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Construction giant Carillion on hazy outlook after contracts writedown

by Yu Ning

Carillion PLC (Carillion), one of the UK's leading construction and support services companies is experiencing a series of adversities and finds itself hard to turnaround. The RMI-CRI 1-year Probability of Default (PD) for Carillion surged from 34.5bps to 408.57bps in just a week in July this year and has kept a rising trend since then (see Figure 1). On 10 July 2017, the troubled company had to issue a shocking profit warning and was forced to oust its Chief Executive Officer, Richard Howson. Under the pressure of soaring debt and a writedown of GBP 845mn related to four major contracts, shortly after the profit warning, Carillion suspended its dividend to save an estimated GBP 80mn in cash. JP Morgan downgraded Carillion to 'Neutral' from 'Overweight' and lowered its profits forecasts for the next three years by around 20%. By 30 August 2017, Carillion's share price plunged drastically, dropping nearly 76% compared to the price prior to profit warning. Correspondingly, the company's market capitalization slid around GBP 580mn and was removed from FTSE 250.

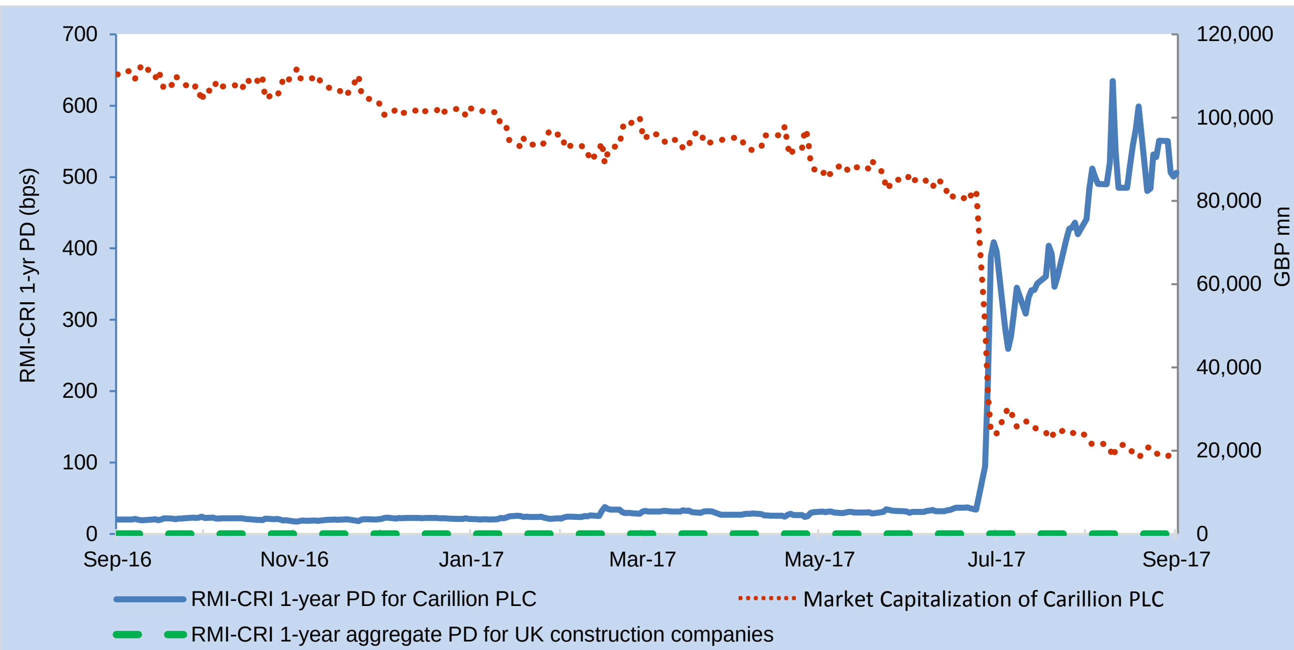

Figure 1: RMI-CRI 1-year PD for Carillion PLC and RMI-CRI aggregated 1-year PD for UK construction companies (LHS) market capitalization for Carillion PLC (RHS) *Source: RMI-CRI, Bloomberg*

The turmoil started with four significant contracts that had been found problems after a review by KPMG. Carillion has worked on many contracts both in UK and foreign countries, including Royal Liverpool University hospital, Battersea power station revamp, and Birmingham's flagship library. But some of these projects went into problem and became over the center of late payment concerns. Therefore, Carillion commissioned a review by its auditing firm KPMG into 58 contracts. The results of the review, released on 8 July, identified four problematic contracts – three large public private partnership contracts (PPP) in the UK accounting for GBP 375mn and one in the Middle East for GBP 470mn, resulting in a total of GBP 845mn writedowns. This huge writedown directly poses a threat on Carillion's operations and brought in a shocking profit warning. After that, the company declared that it would no longer bid for big construction projects and would instead focus on providing support service in rail, road, telecoms and power networks.

	1H 2015	2H 2015	1H 2016	2H 2016
Net Income (GBP mn)	31.5	62.4	54.9	53.5
Gross Margin (%)	7.76	9.49	8.11	7.86
Net Debt/Equity (%)	21.36	16.69	29.94	29.99
Total Debt/EBITDA (%)	2.64	2.75	3.16	3.76
Cash & Equivalents (GBP mn)	421.7	462.2	375.7	469.8

Table 1: Financial Data for Carillion PLC *Source: Bloomberg.*

The RMI-CRI surging 1-year PD is also correlated with Carillion's increasing leverage. The total debt to EBITDA ratio has increased and the company is generating less profits. (See Table 1). Carillion's debt troubles have been triggered after an aggressive series of acquisition spree: Eaga in 2011, Ask Real Estate Ltd. in 2016 and Facilities management division from Compass Group PLC this year. Net debt has skyrocketed from GBP 46mn in 2011 to about GBP 219mn by the end of 2016, and spiraled to almost GBP 700mn in the first half of 2017. By September 2017, Carillion has a total debt of GBP 567mn, with GBP 170mn due 2019, and GBP 397 due 2020. Despite a pile of debt to be paid, Carillion's GBP 2.3bn pension fund had a deficit of GBP 393mn at the end of 2015. "The pension deficit could have grown to as much as GBP 800mn", according to Stephen Rawlinson, an independent analyst. However, by the end of 2016, Carillion generated only GBP 469.8mn in cash and cash equivalents. Also, affected by the rising materials and labor costs in the UK and spending cuts by governments in the Middle East prompted by low oil prices, Carillion's profitability worsened, with net income and gross margin in 2016 dropping to GBP 53.5mn and 7.86%, respectively. The worsening performance forced Carillion to lower its 2017 revenues to less than GBP 5bn, below the original estimated GBP 5.03bn. Annual pre-tax profits will also fall short of the GBP 179mn forecast. As further bad news, Oxfordshire Country Council said it would end a 10-year deal with Carillion to build schools and supply property management services in September, which had been signed in 2012 and is worth GBP 500mn. This terminated deal would bring Carillion's profitability into further trouble. As JP Morgen forecasted a 20% lower profit for the next three years, it becomes an unknown for the company whether it can repay the debt without a default in the future.

Pressured by these contract problems and high debt, failure of senior management seems to be a likely reason for Carillion's distress. The writedown of GBP 845mn in contracts suggested that Carillion's senior managers failed in fulfilling their core responsibilities. Followed by the exit of Richard Howson as CEO, Carillion's CFO, COO, some managing directors, and group strategy director all left with immediate effect, resulting in a chaotic situation in the management structure.

The RMI-CRI 1-year aggregate Probability of Default (PD), a median of the PDs for 28 UK construction companies, has kept at a low level with an average of 12.67bps since September 2016 (See Figure 1), implying that the construction industry in UK is under low default risk. Meanwhile the CRI-RMI 1-year PD for Carillion lies way above the industry's PD, indicating that the company is experiencing greater predicament compared with peers.

The recent profit warning and share price plunge brought Carillion's future into deep doubt. The company was due to publish half-year results in August 2017, but delayed its release to the end of September. Even though the financial report is not yet published, it can be predicted that Carillion is under great pressure of high debt and low profitability. However, Government intervention may save the troubled company from the plight. Several days after Carillion's stock market plunge, the British Government intervened to award Carillion millions of pounds of work on the new High Speed 2 railway line, and provided a Carillion joint venture with two separate British defense infrastructure contracts worth GBP 158mn, which makes some analysts more optimistic about the future of the company. While these projects need a great amount of funds for preparation, whether Carillion can wait for the revenues to ease the crisis is still a question. The next task for the company should be to restructure the internal management with the new top management team, trying to engage more profitable contracts to generate revenue and recovery from the turmoil.

Credit News

Global debt may be understated by USD 13tn: BIS

Sep 18. According to Bank for International Settlements (BIS), global debt may be under-reported by about USD 13tn because traditional accounting practices exclude foreign exchange derivatives used to hedge international trade and foreign currency bonds. Accounting conventions leave the debt mostly off-balance sheet, as a derivative, although it is in effect a secured loan with principal to be repaid in full at maturity. Most of them are short-term and had a maturity of less than a year at the end of 2016. While the debt is mostly secured as counterparties to reduce currency exposure, the make-up of these largely short-term transactions indicates they are often the most vulnerable to strains in the financial system. (Reuters)

Spain's construction sector rises from the ashes

Sep 17. The once gloomy Spanish construction sector looks to be headed for a rebound after the successful IPO of Neinor Homes. Growth in the construction sector resurfaced as the Spanish economy begin to recover and there had been practically no new residential homes built since the last property price crash in 2007. With increased residential construction activity, more construction companies are considering a public listing. Combined profits for the four big Spanish Socimis in Q1 2017 increased 50% from the same period last year. However, not all construction groups will benefit from the higher property prices. Companies focused on large infrastructure projects will feel little impact as the government holds back on spending. (FT)

Pub industry pressures causing 'early warning signs' over debt, Moody's warns

Sep 17. Credit rating agency Moody's Investors Service expects the credit performance of UK pub companies to decline as they face rising business rates, labor costs and inflation. Punch Taverns and Mitchells & Butler, two of the largest pub companies could breach debt covenants by the end of 2018 if costs rise by a further 5 percent. The National Living Wage will increase staffing costs to GBP 9 per hour in April 2020 from the current GBP 7.5 per hour and a weak Sterling may dampen the firms' earnings as most of the pubs purchase their goods from overseas. Credit multiples show a downward trajectory and the debt serviceability reveals early warning signs. (The Telegraph)

Seadrill files for bankruptcy in bid to shrink debt burden

Sep 13. Senior creditors will inject USD 1bn into Seadrill as the company files for Chapter 11 to help it reorganize under court protection. The deal extends the maturity on USD 5.7bn in debt with no amortization payments due until 2020. Unsecured creditors have the option to convert their bonds into a 15 percent stake into the firm while shareholders may end up with 3 to 4 cents a share. The USD 1bn investment consists of USD 860mn in secured notes and USD 200mn of equity in the restructured firm. A number of institutional players including hedge funds Centerbridge Partners and Saba Capital are investing in the secured notes as Seadrill expects to emerge from Chapter 11 in six to nine months. (Bloomberg)

Novo Banco's debt restructuring in limbo

Sep 11. Novo Banco's debt restructuring exercise is uncertain after investors holding nine of the 36 series of targeted notes or 28% of the targeted debt accepted the offer made by the bank. 75% of the EUR 8.37bn debt must accept the bank's offer in order for the offer to succeed. Portuguese authorities have highlighted that the deal is necessary in order for the sale of the bank to US investor Lone Star to proceed. Meetings involving investors have adjourned but credit analysts are not optimistic about the exercise to go through as they estimated investors holding only two-thirds of the total debt to accept the offer. (Reuters)

Huishan Dairy debt woes deepen as banks demand USD 220mn repayment (Reuters)

Future ownership of Westinghouse shrouded in doubt (FT)

Toys 'R' Us vendors cut shipments on bankruptcy fear (Bloomberg)

Regulatory Updates

SIAS, Rajah & Tann seek MAS action on insurance for Singapore bonds

Sep 18. Securities Investors' Association of Singapore (SIAS) and Rajah & Tann Singapore have jointly submitted to the Monetary Authority of Singapore a two-pronged proposal, which calls for bond issuers to take up an insurance policy at the time of issuance and for bond promoters to allocate a minimum 30% of total issue to institutional investors to diversify the investor composition. These reforms come in the wake of bond defaults by offshore and marine services firms hit by a prolonged commodity slump. While the proposal for bond-default insurance coverage could bring hope and cheer to Singapore's bond market, some people find the proposal impractical to set aside a mandatory tranche for institutional investors for bond issues. (Business Times)

Capitalization bonds may be floated to support public sector banks

Sep 12. The Indian government is looking to sell capitalization bonds to support the increasing capital requirements of weaker state-run banks. These lenders expect to raise money from the market on their own but they are finding it difficult to raise capital from the market. A Fitch Ratings report said that Indian state-run lenders are likely to require about 90% of the USD 65bn additional capital to meet Basel III capital standards. The Indian government is in a tight spot as it is still committed to keep the fiscal deficit at 3.2% of GDP in FY 2018 and 3% in FY 2019. However, the government has to step in to support these troubled lenders in order to strengthen them to take on bad loans and weak loan growth problems. (Economic Times)

UK financial regulator warns of 'very high' risks associated with initial coin offerings (FT)

Too much competition can destabilise financial system: APRA (The Australian)

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