there is 3-12% chance of Carillion defaulting over a 10 year period but a much higher 6-19% chance of Carillion defaulting over a 15 year period.

This provides useful perspective for quantifying the additional payment risk attaching to extended recovery plan length.

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
BBB+	0.08%	0.24%	0.47%	0.75%	1.08%	1.45%	1.85%	2.28%	2.74%	3.23%	3.75%	4.29%	4.85%	5.43%	6.03%
BBB	0.17%	0.46%	0.84%	1.29%	1.80%	2.36%	2.96%	3.60%	4.27%	4.97%	5.70%	6.45%	7.23%	8.03%	8.85%
BBB-	0.36%	0.89%	1.53%	2.25%	3.04%	3.88%	4.77%	5.70%	6.66%	7.65%	8.67%	9.72%	10.79%	11.88%	12.99%
BB+	0.72%	1.65%	2.70%	3.84%	5.04%	6.30%	7.60%	8.94%	10.31%	11.71%	13.14%	14.59%	16.06%	17.55%	19.06%

Source: Gazelle Mousetrap ©proprietary longer-term default rates based on Moody's 20 year default dataset.

4.5 Gazelle's conclusions on payment risk on recovery plan contributions

Gazelle assessment would be that Carillion is currently capital constrained because it is approaching maximum debt capacity and access to equity markets is also currently debilitated by short-term trading of its shares. This places pension contributions in overt competition as a competing use of cash flow with the business, shareholders and debt providers.

Management actions to improve business performance and place the group on a much better longer-term footing have not delivered sufficient net operating cash flows to prevent a trend of increasing average net debt. A clear decision and strategy to achieve debt reduction is now expected by markets but has yet to be spelled out by management. This is creating some uncertainties and in Gazelle's view a higher level of risk that confidence in Carillion's credit standing could be questioned by debt as well as equity markets.

Rightly or wrongly the Santander facility and reverse factoring may be being taken as anecdotal evidence of financial strain.

As a result we are not currently wholly confident that the business could withstand a material financial shock. Our confidence reflects not a lack of management ability to find additional short-term financing, at which it is adept, but that a material shock could quickly impact the debt market confidence on which Carillion is currently very reliant because it is currently so close to maximum committed facilities. In the worse instance we note that Carillion would be able to take actions to conserve cash by eliminating the dividend, and suspending acquisitions and that together these actions might provide some £100 million of additional breathing space.

In the event of a dividend cut, or commitment to cut the dividend, or indeed an alternative remedy to produce a step down in current average net debt, we should then be able to advise the Trustee to consider taking a more relaxed view on payment risk.

5 Carillion plc: medium and longer-term support for the Schemes

5.1 Longer-term growth of sponsor free cash flow and affordability

Carillion has chosen 3 years as the appropriate period for its viability statement indicating that forecasting beyond a 3 year horizon introduces material uncertainties.

In seeking to look beyond 2019 we would be fairly confident of the following positives:

- There will likely be a c £20 million one-off step-up in free cash flow from 2020 onwards if Project Rio and the cost saving programmes both deliver and are then discontinued, and capital expenditure returns to a normalised lower level reflecting increasing Support Services business profile
- We would expect that over the medium-term Support Services would drive a 5% "organic" increase in annual operating cash flow generating an increase in normalised cash flow of £10-15 million per annum
- We would expect management to step up expenditure on Support Services acquisitions once capital constraints are released. This will generate additional growth in operating cash flow depending on success.

We therefore see medium term potential for Carillion to improve affordability of deficit repair contributions and offer greater support than currently to its defined benefit pension plans.

Our medium-term view could turn out better if "austerity" does now transfer effectively into "increased infrastructure spending" reflecting a very material and favourable change in government policy for Carillion.

However this is likely to depend on Brexit being a success or at least not a failure. Failure could take two forms. Firstly a blockage in the legislative timetable and parliamentary time which results in anything new in the way of infrastructure spending being "crowded out". Secondly the economy could stall or decline reducing tax revenues increasing public borrowing and leading to sterling falling and a high risk of imported inflation. We are not able to give Trustee a view on which way it may go at this point in time but would highlight that risks are increased as a result of this extra uncertainty. Carillion's viability statement also highlights possible risks to its financing sources from Brexit.

In terms of increasing sponsor support for the Schemes over the medium-term there is therefore potential for improvement in sponsor affordability post-2020 but with some big uncertainties currently tempering this.

5.2 Underfunding risk and longer-term sponsor viability

At the current time Carillion's market capitalisation is approximately £950 million whereas, based on the current investment strategy, the Technical provisions deficit for the 5 Schemes is £943 million. Put simply if the company's shares were sold at the current market price this would not meet the aggregate Technical Provisions deficits of all the schemes. The balance between the size of the Schemes and the size of the sponsor is therefore an uncomfortable comparison.

At the same time the Schemes present considerable uncovered risk exposures. For Carillion Staff these are set out below. Uncovered exposures for the other schemes are not readily available but would provide a basis for reviewing exposures.

- 71% exposure to interest rate risk (29% hedged)
- 57% exposure to inflation risk (43% hedged)
- 60% exposure to longevity risk (40% hedged)
- 28% exposures to equity investment risk (Mowlem Staff, McAlpine & PME considerably higher)

Carillion business operations are arguably not exposed to anything approaching this level of "value loss exposure".

It is also clear from the analysis of Carillion's projected net cash flow that without a substantial cut in the dividend, it may already be constrained by affordability in trying to repair the 2016 Technical Provisions deficit certainly over normally acceptable and benchmarked plan lengths. In Gazelle's view recovery plans that are longer than 10 years increase the chance of developing large "structural deficits" which become difficult to repair because reduced contribution rates place undue pressure on investment performance. In addition The Mercer papers highlight the extent to which negative scheme cash flows are beginning to introduce additional scheme risks which requires portfolio adjustment.

We therefore consider that, for the particular context of the Schemes, there is likely to be a limit on recovery plan length beyond which it would be ill-advised to extend recovery plans regardless of payment risk on contributions which has been analysed in Section 4. Mercer's views on where this limit should be given scheme maturity, negative cash flow profile and expected investment returns should also be considered in order to agree a sensible upper boundary on acceptable recovery plan length.

The Schemes have probably reached a point where further investment de-risking is equally not affordable.

Non-pensioner members in particular are therefore exposed to an extended period of sponsor payment risk during which dependency on contributions will remain high and there will be exposure to higher levels of investment risk than would be optimal given the maturity of the Schemes, net cash outflows and sponsor credit support.

We define underfunding risk as when in the longer-term a scheme depletes its asset base faster than would support future benefit cash flow payments. At an eventual point in time the scheme actuary would be forced to concede that there are insufficient assets to pay benefit obligations and the scheme would wind-up crystallising a Section 75 debt. This occurs only where a sponsor has been unable to adequately repair deficits arising.

We have not undertaken any integrated risk modelling to illustrate the extent and quantum of underfunding risk for the Carillion Schemes but would expect that it is a genuine risk and one that could ultimately also threaten the viability of the sponsor. This statement is in no way inconsistent with the sponsor's viability statement which only covers a period of time to February 2020.

Underfunding risk particularly impacts younger scheme members and has been demonstrated to result in significant benefit losses for these members.

The likelihood of longer-term structural deficits and ultimately underfunding risk presents additional urgency to improving funding and benefit security from both a trustee and sponsor viewpoint. In particular given the current relative size of the Schemes' deficits to the sponsor's net cash flow generating ability, it is particularly important that there is no further expansion in scheme liabilities.

5.3 Integrated risk considerations

Integrated risk considerations concern the extent to which sponsor performance and affordability of contributions is correlated with the 4 key pension scheme risks- investment performance, interest rates, inflation and longevity. The purpose of considering this is to ascertain the extent to which adverse scheme experience can be expected to coincide with adverse sponsor experience, thereby resulting in "double jeopardy" with higher risk levels attendant than where each risk is examined separately. We assume that there is no correlation between sponsor performance and longevity and examine in turn the likely correlation of sponsor performance with investment performance, interest rates and inflation.

Investment performance: based on the relationship between Support Services and the overall equity market we consider that it is reasonably likely that poor scheme performance for growth assets would be accompanied also by increased pressures on sponsor affordability

Interest rates: increasing interest rates would increase Carillion's cost of floating rate borrowings but would have a beneficial impact in reducing the value of scheme liabilities. Lower or negative interest rates can be expected to have the opposite impact.

Inflation: increasing rates of inflation could increase benefit obligations and increase liabilities. The sponsor is exposed to cost increases but many contracts are indexed.

As highlighted in 5.2 above the Schemes, subject to individual differences, currently continue to have material exposures to each of these risks.

5.4 Opportunities potentially afforded by scheme consolidation

Ultimately the Schemes should be consolidated into a single combined scheme with segregated liabilities but shared services, asset pooling and single governance.

The PLSA DB Task Force "Case for Consolidation" (March 2017) indicates the considerable cost savings per member potentially available. From smaller and medium sized schemes this has been "scoped out" to be in excess of 0.5% per annum of total assets which, in a lower return environment and over the longer term, would make a considerable difference to overall funding level and benefit security. In addition gains from improved governance, improved ability to hedge inflation and interest rates more economically and potentially access, for the smaller schemes, to new asset groups may offer additional improvements.

Formal support from Carillion plc for a consolidated scheme would both optimise longer-term covenant support, which could be reflected in funding prudence levels, and provide an incentive for individual schemes to merge to secure this formal support.

6 Recovery plan "ready reckoner" for the Schemes

6.1 Recovery plan commitments to other schemes

The table below shows Carillion's existing recovery plan commitments to the additional defined benefit schemes which are outside of the scope of this report.

We do not currently have visibility of the expected outcomes when these schemes agree new valuations. However assuming these schemes will have to work within the same affordability constraints on additional deficit repair contributions identified in this report of in total £21.1 million per annum 2017-2019, this represents a 45.2% increase in current average annual repair contributions 2017-2019.

Pro-rating the £12.0 million average annual deficit repair contributions of the other pension schemes by 45.2% would give new recovery plans of £17.4 million per annum utilising £5.4 million of the potentially available £21.1 million.

This would leave approximately £16 million of additional deficit repair contributions available to the Schemes covered by this report.

Other Pension Scheme Liabilities £m	Deficit 31.12.16 / Deficit last valuation	Latest Solvency Deficit	Deficit repair contributions FY17	FY18	FY19
Mowlem (1993) Pension Scheme**	11.7/6.4	70.0	2.9	0.7	0.7
Carillion Public Sector Pension Scheme*	84.0/28.4	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
Bower Group RBS	14.6/8.0		0.7	0.7	0.7
Total		**468.8**	**13.5**	**11.3**	**11.3**
** 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*					

We believe that there are additional plans for which we do not have information on deficits or contributions including CENTRAC, GTRM and Canadian plans.

6.2 Recovery plans “ready reckoner”

We can only provide a simplistic recovery plan ready reckoner based on (i) no outperformance applied to recovery plan contributions and (ii) linear recovery plans comprising equal annual contributions.

We understand that Mercer has previously applied a 2.5%- 3.0% outperformance rates on contributions which reduce to gilts +1.5% over time.

We however believe that the simplistic recovery plan ready reckoner gives a useful illustration of the overall scope of options and the constraints identified in this report.

Illustrative affordability constraint

Basic contribution (£m) matrix

		Recovery plan length in years										
TP deficit £m		7	8	9	10	11	12	13	14	15	16	17
	700	£100	£88	£78	£70	£64	£58	£54	£50	£47	£44	£41
	750	£107	£94	£83	£75	£68	£63	£58	£54	£50	£47	£44
	800	£114	£100	£89	£80	£73	£67	£62	£57	£53	£50	£47
	850	£121	£106	£94	£85	£77	£71	£65	£61	£57	£53	£50
	875	£125	£109	£97	£88	£80	£73	£67	£63	£58	£55	£51
	900	£129	£113	£100	£90	£82	£75	£69	£64	£60	£56	£53
	925	£132	£116	£103	£93	£84	£77	£71	£66	£62	£58	£54
	950	£136	£119	£106	£95	£86	£79	£73	£68	£63	£59	£56
	1000	£143	£125	£111	£100	£91	£83	£77	£71	£67	£63	£59
	1050	£150	£131	£117	£105	£95	£88	£81	£75	£70	£66	£62
	1100	£157	£138	£122	£110	£100	£92	£85	£79	£73	£69	£65

Not affordable

Affordable

The outperformance assumptions on recovery plan contributions will materially increase the affordability of the recovery plans compared to those illustrated above but we are unable to say by how much.

Considerations relating to acceptable plan length

The Pension Regulators published Funding Statistics based on recovery plan submissions in 2016 show for schemes with deficits the following average recovery plan lengths relating to tPR’s ascribed Covent Group rankings. This provides the Trustee with some benchmarking perspective on appropriate recovery plan length.

Covenant Group	Tranche 9 average recovery plan length
CG1 Strong	6.2 years
CG2 Tending to strong	7.3 years
CG3 Tending to weak	8.9 years
CG4 Weak	9.4 years

The statistics indicate that recovery plan length in excess of 10 years could be classified as being in the bottom quartile for CG4 Weak Covenant Group schemes.

We note that a number of schemes have recovery plans in excess of 10 years but that these are generally either in regulated sectors such as utilities where the regulation itself provides a context for very low payment risk or where long-term contingent assets or security are in place to reduce payment risk on contributions.

In Section 4 we concluded that, other things being equal, a reduction in plan length is both necessary and required in particular because there is more payment risk attaching to new recovery plans unless management take action to materially reduce debt.

We illustrate below that if a 10 year maximum length of recovery plan were to be considered appropriate by trustees, then there are no recovery plans available which are both affordable and not more than 10 years in length. A material level of outperformance on recovery plans is needed to present any acceptable options.

Basic contribution (£m) matrix

		Recovery plan length in years										
		7	8	9	10	11	12	13	14	15	16	17
TP deficit £m	700	£100	£88	£78	£70	£64	£58	£54	£50	£47	£44	£41
	750	£107	£94	£83	£75	£68	£63	£58	£54	£50	£47	£44
	800	£114	£100	£89	£80	£73	£67	£62	£57	£53	£50	£47
	850	£121	£106	£94	£85	£77	£71	£65	£61	£57	£53	£50
	875	£125	£109	£97	£88	£80	£73	£67	£63	£58	£55	£51
	900	£129	£113	£100	£90	£82	£75	£69	£64	£60	£56	£53
	925	£132	£116	£103	£93	£84	£77	£71	£66	£62	£58	£54
	950	£136	£119	£106	£95	£86	£79	£73	£68	£63	£59	£56
	1000	£143	£125	£111	£100	£91	£83	£77	£71	£67	£63	£59
	1050	£150	£131	£117	£105	£95	£88	£81	£75	£70	£66	£62
	1100	£157	£138	£122	£110	£100	£92	£85	£79	£73	£69	£65

Not affordable

Too long

Based on this approach, he sponsor covenant provides two principal constraints on agreeing a new schedule of contributions for the Schemes. Firstly an affordability constraint and secondly a constraint on the acceptability of payment risk attaching to very long plan lengths.

Outperformance assumptions, valuation assumptions and investment policy options provide the only “wriggle room” to escape the current straightjacket.

7 Appendix

Gazelle questionnaire and sponsor responses.

<table>
<tr><td>QUESTIONS</td><td>ANSWERS</td></tr>
<tr><td>1.Cash flow sources</td><td></td></tr>
<tr><td>Can we have some more detail around the average exchange rate assumptions for RFI and Plan 18 & 19 compared to 2016. How much of the underlying growth in operating profit results from weaker sterling?</td><td>The exchange rate assumptions are as follows:
<table>
<tr><th></th><th>Actual
2016</th><th>RF1
2017</th><th>B.Plan
2018/2019</th></tr>
<tr><td>CAD</td><td>1.80</td><td>1.66</td><td>1.89</td></tr>
<tr><td>AED</td><td>4.98</td><td>4.54</td><td>5.12</td></tr>
<tr><td>OMR</td><td>0.52</td><td>0.48</td><td>0.54</td></tr>
</table>
The RF1 rates result in increased operating profit in Canada of £3.6m and in the Middle East of £2.5m.</td></tr>
<tr><td>Working capital: can we split out the PPP disposal from W.Cap movement. Quite a few of the analyst reports suggest very little scope for further W.Cap release. Can you explain what you are hoping for here if anything?</td><td>In 2015 and 2016, the benefit to working capital was £16.4m and £34.4m respectively.

We have had 16 projects in our portfolio at 31 December 2016 with a value of £50m at a 7% discount rate. Future equity investments in these projects is estimated at £68m. Cashflow contribution from these will depend on timing of investments and timing of disposals.</td></tr>
<tr><td>JV dividends. What underlies the step-up in 2017 and then step down after?</td><td>The increase in 2017 is due to Developments. JV distributions can move up or down depending on the structure we adopt for delivery of various projects and therefore it is more appropriate to look at the overall profile</td></tr>
</table>

	of profit and cash flow. We would expect future distributions for our Middle East JV's but these have not been factored into the plan.
2. Cash flow uses	
How much is Project Rio contributing to restructuring costs in 2017 and I guess the uptick in Capex (you indicated IT) in 2017. What benefits is Rio delivering in terms of cash flow sources in 18 and 19?	Project Rio is not in restructuring costs. The capex is as follows: 2017: £20.9m 2018: £13.4m 2019: £13.9m 2020: £9.2m There are significant benefits expected from Project Rio (£10m - £12m) and they will start to accrue during the business plan period but will not be fully realised until 2020/2021.
Given issues with ME construction and scaling of UK construction we talked about, is there realistically quite a possibility of further restructuring to undertake in 2018 and 2019 and what do you feel would be a reasonable assumption to make about this?	No significant further restructuring is planned in 2018 or 2019 but you could include say £5m to provide some cover.
Is there anything that could potentially be done to reduce the tax charge step-up in 18 and 19?	The tax rate assumed is 17% in 2018 and 18% in 2019. Our future tax rate generally includes an element of prudence and we would expect to outperform the current forecast though the exact level will depend on future mix of profits.
Is £27 m of net capex pa post Project Rio what is considered to be the long-term underlying business requirement: is it judgement largely or already allocated to potential projects?	Capex for 2018/2019 is a bit higher than the historic run rate and we expect to manage Rio within this.
Dividends: would it be possible to have the	We are assuming an increase of 1% per annum in dividends

underlying increase assumptions ex- options exercise etc? I need to take care to carefully explain the apparent dividend increases to trustees - this related to minorities in the main. So are these increases to minorities contractual or discretionary and a bit of explanation would help a lot?	per share. There is no impact from option exercise as we buy shares to fund them. These are payable to minorities in Canada in relation to the businesses we have acquired over the last couple of years. There are two businesses which are consolidated but not owned 100% - these are Bouchier (49% owned) and Rokstad (60% owned). The business plan assumes that we pay dividends based on the level of profits in the previous year, in reality the directors of those businesses will determine what the dividend will be based on all sorts of factors such as Capital investment, cash forecasting etc.
The page 2 Business Plan and Free Cash Flow had lower figures for acquisitions and disposals (I assume not PPP). My understanding was that this reflected slightly different scenarios on deferred consideration. I think we really need to understand this composite number a bit better and what it is made up of. Any chance of a breakdown however broad brush? Are there disposals in here. Are there new acquisitions in here or it is really just completed ones with deferred cash consideration. The committed net acquisitions forecasts seem to indicate that there is an additional 20 m plus in 2018 and 2019 over and above PPP and deferred consideration- is that correct and is it actually committed or is there a bit of headroom built in?	Acquisitions and Disposals is made up broadly of £20m – £25m of PPP investments, £10 – 15m of committed acquisition payments in Canada and the balance is contingency for future investment/acquisition opportunities. These are not committed but are baked in to support future growth.
3. Viability statement information	
Would I be right in taking the view based on this that the group has reached a point where it is now pretty well capital constrained at max uncommitted facilities and while there may be pockets of extra financing that can be tapped into, it is not mainstream bank lending?	Broadly that's correct. We continue to attract some interest from new banks – we are entering into a new £30m bilateral loan facility at the moment – but it is probably fair to say that there isn't a lot of additional appetite in the bank credit market for us at the moment. This isn't much of a surprise given that we have big commitments already from the main corporate lenders in the market and indeed our medium term financing plans assume more access to the capital markets in future.
Do you have any contingency plans in case debt markets closed up for say 6 months because of another Lehmans or financial sector crisis?	No significant maturities until 2019, we would look to refinance these well ahead of maturity and therefore a 6 months issue should be manageable.

Is it fair to take a view that equity markets are also effectively out of bounds because no one would underwrite a rights issue for the current shareholder base and a deep discount one would be pretty risky to try and undertake?	The ability to raise equity obviously depends on the quality of the investment case presented to shareholders and potential shareholders. Over recent years, several companies in our sectors have substantially rebalanced their businesses and at the same time raised equity. Furthermore, some have also done this while writing down assets and rebased earnings.
4. Debt	
Without reverse factoring, what might average net debt have been? Is it fair to say, as alluded to by several analysts, that the only 2 realistic options for producing a meaningful reduction in borrowings is therefore (i) cutting the dividend by say 50% and rebasing dividend growth of say 10% pa off that lower base yielding c £130m of reduced borrowing by 2020 or (ii) selling all or parts of the Middle East business.	It is difficult to say exactly, because to calculate this one would need to know when the supplier would have been paid had they not joined our Early Payment Facility (the reverse factoring scheme we introduced at the request of the UK Government in 2013). However, we estimate that debt would have been around £100m or so higher. It is also worth remembering that Carillion effectively covers the cost (charged by the banks) for suppliers to take payments much earlier under our EPF, which was c£8m in 2016 i.e. our pre-tax profit would have been £8m higher if we didn't have the EPF. The Board is obviously aware of all the options that could, in principle, be used to reduce debt, including changing the way it allocates capital. Currently, the Board has chosen to pursue a number of actions focused on accelerating the rebalancing of the business in to markets where we can achieve good margins and cash flows, the tighter management of working capital across all our contracts and cost reduction programmes
On selling the Middle East we would presume that would be mainly construction and therefore could have a nasty cash impact from working capital like the UK did? Does that make this option less attractive as it might not be as effective a measure to deliver a meaningful reduction in borrowings.	Selling businesses, for example in order to accelerate the rebalancing of our business, is one of the options available in principle. If pursued, we would look at the relative merits of individual sales in order to determine their financial impacts, including on net debt.
We can't envisage that any other realistic short-term options would produce a meaningful reduction in debt. Do you broadly agree?	None other than those noted above.

5. General	
I am guessing the business plan gets redone in June and you may choose to present some new numbers as pension discussions progress. To avoid surprised are there any obvious material changes that can already be anticipated?	- We are currently working through the Business Plan for this year which we will finalise in June/July and therefore this we will not be available for a while. We have already flexed the numbers we provided for any prior year variances
In considering the correlation between Carillion's performance and scheme asset and liability developments: - What overall impact on group performance might be expected if inflation increased to 3% pa? - What overall impact on group performance might be expected if interest rates were to rise by 1 %?	- A 0.1% increase in RPI would increase the deficit by around £50m - A 0.1% increase in the discount rate would reduce the deficit by around £60m (i) Higher inflation – whilst this would impact labour costs, the majority of our service contracts are indexed. On construction contracts, we use a lot of subcontractors. Therefore I would assume no significant impact. (ii) Over £500m of our debt is made up of various private placement issues plus a convertible bond where the coupon is fixed – and therefore is not impacted by changes in interest rates. We borrow above this core debt from our revolver which is variable rate borrowing and therefore is impacted by changes in interest rates. The precise figure will depend on the pattern of bank borrowing over the year but will be low single digit millions for each 100bp increase in interest rates

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