05 April 2016

THE ANALYST

Carillion: Mind the Earnings Gap & High Leverage
SHORT @ 291p

Carillion – View All Notes and Models

Analyst: **James Woodrow**

Recommendation: **Short (Initiation of Coverage)**

Price: **291p**	Market Cap: **£1.23bn**	Ticker: **CLLN LN**
3m Average Daily Volume: **$8m**	2-Year Price Target: **180p**	Forecast Return: **38%**
Valuation Metric: **Dividend Yield FY'18**	Current Multiple: **4%**	Target Multiple: **6%**

Investment Thesis

- **Support services and construction company with weakening working capital dynamics, accounting one-offs and average net debt significantly higher than period reported net debt (£369m higher).**
- **Holding profits flat looks to be the best case scenario as PPP profits reduce (15% of FY15 EBIT), PP&E profits on disposal (6% of FY15 EBIT) do not recur and margin reductions continue in Construction divisions (26% of FY15 EBIT).**
- **Balance sheet is over-geared (2x+ average ND to EBITDA + £394m of pension liabilities) and dividend cut or equity raise needed in coming years to rebuild balance sheet strength, either diluting equity holders or removing dividend yield support from current share price.**
- **We assume dividend falls to ~11p within three years, creating significant downside to our 180p price target based on a normalised 6% dividend yield.**

Introduction

We add Carillion to our Short list as:

- analysis of the recent results;
- our negative house view on support services (MITIE, G4S, ISS); and
- the key driver of historic growth being transformative M&A deals (with further material M&A being difficult within current highly-levered structure),
- gives us conviction that further EPS downgrades and challenges for this business model lie ahead.

We know that this stock is already well-shorted by the hedge fund community and this drove us to examine the investment case in more detail. We like looking for taking contrarian views on well-shorted stocks (see our recent Buy initiation on Elekta and our continued attraction to the heavily-shorted Ocado equity story), but our due diligence on Carillion led us to develop a strong Short case and a belief that we had additional points to add to the debate.

Margins Under Pressure in Construction Business, Unlikely to Reverse

Margins at Carillion are under pressure in the Construction businesses and we expect margin pressure to be forthcoming in the Support Services segment given that recent contract wins were highly competitive. For example, the Next Generation Estates Contracts (NGEC) bid won by CarrillionAmey was challenged in court by a rival bidder (the case was subsequently dropped), and CarillionAmey has subsequently faced newspaper exposés over service quality with both companies making a public apology following this controversy, but still at risk of losing the contract. We also anticipate some forthcoming margin pressure from the Living Wage in the UK.

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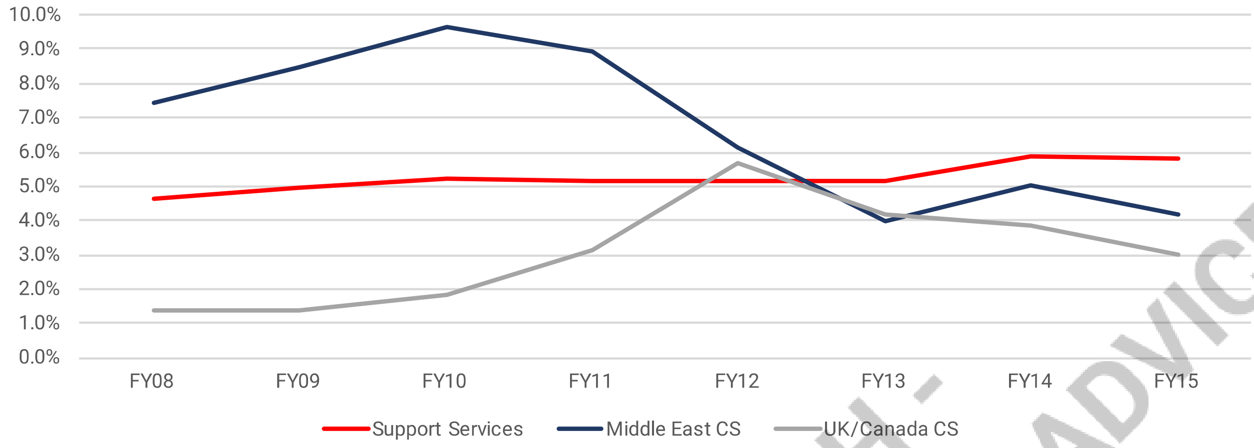
Exhibit 1: Margins of Carillion's core business lines



Source: Carillion filings

SAMPLE RESEARCH - NOT CURRENT INVESTMENT ADVICE

Margin pressure will not abate in the next two-to-three years due to the following:

- Construction margins in the UK will remain under pressure, given that many projects were bid a number of years ago and there has been significant cost price inflation in the UK construction market. Operating margins were 3.0% in 2015 and management has guided to a reduction in the FY'15 results statement to between 2.5% and 3.0%.

- Middle East construction will become increasingly competitive in a low oil price environment. Margins in 2015 were boosted by a "*profit generated from re-organising staff accommodation facilities in Oman*" which will not recur in 2016. If we remove this one-off gain, then we estimate profitability fell by 55% year-on-year and management has guided to continued pressure in 2016.

- The Middle East Construction operations have historically benefited from UK Export Finance which we estimate delivers premium margin work – this delivery mechanism benefitted 2014 (c.£8m profit) but did not appear to have any benefit in 2015. Given the challenging market likely to be encountered in the Middle East market in a low oil price world, the ability to utilise UK Government Export Finance or PPP may not be enough to deliver a sustainable competitive advantage at high margins for Carillion.

- In the UK, the Living Wage is being introduced and we would expect this to have some impact on Carillion's workforce. We are yet to see an estimate of this from Carillion but this is a headwind which Interserve and G4S have flagged as an issue.

- MITIE cited that its "*contractual protections ensure that it [the Living Wage] will not have a material impact on future earnings*" but did go on to warn that "*going forward there are broader changes to UK employment costs in addition to the National Living Wage, such as rising employer pension contributions, a new apprentice levy, and additional labour legislation. These changes are contributing to an increase in the overall cost of more labor-intensive services. In what is already a competitive environment, we expect this will create further shifts in our markets.*"

- Street models appear to have Support Services margins going up further in coming years – we question the sustainability of this given there appears to be pressure on this industry as a whole.

- In Canadian Support Services Carillion acquired the Outland Group in May 2015 for consideration of up to £63m with an initial installment of £11m. This business provides "remote-site accommodation and associated services" across Canada and in the year-ended September 2014 generated revenue of £112m and PBT of £12m, implying a high operating margin making an assumption for interest (note: we have been unable to find local accounts for Outland). Given the weakness in commodity prices (sector exposures include mining, gas and oil), we would anticipate profitability will reduce in this business from the current double digit margin level.

- Carillion did not report 2015 performance for Outland, simply stating in the 2015 Annual Report "*The above acquisitions do not have a material impact on the balance sheet of the Group and therefore the full disclosures required by International Financial Reporting Standard 3 'Business combinations' have not been presented.*"

Exhibit 2: 2015 Annual Report, Note 30 – Reduced Level of Discloser vs. 2014 Acquisitions

30. Acquisitions and disposals

Acquisitions in 2015

On 28 May 2015, the Group acquired the entire share capital of the Outland Group (Outland). Outland provides a complete range of remote site services across a number of growth sectors in Canada, including mining, utilities, forestry, gas and oil. The total cash consideration, which is capped at approximately £63 million, is dependent on the financial performance of Outland between 2015 and 2017. The first instalment of the consideration of £10.7 million has been included in the cash flow statement within the acquisition of subsidiaries, net of cash and cash equivalents acquired. The second instalment of approximately £25 million is due in 2016, with the remainder due in 2018 and 2019. The fair value of the deferred and contingent consideration is included within liabilities in the balance sheet and is derived from inputs that are not observable in the market. Consequently, the fair value has been determined using an estimate of the contractual cash flows that could be paid under the terms of the sale and purchase agreement using a risk adjusted discount rate of 3.4 per cent.

A provisional assessment has been made of the fair value of the net assets acquired of £18.6 million, which includes identifiable intangible assets of £7.2 million net of deferred taxation. This is after excluding goodwill on the Outland acquisition balance sheet of £0.8 million, and provisional fair value adjustments totalling £9.0 million that reduced the carrying value of net assets at the acquisition date. On the basis of this assessment the provisional goodwill arising on the acquisition amounts to £43.1 million.

On 24 December 2015, the Group acquired a 67 per cent controlling interest in Ask Real Estate Limited, a property development company based in the United Kingdom. The cash consideration of £4.0 million was paid in January 2016. No goodwill arose on the acquisition.

The above acquisitions do not have a material impact on the balance sheet of the Group and therefore the full disclosures required by International Financial Reporting Standard 3 'Business combinations' have not been presented.

Total acquisition costs incurred in relation to contracts and due diligence procedures for merger and acquisition activities in the year of £2.5 million (2014: £9.9 million) have been included in non-operating items in the income statement (see note 4).

Source: Carillion 2015 Annual Report

In our view, the days of Carillion over-earning in UK and Middle East Construction appear to be over, and flat-lining profits looks like a best case scenario for the next two years. We expect PPP profits to continue to reduce given the sale of PPP assets in 2015, the immaturity of the current portfolio and the trend ongoing back towards a normalised level of profits. This therefore leaves Support Services as the core growth driver of profits in the short to medium term.

Support Services Margin Trajectory Looks Unsustainable

Margins at Carillion's Support Services segment have been rising in recent years despite the market becoming increasingly competitive and new bids coming in at what we believe are lower margins, when one very high margin (27%) joint venture MoD-related contract is excluded from the underlying base, as we believe contracts like this are unlikely to be awarded under the current austerity regime at the MoD.

Modelling through the guidance in the report for other segments (both Construction divisions' margins down and PPP profits down) implies significant growth in revenue and expansion of Support Services operating margins to get anywhere near to consensus profit and EPS expectations.

We note the following points on revenue growth at Support Services:

- Support Services revenues in H2 2015 increased by 6%, or £73m, from £1,223m to £1,296m, including joint ventures.

- The acquisitions of Rokstad (announced 1 December 2014, completed 24 December 2014) added £108.5m of historic revenues (based on the acquisition press release) and Outland (announced 29 May 2015) added £112.2m of historic revenues (based on the acquisition press release).

- These two acquisitions combined added around £221m of revenues to Carillion, implying an H2'15 increase of around £110m (some downward adjustment may be needed to this figure for work completed between 24 December 2014 and 31 December 2014 at Rokstad, but this does not change the conclusion of our analysis). The £73m increase is after £35m of total group headwind from the Canadian dollar, so even adjusting for this it looks like organic growth in the Support Services business in H2 2015 was negative.

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- The key point we are making is that a strong organic growth turnaround within Support Services is needed to get anywhere near achieving 2016 and 2017 consensus estimates. The start point for improvement is that Support Services organic growth was negative in H2'15 and therefore 2016 requires a significant step up in organic progress.

On the margin front we note the following:

- Despite significant mobilisation costs in 2015, margins were flat (5.8% including JVs proportionately consolidated) and improved in H2'15 from 6.6% to 6.8%.
- The group (fully consolidated) margin was flat at 5.4% in 2015. This is broadly in line with peer margins that we have seen. ISS earned an operating margin of 5.7% in 2015, MITIE earned a 5.2% H1'16 operating margin (down from 5.9% in the prior year) and Interserve earned a 5.0% margin in the UK and 4.1% internationally.
- We believe that Support Services margins in the UK came under pressure in 2015 ex-mobilisation costs and acquisitions.
    - The Canadian acquisitions deliver higher margins than the group average prior to their consolidation, thereby boosting the underlying margin.
    - The JV margins continued to improve, contributing to the group margins.
    - Net net, there was an underlying organic reduction in Support Services margins in 2015, even after adjusting for mobilisation costs, and we understand that market estimates are looking for a marked improvement in 2016E.
- JV margins continued to increase from 10.0% in 2014 to 10.1% in 2015. We have looked into this deeply to try to explain what is actually happening in the Support Services JV line of the income statement by looking at the Companies House filings. We have to do this on a nine-month lag, and assuming the same accounting policies are used, but our analysis shows that the main profit driver is the Facilities Management contract on Project Allenby Connaught. Carillion owns a 50% stake in Aspire Defence Services Limited which delivers the FM services and this is held through its Carillion JM Limited subsidiary (100% owned by Carillion PLC).

  In 2014, this JV earned £26m of profit (pre interest and taxes) on £96.7m of revenue. Carillion accounts for 50% of this in its accounts, giving £48.5m of revenue and £13.0m of EBIT vs. the Support Services JV line of the income statement which states £224.2m of revenue and £22.4m of EBIT. Therefore, one contract is worth 58% of the JV profit line at a 27% operating margin which is likely to continue for a long time (this is a 35-year concession, the company commenced trading in January 2004 and the service commencement started in July 2006).

  The other JVs do not look to be as profitable as the Project Allenby Connaught contract:

    - CarillionAmey Limited in the year ended December 2014 reported £131.9m of sales and £5.7m of EBIT – this is a 4.3% margin. We understand this is a joint venture reported in the Support Services business.

    - We calculate the Middle East Support Services business as having £92.2m of consolidated revenue (£451.1m Middle East revenue less £358.9m of Middle East construction revenue) and £23.2m of JV revenue (£265.9m of JV Middle East revenue less £242.7m JV Middle East revenue), giving £115.4m of total Middle East Support Services revenue. We do not have a Middle East profit breakdown.

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Exhibit 3: Carillion JV Reconciliation vs. Subsidiary Filings

£m, Y.E. December	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Carillion Support Services										
JV Revenue	143.9	224.2	236.4	281.2	266.5	225.4	228.3	271.5	224.2	191.8
JV EBIT	7.3	11.5	14.0	14.8	18.1	15.1	20.9	25.2	22.4	19.3
JV Margin	5.1%	5.1%	5.9%	5.3%	6.8%	6.7%	9.2%	9.3%	10.0%	10.1%
Carillion Group										
JV Dividend Received	15.7	23.7	25.0	38.6	48.1	39.6	13.6	18.2	9.1	16.8
Aspire Defence Services Limited (50% owned JV)										
Limited Company Results										
Revenue	34.1	68.5	80.3	76.5	86.2	84.0	88.0	92.9	97.0	
Operating Profit	11.0	10.0	13.6	15.6	19.0	17.0	19.9	28.7	26.0	
Margin	32.4%	14.7%	16.9%	20.3%	22.0%	20.2%	22.6%	30.9%	26.8%	
Dividend Paid	-6.1	-6.9	-10.4	-11.1	-12.5	-11.2	-12.5	-20.0	-11.6	
Implied Carillion Share										
Carillion Ownership	50%	50%	50%	50%	50%	50%	50%	50%	50%	
Carillion Revenue	17.1	34.3	40.1	38.2	43.1	42.0	44.0	46.5	48.5	
Carillion Operating Profit	5.5	5.0	6.8	7.8	9.5	8.5	10.0	14.3	13.0	
Carillion Dividend	-3.1	-3.5	-5.2	-5.6	-6.3	-5.6	-6.3	-10.0	-5.8	
CARILLIONAMEY Limited (formerly CarillionEnterprise Limited) (50% owned JV)										
Limited Company Results										
Revenue	71.3	168.9	172.0	153.9	114.7	100.8	123.0	145.7	131.9	
Operating Profit	4.4	6.6	7.8	7.4	8.1	6.0	7.6	7.5	5.7	
Margin	6.1%	3.9%	4.5%	4.8%	7.1%	6.0%	6.2%	5.1%	4.3%	
Dividend Paid	-1.0	-5.0	-5.8	-6.1	-4.6	-5.0	-5.7	-5.2	0.0	
Implied Carillion Share										
Carillion Ownership	50%	50%	50%	50%	50%	50%	50%	50%	50%	
Carillion Revenue	35.7	84.4	86.0	77.0	57.4	50.4	61.5	72.9	65.9	
Carillion Operating Profit	2.2	3.3	3.9	3.7	4.1	3.0	3.8	3.7	2.9	
Carillion Dividend	-0.5	-2.5	-2.9	-3.1	-2.3	-2.5	-2.8	-2.6	0.0	
Reconciliation										
Support Services JV Revenue										
Carillion JV Revenue	143.9	224.2	236.4	281.2	266.5	225.4	228.3	271.5	224.2	
less: Aspire Defence Services Limited	-17.1	-34.3	-40.1	-38.2	-43.1	-42.0	-44.0	-46.5	-48.5	
less: CARILLIONAMEY Limited	-35.7	-84.4	-86.0	-77.0	-57.4	-50.4	-61.5	-72.9	-65.9	
Implied Other	**91.2**	**105.5**	**110.2**	**166.0**	**166.1**	**133.0**	**122.8**	**152.2**	**109.8**	
Support Services JV EBIT										
Carillion JV EBIT	7.3	11.5	14	14.8	18.1	15.1	20.9	25.2	22.4	
less: Aspire Defence Services Limited	-5.5	-5.0	-6.8	-7.8	-9.5	-8.5	-10.0	-14.3	-13.0	
less: CARILLIONAMEY Limited	-2.2	-3.3	-3.9	-3.7	-4.1	-3.0	-3.8	-3.7	-2.9	
Implied Other	**-0.4**	**3.2**	**3.3**	**3.3**	**4.5**	**3.6**	**7.1**	**7.1**	**6.5**	
Implied Other margin	-0.4%	3.0%	3.0%	2.0%	2.7%	2.7%	5.8%	4.7%	6.0%	
Carillion Group JV Dividend Income										
Carillion JV Dividend	15.7	23.7	25	38.6	48.1	39.6	13.6	18.2	9.1	
less: Aspire Defence Services Limited	-3.1	-3.5	-5.2	-5.6	-6.3	-5.6	-6.3	-10.0	-5.8	
less: CARILLIONAMEY Limited	-0.5	-2.5	-2.9	-3.1	-2.3	-2.5	-2.8	-2.6	0.0	
Implied Other	**12.1**	**17.8**	**16.9**	**30.0**	**39.6**	**31.5**	**4.5**	**5.6**	**3.3**	

Source: Carillion Annual Report & Accounts, Companies House for subsidiary filings, The Analyst
Note: Accounting standards may differ between subsidiary filings and Carillion

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Exhibit 4: Carillion Support Services Segment Breakdown

Divisional Split	FY08	FY09	FY10	FY11	FY12	FY13	FY14	H115	H215	FY15	FY16E	FY17E	FY18E	FY19E	FY20E
Support Services															
Support Services - Group Revenue	2,227	2,108	1,842	2,120	2,131	2,029	2,100	1,159	1,184	2,342	2,483	2,557	2,634	2,713	2,795
Growth		-5.3%	-12.6%	15.1%	0.5%	-4.8%	3.5%	22.9%	2.3%	11.6%	6.0%	3.0%	3.0%	3.0%	3.0%
Support Services - Group EBITA	100	103	92	106	100	93	114	49	79	127	139	138	137	136	140
Growth		3.4%	-10.3%	14.5%	-5.4%	-7.2%	22.3%	13.2%	11.5%	12.2%	9.2%	-0.7%	-0.8%	-1.0%	3.0%
Margin	4.5%	4.9%	5.0%	5.0%	4.7%	4.6%	5.4%	4.2%	6.6%	5.4%	5.6%	5.4%	5.2%	5.0%	5.0%
Support Services - JV Revenue	236	281	267	225	228	272	224	80	112	192	196	200	204	208	212
Growth		19.0%	-5.2%	-15.4%	1.3%	18.9%	-17.4%	-49.4%	68.8%	-14.5%	2.0%	2.0%	2.0%	2.0%	2.0%
Support Services - JV EBITA	14	15	18	15	21	25	22	10	10	19	20	20	20	21	21
Growth		5.7%	22.3%	-16.6%	38.4%	20.6%	-11.1%	-22.1%	-3.9%	-13.8%	1.4%	2.0%	2.0%	2.0%	2.0%
Margin	5.9%	5.3%	6.8%	6.7%	9.2%	9.3%	10.0%	11.9%	8.8%	10.1%	10.0%	10.0%	10.0%	10.0%	10.0%
Support Services - Group + JV Revenue	**2,464**	**2,390**	**2,109**	**2,345**	**2,360**	**2,301**	**2,324**	**1,239**	**1,296**	**2,534**	**2,679**	**2,757**	**2,838**	**2,921**	**3,006**
Growth		-3.0%	-11.8%	11.2%	0.6%	-2.5%	1.0%	12.5%	5.9%	9.0%	5.7%	2.9%	2.9%	2.9%	2.9%
Support Services - Group + JV EBITA	**114**	**118**	**110**	**121**	**121**	**118**	**136**	**58**	**88**	**147**	**159**	**158**	**157**	**156**	**161**
Growth		3.7%	-6.2%	9.4%	0.1%	-2.4%	15.2%	5.4%	9.6%	7.9%	8.2%	-0.3%	-0.5%	-0.6%	2.9%
Margin	4.6%	4.9%	5.2%	5.2%	5.1%	5.1%	5.8%	4.7%	6.8%	5.8%	5.9%	5.7%	5.5%	5.4%	5.4%

Source: Carillion Reports (Historic Numbers), The Analyst Estimates

Is Profit Completely Cash-Backed?

Management is remunerated on underlying year end cash flow conversion of 95% to 110%, averaged over three years. This is calculated as underlying cash from operations divided by underlying operating profit but excludes pension costs, capex (an add back is made in the calculation for depreciation but no adjustment is made for corresponding capex) and non-recurring items. We admit that pension costs (£199m 2011-15) are out of management's control as they are a legacy issue, but note that non-recurring item cash flows (£103.4m 2011-15) are excluded from these metrics and are at management's discretion despite being fairly material relative to cumulative underlying cash flow from operations (£1,017.8m 2011-15).

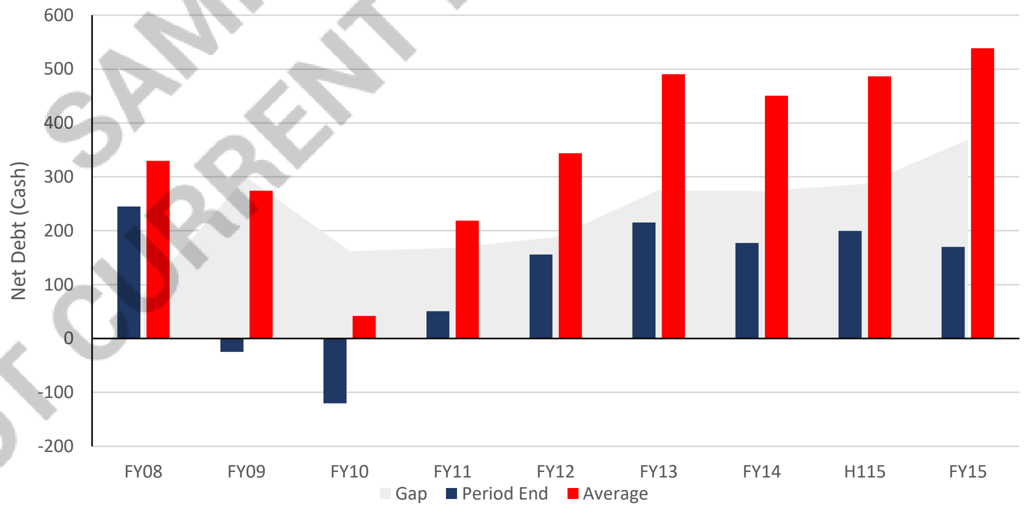
The main problem we have with the use of these performance metrics to pay management is **that it simply takes a year-end picture and ignores the fact that average net debt has been consistently rising** despite significant realisations from PPP disposals (£247.7m 2011-15, albeit slightly offset by investments in new projects), limited spend on M&A deals (£411.9m 2011-2015 and £135.3m 2012-2015) and low levels of cash tax and capex.

We would have expected average net debt to have reduced, but the fact that it went up leads us to conclude that the underlying average monthly cash flow performance of Carillion is weaker than the reported period end cash flows would suggest, and this leads us to question how we should look at the equity value of the business within a total enterprise value calculation given that an adjustment is needed for average net debt. Reported net debt at the end of 2015 was £169.8m (starting position of £177.3m) vs. average net debt of £538.9m (H1'15 average net debt was £486.5m implying H2 was around £590m). This is 1.4x of EBITDA higher, or £369.1m, and so is not immaterial in the context of Carillion's equity market capitalisation of £1.23bn.

We also question why, if Carillion's profit is meaningfully cash-backed, a business with reported net debt of £169.8m paid out £35.5m in cash interest costs in 2015 and needed to pay fees for liquidity facilities of £790m RCF, £300m US Private Placement, £170m of convertible bonds and other facilities which all together total some £1.4bn.

Our analysis implies that Carillion requires a much higher level of invested capital to run its operations, and is a much lower return asset, than calculations using the period end capital employed disclosures would suggest.

Exhibit 5: Period End Net Debt vs. Average Net Debt – Gap Rising Between the Two



Source: Carillion Filings

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Exhibit 6: Cash Flow Based on Adjusted Disclosures in Carillion Reports

CF Mgmt. Basis	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Underlying Group Operating Profit	**120.1**	**130.9**	**148.9**	**178.7**	**193.6**	**187.8**	**191.8**	**208.4**
Growth		9.0%	13.8%	20.0%	8.3%	-3.0%	2.1%	8.7%
D + Non-cash	19.2	38.8	32.0	32.1	26.9	21.3	26.6	10.7
WK	34	59.9	1.2	5.1	-136.2	-66.4	31.1	9
JV Dividends	25	38.6	48.1	39.6	13.6	18.2	9.1	16.8
Underlying CF from Operations	**198.3**	**268.2**	**230.2**	**255.5**	**97.9**	**160.9**	**258.6**	**244.9**
Growth		35.2%	-14.2%	11.0%	-61.7%	64.4%	60.7%	-5.3%
Pension deficit contributions	-50.5	-29	-35.2	-36.2	-30.2	-39.2	-46	-47.4
Rationalisation costs	-32.4	-17.1	-15.6	-34.4	-28.6	-22	-11.5	-6.3
Interest and taxation	-14.8	-8.8	-4.5	-9.1	-8.6	-15.2	-31	-40.4
Net capital expenditure	-26.4	-47.3	-15.3	4.6	-15.6	-27.2	-22.4	-12.8
Other	0	-2.7	-5.6	-6.7	-8.8	-12.4	1.4	-10.9
M&A	-227	142.7	2.7	-276.6	-32.6	-28.6	-34.5	-39.6
Dividends	-47.4	-54.4	-61.4	-68	-78.6	-75.7	-76.7	-80
Change in Net Debt	**-200.2**	**251.6**	**95.3**	**-170.9**	**-105.1**	**-59.4**	**37.9**	**7.5**
Net Debt - BOP	-44.9	-226.7	24.9	120.2	-50.7	-155.8	-215.2	-177.3
Net Debt - EOP	**-245.1**	**24.9**	**120.2**	**-50.7**	**-155.8**	**-215.2**	**-177.3**	**-169.8**
Period End Net Debt	-245.1	24.9	120.2	-50.7	-155.8	-215.2	-177.3	-169.8
Average Net Borrowing	**-329.8**	**-274.4**	**-41.8**	**-218.9**	**-344.1**	**-490.6**	**-450.7**	**-538.9**
Gap	**-84.7**	**-299.3**	**-162**	**-168.2**	**-188.3**	**-275.4**	**-273.4**	**-369.1**
/ EBITDA (Period End)	**1.1**	**-0.1**	**-0.5**	**0.2**	**0.6**	**0.9**	**0.7**	**0.6**
/ EBITDA (Average)	**1.4**	**1.2**	**0.2**	**0.8**	**1.3**	**2.0**	**1.8**	**2.0**

Source: Carillion Accounts

Change in JV Working Capital Flattered YE Working Capital

Note 10 of the 2015 full year results press release and Note 29 of the 2015 Annual Report highlight a large working capital inflow for Carillion in transacting with its joint ventures.

- 2015 vs. 2014, £69.1m of cash appears to have been generated from a reduced receivables balance and £49.8m generated from increasing payables days to PPP joint ventures and other joint ventures.
- During the same period, sales to joint ventures dropped from £277.0m to £181.2m.
- Combined, these two factors based on our interpretation improved Carillion's working capital picture by £118.9m year-on-year excluding any FX translational impacts. This accounts for more than 100% of our £74.1m defined FCF for 2015.
- A significant amount of the improvement did come from receivables unwinding from PPP joint ventures which reduced from £83.6m to £17.2m so is clearly reversing some of the prior year increase, but this is not a sustainable working capital reduction to model in outer years.
- We also note the significant increase in payables from the JV in the Middle East (Al Futtaim Carillion) which delivered a significant year-on-year benefit to the period end balance sheet position. The payables are significant at £56.5m vs. £2.4m of sales during 2015.

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Exhibit 7: Carillion – Transactions with JV and Associated Working Capital Disclosures

Transactions with joint ventures

The table below summarises the principal receivable and payable balances, together with sales to the Group's joint ventures, which are in the normal course of business and on commercial terms:

	2015			2014		
	Sales £m	Receivables £m	Payables £m	Sales £m	Receivables £m	Payables £m
PPP joint ventures						
Aberdeen Roads Holdings Ltd	0.8	0.4	–	-	-	-
COE (CAMH) Limited Partnership (Canada)	–	–	–	1.3	0.1	-
CSS (FSCC) Partnership (Canada)	0.2	0.1	–	11.6	0.9	-
Healthcare Infrastructure Partners (NOH) Partnership	0.1	3.1	–	50.3	21.3	-
Inspiredspaces Durham Ltd	2.5	–	–	18.1	10.6	(1.5)
Inspiredspaces Nottingham (Projectco2) Ltd	0.6	–	–	0.9	-	-
Inspiredspaces Nottingham Ltd	–	–	–	13.1	4.5	(0.4)
Inspiredspaces Rochdale (Projectco2) Ltd	–	–	–	5.3	-	-
Inspiredspaces Rochdale Ltd	1.9	–	–	10.8	1.9	(0.2)
Inspiredspaces STAG (Projectco2) Ltd	–	–	–	-	0.8	-
Inspiredspaces STAG Ltd	3.9	–	–	4.7	2.5	-
Inspiredspaces Tameside Ltd	9.1	–	–	16.4	4.8	(1.1)
Inspiredspaces Wolverhampton (Projectco2) Ltd	15.1	–	(0.3)	23.2	4.5	-
Inspiredspaces Wolverhampton Ltd	–	0.3	–	23.1	8.6	(0.4)
LCED (Sault) Limited Partnership (Canada)	–	–	–	3.3	-	-
PBSP Midlands Ltd	18.5	2.0	–	-	-	-
The Healthcare Infrastructure Company of Canada (ROH) Inc.	–	0.8		5.7	0.4	-
The Hospital Company (Liverpool) Ltd	84.8	10.0	–	34.4	12.9	-
The Hospital Company (Sandwell) Ltd	16.3	–	(13.3)	-	-	-
The Hospital Company (Southmead) Ltd	–	–	–	26.3	9.2	-
Other	2.6	0.5	(0.1)	0.1	0.6	-
	156.4	17.2	(13.7)	248.6	83.6	(3.6)
Other joint ventures						
Al Futtaim Carillion LLC (UAE)	2.4	0.1	(56.5)	4.2	10.8	(24.9)
CarillionAmey (Housing Prime) Ltd	–	–	–	0.7	-	-
Carillion-Breathe Ltd	12.9	3.3	–	2.9	-	-
Carillion Eltel JV Ltd	–	0.2	–	2.7	1.0	-
Carillion Richardson Partnership	–	26.7	–	-	18.2	-
Carillion Richardson Thanet Phase 2 Ltd	–	–	(1.6)	-	-	(2.5)
Carillion Richardson Worcester Ltd	0.1	0.5	–	0.2	1.0	-
CarillionAmey Ltd	9.4	2.9	–	11.3	4.8	(1.5)
Lodge Park Commercial Developments Ltd	–	3.0	–	-	-	-
Aspire Defence Services Ltd	–	–	(15.1)	-	-	-
Siglion LLP	–	3.4	–	6.2	2.5	(4.5)
Vanmed Construction Company (Canada)	–	–	–	0.2	0.9	-
Others	–	2.3	(0.1)	-	5.9	(0.2)
	181.2	59.6	(87.0)	277.0	128.7	(37.2)

Source: Carillion 2015 Annual Report

Exhibit 8: Working Capital from JV Appears to Have Benefitted FY'15 Working Capital Significantly

JV	FY10	FY11	FY12	FY13	H114	H214	FY14	H115	H215	FY15
JV Revenue	**902.5**	**898**	**736.6**	**748.3**	**350.1**	**227.9**	**578**	**297.3**	**338.9**	**636.2**
JV EBITA	**64.6**	**71**	**52**	**41**	**19.5**	**14.7**	**34.2**	**16.9**	**19.1**	**36**
JV Finance	-13.9	-18.8	-16	-10.1	-3.9	-2.5	-6.4	-1.3	-5.8	-7.1
JV Tax	-4.7	-3.5	-1.7	-4.4	-1.1	-1.6	-2.7	-1.5	-1.4	-2.9
JV PAT	**46**	**48.7**	**34.3**	**26.5**	**14.5**	**10.6**	**25.1**	**14.1**	**11.9**	**26**
Sales to JV	841.4	776.1	988.4	486.2	146.5	130.5	277	105.4	75.8	181.2
Amounts receivable from JV	105.5	128.5	107.7	108.8	89.3	128.7	128.7	84.7	59.6	59.6
Amounts payable to JV	-15.5	-15.5	-55.3	-48.8	-36.1	-37.2	-37.2	-49.2	-87	-87
Net JV Working Capital	**90**	**113**	**52.4**	**60**	**53.2**	**91.5**	**91.5**	**35.5**	**-27.4**	**-27.4**
Chg in JV Working Capital		23	-60.6	7.6	-6.8	38.3	31.5	-56	-62.9	-118.9

Source: The Analyst, Carillion

- We also note that Carillion has a high level of gross working capital. 2015 year-end trade and other receivables were 32% of sales and trade and other payables of 43%. These are period end numbers so the underlying position is likely to be weaker.

Deferred Consideration Amongst Factors Pointing to Further Increase Average Net Debt

Net debt is likely to increase further in coming years:

- Deferred consideration on recent acquisitions will utilise cash flow in coming years. In total, according to note 27 of the 2015 Annual Report, £101.9m is outstanding on deferred and contingent consideration.

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- The Outland Group has £25m of installments to be paid in 2016 with further installments potentially forthcoming in 2018 and 2019.
- The Rokstad Power Corporation deal has up to £12m of deferred consideration in 2016 and 2017.

Exhibit 9: Deferred Consideration Payments (emphasis added by The Analyst)

27. Financial instruments (continued)

Maturity of financial liabilities

The remaining contractual maturity profile of the Group's liabilities, which includes estimated future interest payments, is as follows:

31 December 2015	Trade payables £m	Deferred and contingent consideration £m	Bank overdrafts £m	Bank loans £m	Other loans £m	Finance leases £m	Total £m
Less than one year	(591.4)	(31.0)	(6.4)	(19.4)	(23.2)	(7.0)	(678.4)
Between one and two years	–	(2.5)	–	(38.9)	(36.1)	(5.9)	(83.4)
Between two and three years	–	(15.1)	–	(2.1)	(67.0)	(3.4)	(87.6)
Between three and four years	–	(15.1)	–	(1.9)	(257.9)	(0.7)	(275.6)
Between four and five years	–	(38.2)	–	(66.8)	(9.6)	(2.2)	(116.8)
More than five years	–	–	–	–	(204.2)	–	(204.2)
	(591.4)	(101.9)	(6.4)	(129.1)	(598.0)	(19.2)	(1,446.0)

31 December 2014	Trade payables[1] £m	Deferred and contingent consideration[1] £m	Bank overdrafts £m	Bank loans £m	Other loans £m	Finance leases £m	Total[1] £m
Less than one year	(611.7)	(7.2)	(6.2)	(25.0)	(18.7)	(7.9)	(676.7)
Between one and two years	-	(9.6)	-	(4.7)	(18.7)	(7.4)	(40.4)
Between two and three years	-	(2.8)	-	(3.2)	(34.6)	(6.3)	(46.9)
Between three and four years	-	-	-	(120.9)	(66.5)	(3.8)	(191.2)
Between four and five years	-	-	-	-	(254.1)	(0.7)	(254.8)
More than five years	-	(43.2)	-	-	(205.5)	(2.5)	(251.2)
	(611.7)	(62.8)	(6.2)	(153.8)	(598.1)	(28.6)	(1,461.2)

(1) Restated for the retrospective adjustment to provisional amounts recognised on the acquisition of the Rokstad Corporation in 2014.

Source: Carillion 2015 Annual Report

- The PPP directors' valuation now sits at £46m. We view material PPP gains of the scale of 2014 and 2015 as unlikely, with offsetting cash investment in PPP investments forthcoming (the 2015 results statement highlighted four projects requiring £26m of investment). The FY'08 to FY'15 average for disposal profits was £22m vs. £38m in FY'15.
- The £15.7m of proceeds received from the re-organising of staff accommodation facilities in Oman will not recur in 2016, meaning net capex will likely increase.
- Working capital pressure is likely to increase as sub-contractors demand earlier payment terms to work for Carillion given a tightening of the subcontractor supply chain in the UK market (note UK housebuilding growth) and the increasing availability of financing for small businesses. Carillion benefitted from putting in place a reverse factoring plan which helped improve payables, but this is not a sustainable advantage as competitors will just as easily be able to put in place reverse factoring for their supply chains on similar terms to Carillion.

Given that we expect:

1. continued investment in average working capital within the business;
2. no real improvement in overall profitability at Carillion;
3. no material increase in cash remittance from the Middle East as JV dividends;
4. non-recurrence of the Oman disposal; and (v) cash out on M&A;

we do not see how average net debt reduces from here.

Additional Leverage Needs to Be Considered in Addition to Bank Debt

We think that Carillion's real leverage is a lot higher than the headline figures suggest, and note the following:

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- Average net debt was £538.9m in 2015 vs. reported net debt of £169.8m with H2 average net debt on our calculations of £590m.

- The gross pension deficit on an IAS 19 basis was £393.5m, consuming around £47m per annum of cash top-up payments, equivalent to paying for a debt instrument with a >10% annual coupon. The pension schemes are legacy issues somewhat outside of management's control but the balance sheet elsewhere should be structured accordingly.

- Carillion has guaranteed commitments in relations to both deferred equity payments into PPP special purpose entities (£61.6m at December 2015) and guarantees in respect of letters of credit issued by banks in relation to performance on contracts for PPP customers (£47.3m at December 2014).

- Operating lease liabilities of £125.6m at December 2015 (£51.5m property and €74.1m of other).

Purely using the average net debt figure gears Carillion to 2.0x ND to EBITDA vs. 0.6x reported. Adjusted for pensions and other items mentioned above increases leverage multiples even further. We also note the size of the debt facility in place (£1.4bn) for the level of gearing Carillion may at some points be running with, given it needs a facility capacity of ~7x period end net debt.

Other Red Flags

There are a long list of other issues we are concerned about at Carillion:

Carillion pays a low cash tax rate and in some years has received cash back from the exchequer. A number of historical deals have brought about tax benefits but we are always wary of companies which pay low levels of cash tax. Tax losses at the end of 2015 were around £216m (source: FY'15 AR, page 37, down from £247m in 2014) so in a couple of years there may be a step-up in cash tax, but additional losses to utilise could be found to keep cash tax at a low rate.

Exceptional cash items and provision releases have been consistent in recent years and have dragged on FCF.

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Exhibit 10: Carillion FCF – The Analyst definition

CF	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Group EBIT	**42.9**	**84.9**	**111.9**	**104.9**	**159.6**	**124.4**	**175**	**183.4**
Growth		97.9%	31.8%	-6.3%	52.1%	-22.1%	40.7%	4.8%
D+A	86.5	67.7	63.4	62.3	62.2	44.3	44.8	45.4
PP&E disposal profits	-8.3	2.5	-1.3	0.6	1.6	2.3	0.3	-14.4
PPP disposals	0	0	0	-11.5	-13.2	-44.6	-13.9	-37.7
Other non-cash	-4.5	-0.6	-2.5	0.2	-5.5	-6.1	-1.7	-0.3
Non-recurring items	22.7	15.2	9.4	42.8	2.6	44.2	0	5
CF pre WK + exceptional	**139.3**	**169.7**	**180.9**	**199.3**	**207.3**	**164.5**	**204.5**	**181.4**
Growth		21.8%	6.6%	10.2%	4.0%	-20.6%	24.3%	-11.3%
Increase in inventories	4.1	4.1	-3.4	19.7	15.2	-1.1	-1.4	-14.3
Decrease/(increase) in trade and other receivables	-130.1	107.3	-8.3	53.3	-36.6	-123.8	-40.1	48
(Decrease)/increase in trade and other payables	160	-51.5	12.9	-81.6	-143.5	-40.6	50.5	-41.1
WK	34	59.9	1.2	-8.6	-164.9	-165.5	9	-7.4
Pension Costs	-50.5	-29	-35.2	-36.2	-30.2	-39.2	-46	-47.4
Rationalisation Costs/Exceptionals	-32.4	-17.1	-15.6	-35	-28.6	-22	-11.5	-6.3
Operating CF	**90.4**	**183.5**	**131.3**	**119.5**	**-16.4**	**-62.2**	**156**	**120.3**
Financial income received	17.1	11.6	11.7	16	15.8	11.1	2.9	2.4
Financial expense paid	-36.6	-23.3	-13.5	-21.3	-27.3	-30.9	-29.6	-35.3
Net Finance	-19.5	-11.7	-1.8	-5.3	-11.5	-19.8	-26.7	-32.9
Acquisition related items	0	0	0	-7.2	-0.6	-1	-1.2	-6.6
Tax	4.7	2.9	-2.7	-3.8	2.9	4.6	-4.3	-7.5
Disposal of PP&E	20.5	5.5	5.5	17.2	2.7	0.9	6.4	17.6
Acquisition of intangible assets	-2.7	-4.3	-7.5	-2.8	-3.7	-6.5	-3	-1.2
Acquisition of PP&E	-44.2	-48.5	-17.1	-9.8	-14.6	-21.6	-25.8	-29.2
Net Capex	-26.4	-47.3	-19.1	4.6	-15.6	-27.2	-22.4	-12.8
JV Dividends	25	38.6	48.1	39.6	13.6	18.2	9.1	16.8
Dividends to Minorities	-1.6	-1.0	-2.3	-3.4	-8.2	-1.1	-1.0	-3.2
Equity FCF	**72.6**	**165**	**153.5**	**144**	**-35.8**	**-88.5**	**109.5**	**74.1**
Growth		127.3%	-7.0%	-6.2%	-124.9%	147.2%	-223.7%	-32.3%

Source: The Analyst, Carillion

- Management does not own a material amount of shares in Carillion and does not appear to have used weakness in the shares to invest in the company.
    - Richard Howson owns 128,490 shares worth £0.38m.

- Richard Adam owns 120,444 shares worth £0.35m.
- This is below one times salary, and given the tenure of both board members as members of the senior management at Carillion we would expect a larger shareholding in the company.

Bridging the Gap from 2015 to 2016 Is Hard – Risk to Consensus Earnings Estimates

Bridging the gap from 2015 to 2016 is tricky, given the multitude of moving parts in the numbers. Our start point is 2015 EBITA of £234.4m and we note Bloomberg consensus EBITA estimates for 2016 of between £218m and £239m.

- We subtract £13.9m of non-recurring Oman property disposal profits.
- We subtract the £37.7m of PPP disposal gains.

The leaves an adjusted EBITA base of £182.3m. Some PPP gains will likely be forthcoming – we estimate perhaps £20m to £30m, still leaving a significant growth gap for Carillion to fill (FY'08 to FY'15 average PPP disposal profits of £22m). Adjustment is then required for guided underlying margin reductions in Middle East and Construction Services (ex-Middle East). Consensus estimates look to be best case for flat-to-slightly down profits and we think that that there is likely to be a miss on EPS with downgrades forthcoming during the year. We model a diluted EPS of around 27p (29p basic) vs. the consensus range of 34.3p to 35.2p.

Conclusion

We conclude by initiating on Carillion with a Short recommendation. Carillion is likely to continue to miss on earnings with significant leverage.

Our earnings forecasts for 2016 and 2017 are below consensus as we believe Carillion will see pressure on its business that is not factored into consensus estimates.

We expect continued downgrades to estimates and to see continued increases in average net debt vs. expectations as a likely leg of the story leading to a lower share price. The shares look cheap on 8-9x consensus P/E but we believe sustainable cash EPS (pension costs, working capital investment) is much lower and therefore are cautious on the equity story which on our estimates for 2016E trades on 11 to 12x P/E.

Our valuation explicitly incorporates that the dividend will be cut in two years to 11p/share as working capital pressures, the margin pressures we expect to be forthcoming and earn-outs lead to not enough cash to sustain the current dividend level. We expect average net debt to continue to rise.

Our target price of 180p is based on a 6% dividend yield in 2018E – in line with the current valuation of around a 6% dividend yield. This would still equate to a low single digit free cash flow yield.

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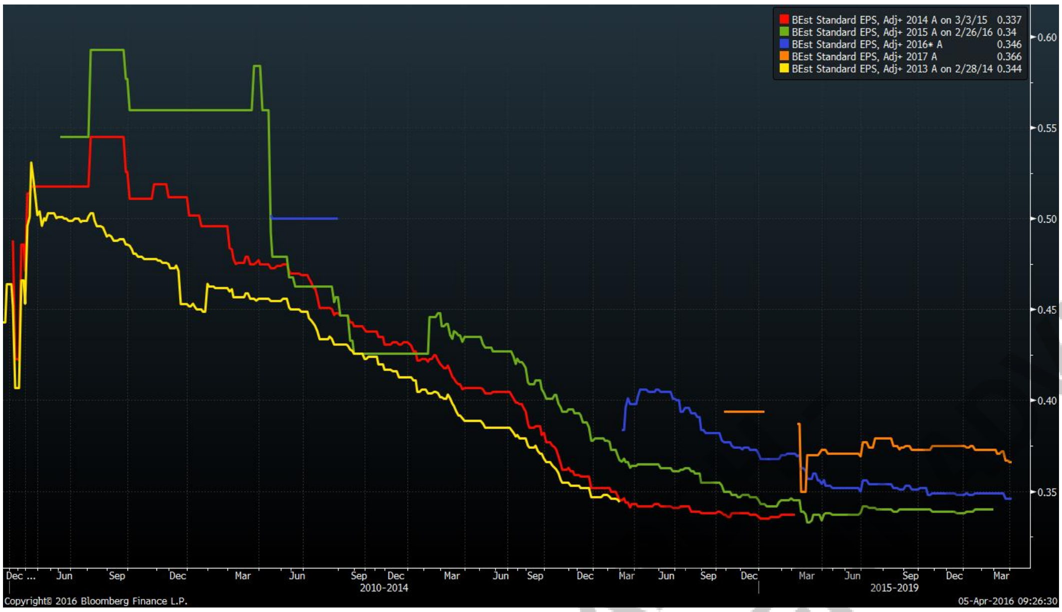
Exhibit 11: Carillion – Constant EPS Downgrade Story to Consensus Estimates



Source: Bloomberg

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