Carillion Plc – Profits warning July 17th 2017

The shares were already at a low level before this announcement but fell almost another 40%, before modestly recovering.

Carillion’s CEO Richard Howson steps down from the board with immediate effect, but stays for up to a year.

The senior non-executive director, Keith Cochrane, becomes interim CEO while a replacement CEO is sought. Keith came over in the call as impressive. He was at Weir Group, as CFO from 2006-09, and then as CEO 2009-16. He did the main presentation on the call.

Carillion has a solid support services business. They are No 1 in UK defence, as well as in UK broadband support, No 2 in both UK road and rail, and no 3 in power transmission in Canada. The company won £2.6bn of new business in H1 this year, of which £2.1bn was in support services. The company is on platforms with future business worth £2.3bn, much of which isn’t in the company’s current order book, which stands at around £1.6bn.

The company’s problems are entirely related to its construction side. It has had to make provisions of £875m, of which £370m relates to contracts in the UK, and another £470m to overseas contracts.

Keith Cochrane identifies three problems – accepting tenders with a high degree of uncertainty, and where too much of the outcome depends on factors which are outside the company’s control, and accepting changes to design specifications without altering the contract price.

The company has decided that it is going to be much more selective in future, in terms of which construction contracts to take on. Overseas it will not take on work where the payments aren't covered by the export credit scheme. As well as the pre-announced and 50% completed exit from Oman, Carillion will now also exit from Egypt, Qatar and Saudi Arabia. Cash has become much tighter in the middle-east oil states since the oil price fall began three years ago, as widely reported by companies operating there. The problem contracts are all at a mature stage, and all should be complete within a year. Completing the contracts will involve a further net cash outflow of £100-150m, and average debt will increase from £695m in H1 to £775-800m in H2, both of these numbers well above forecast figures.

Keith Cochrane pointed out that once you have announced that you are exiting a country, debt collection becomes even harder. However, the company will do its utmost to recover as much as it can, and Ricard Howson (ex-CEO) will be concentrating on this aspect. Debt-collection has been problematic. The company has set up a new team and will in future report on debtor days.
Another problem in UK construction has been that PPP contract prices are fixed long in advance. Costs are subject to variation and have to be absorbed. Carillion has decided to exit the UK PPP construction market for this reason.

The company already had a debt-reduction strategy in place, but the Board have decided that it must be extended and accelerated, and have commenced a strategic review, the results which will be announced in September with the interim results. Features will include £125m of non-core disposals, and further cost-reduction initiatives. Keith Cochrane believes that Carillion is an unnecessarily complex business, and hopes to simplify it. The resulting business will be primarily in support services, with construction work bid for only on a highly selective basis, and overseas only with financial support from the UK Government. The company aims for a strong balance sheet, which will be capable of supporting the services business going forward.

2017’s dividends are suspended, at a saving of £82m.

The CFO mentioned in passing that the pension Triennial Actuarial Review is ongoing, but that the pension deficit has fallen by around £600m since the yearend. This will be as a result of an increase in the discount rate, following the rising gilt yields. This year Carillion will pay £50m in remedial payments. The anticipation of an improvement in the deficit position, and by extension the balance sheet, has been a factor in the investment case.

Consequences

This announcement is a blow to TB Wise Income. The dividend cut reduces the portfolio yield from 5.01% to 4.88%. The capital loss will cost the fund around 0.65%, 65 basis points.

Should we have avoided it?

Along with Braemar and Centrica, Carillion is one of the riskiest stocks in the TB Wise Income portfolio. However, I was hoping that the price had fallen far enough to discount the the risks, and I was hoping that the disposals programme would reduce debt to an acceptable level, and was encouraged by the strength of the order pipeline, particularly in services. What I hadn’t realised was the deterioration in the financials on the construction side, particularly in the UK, and that management hadn’t responded strongly enough.

What do we do now?

It’s quite possible that Carillion will emerge next year in its new form as an attractive service company. They will have decided on their dividend policy during the 2018 financial year. In the meanwhile, we will need to sell the holding, but as this morning’s share price movement appears to be an over-reaction to what has been announced, will wait a little while to do so in anticipation of a further rebound.