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Part A
Carillion’s Collapse: Cause

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Racing to secure bids over rival construction companies, Carillion, the second-largest construction firm in the UK, hit a financial tipping point, lost the backing of the banks and collapsed. Its aggressive growth strategy and the diversification of its business portfolio increased the complexity of its internal structure. Coupled with poor oversight of its day-to-day operations, over-runs on flagship projects and an unclear corporate governance structure, the firm acquired debts of £1.5bn. One may argue that the demise of the construction giant was an inevitable outcome. The aim of this policy brief is to provide insights into the cause of Carillion’s financial meltdown and outline lessons for managers, shareholders, stakeholders and government from the closure of this construction giant.

Introduction

With business roots tracing back to over a century ago, as of 2018, Carillion grew to employ 43,000 employees globally and 19,000 in the UK (about 2,000 in the West Midlands). Carillion was second only to Balfour Beatty in terms of turnover. The firm seemed to be performing, with consistent growth in revenues in recent years. The 2016-2017 financial year was in fact, exceptional, with Carillion reporting £5.2bn in revenue; 14% higher than the preceding year. The fate of this construction giant, however, took a drastic turn in 2017 which ultimately resulted in the closure of the business in 2018, marking a historical year for the UK construction industry.

Overview

Overview of Carillion

Carillion's operating activities could be broken down into three main segments namely: support services; project funding; and construction services. Support services included maintenance, facilities management and energy services for major buildings and large property estates. This also included infrastructure services for roads, railways and utility networks, telecommunications, power transmission, distribution, and remote site accommodation services. With regards to project finance, this involved the arrangement of funding for Public Private Partnership Projects to deliver public sector buildings and infrastructure. Finally, construction services heavily focussed on buildings and infrastructure on large contracts for long-term public and private sector. Carillion's project portfolio was fairly wide, some labelled the firm as the '*Jack of all trades*'. As of 2016, 52% and 42% of Carillion's revenue were generated in support services and construction services respectively. Although only 6% of revenues were acquired with Public Private Partnership Projects in 2016, the firm was heavily dependent on the success of projects within the UK.

Table 1: Carillion's Global Revenue 2014-16

Year	UK	Canada	Middle East & North Africa	Total
2016	£3,831.1m (74%)	£596.4m (11%)	£786.7m (15%)	£5.2bn (+14%)
2015	£3,356.7m (73%)	£513.2m (11%)	£717.0m (16%)	£4.6bn (+13%)
2014	£2,953.8m (73%)	£542.6m (14%)	£575.5m (13%)	£4.1bn

Source: Carillion (2016)

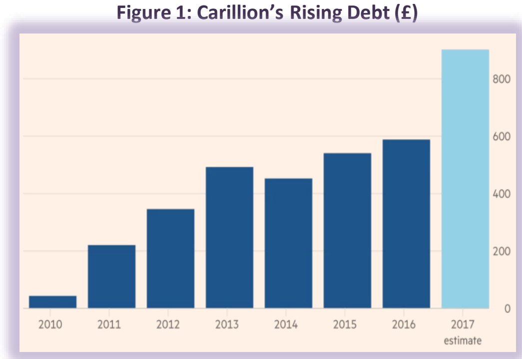
Over-dependency on the UK was not a new phenomenon, although Carillion was operating on a global scale, approximately half of the workforce and 75% of revenue were in the UK. Carillion's UK contracts included:

- **Over 450 Government contracts**
- **Maintained 50,000 homes for military personnel**
- **Provided 218 schools with meal services**
- **Maintained 50 prisons**
- **Provided 11,500 in-patient hospital beds**
- **£1.4bn joint venture contract for HS2**
- **£745m contract for the Aberdeen bypass**
- **£335m contract for the Royal Liverpool Hospital**
- **£350m contract for Midland Metropolitan Hospital**
- **£500m Paradise Circus in Birmingham**

Cause - What Went Wrong?

In July 2017 Carillion issued a profit warning. This triggered a fall in its share price, which subsequently dropped 90% before the firm collapsed. The city lost faith in the firm's business model well before Government, who continued to issue contracts to the firm. An estimated £900m of debt and a £587m pension deficit were revealed in the early stages of the liquidation process. Firms that are owned by shareholders and subject to the short-term priorities (and mob-justice) of stock traders are continually in danger of a run on shares which can devalue their business at a stroke. An important trigger for Carillion was a series of cost overruns across a number of projects. Despite being the most profitable firm in the top-10 firms in the UK, Carillion was hit by a combination of cost overruns and delayed payments, especially three main contacts, namely: The Royal Liverpool Hospital; the Midland Metropolitan Hospital; and the Aberdeen bypass. The combination of all three projects accounted for contracts worth approximately £1.4bn. Poor project management and oversight into day-to-day operations resulted in large delays and high cost over-runs. Figure 1 illustrates Carillion's rising debts over the last few years.

Figure 1: Carillion's Rising Debt (£)



Source: FT 2018

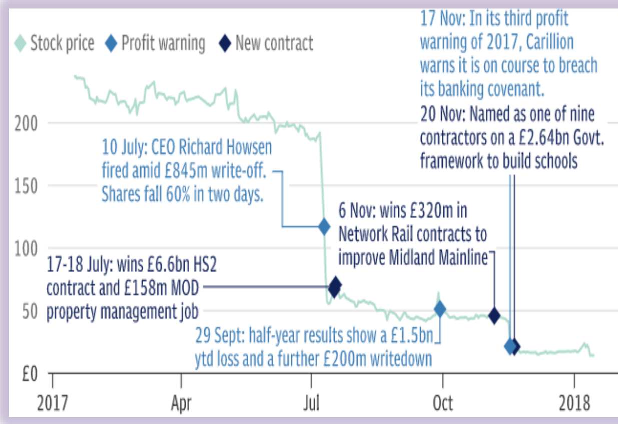
Cause

Some projects were inherently risky and in some cases it is clear that the firm had not carried out a robust assessment of the risks. Cost overruns are particularly damaging in an industry with traditionally low margins. Average margins in the UK construction industry fell to 1.5% in 2016-17 from 1.7% the previous year. Many large firms, pushed by clients including the Government, are in a precarious position where additional costs can quickly turn profit to loss across a series of projects. Carillion may have lost as much as £150m after more than six months' delays on the £745m Aberdeen bypass, while the £350m Midland Metropolitan Hospital in Smethwick, was also delayed due to engineering problems. Crucially, underestimating costs was not new for Carillion, as in 2010 Carillion won the Paddington Integrated main works contract for the transformation of Paddington station, which aimed at smoothly integrating the running of Crossrail services. Initial estimated costs for this project was £27.7m, however, this ended up costing more than three times the estimated figure and actually costed £98m.

With the inclusion of employees in joint ventures, approximately 19,000 employees worked in the Gulf for Carillion. Payments for several major projects in the Middle-East in particular were delayed leading to a major problem with cash-flow. Carillion's largest contract in the Middle-East was a £500m deal for development work in downtown Doha, Qatar's capital, in preparation for the World Cup. This joint venture contract was secured by Carillion in 2011 and was backed by the Qatar Foundation. However, Carillion executives were involved in a dispute with the foundation over £200m, which is what to be thought the company was owed for completed work. In July 2017, when the company announced an £845m deficit in its finances, it has been reported that approximately £314m of this deficit was attributed to projects in the Middle East and the Gulf. However, the developers in the Middle-East believed they were the ones owed money, as Carillion failed to fulfil contractual obligations. Carillion's activities in the Middle-East shrunk substantially in 2017 and the firm announced its exit from Saudi Arabia, Qatar and Egypt In July 2017. Carillion also sold its 50% stake in Carillion Alawi, a joint venture with Oman's Zawawi family in 2017.

Arguably, one of the biggest mistakes made by Carillion concerned continuing to win projects despite illustrating profit warnings in 2017, which can be seen in Figure 2. After announcing profit warnings, Carillion still went on to win contracts concerning HS2, MOD property management, Network Rail and also went on to be named as one of the key contractors for schools being built in the UK. Furthermore, Carillion spent over £1.3bn in mergers and acquisitions within the last 15 years, demonstrating the firm's aggressive growth strategy and continuing diversification of its project portfolio

Figure 2: Carillion Securing Contracts (2017-2018)



Source: Bloomberg 2018

As of 2017 the firm owned 326 subsidiaries around the world and was being steered by a total of 169 Directors. This complexity in management resulted in Carillion finding extremely difficult for senior management to track the overall risk exposure of the firm. Some argue that the firm had grown too big too fast, partly through acquisitions. More information concerning each of the acquisitions is highlighted below.

Timeline of Carillion's Recent Acquisitions

2001 - Expanded into the facilities management services sector and acquired the remaining 51% of GT Rail Maintenance, thus, forming Carillion Rail.

2002 - Acquired Citex Management Services for £11.5m.

2005 - Purchased Planned Maintenance Group for £40m.

2006 - Acquired Mowlem (support services firm) for £350m.

2008 - Purchased Alfred McAlpine for £572m and increased its global presence by acquiring Vanbots Construction in Canada for £14.3m.

2011 - Acquired Eaga (energy efficiency company) for £306m.

2012 - Acquired a 49% stake in The Bouchier Group for £24m, who provided services in the Athabasca oil sands area.

2013 - Purchased the facilities management division of John Laing.

2014 - Carillion increased its Canadian presence by acquiring a 60% stake in Rokstad Power Corporation for £33m, a transmission and distribution company. Previously in 2014, Carillion made three offers concerning a merger with long rival construction company Balfour Beatty, all were rejected. Furthermore, Balfour Beaty ensured that Carillion were not allowed to make a fourth offer by refusing more time for negotiations.

2015 - Purchased the Outland Group in Canada, who provided goods to camps at remote locations in Canada.

2016 - Purchased a majority stake in Ask Real Estate.

Policy Recommendations

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1. Over-diversification of projects – Keep it simple

Diversifying product offerings can certainly help to spread business risk, however, it increases operational and strategic complexity. Governance and risk-management are more difficult. This can be managed and if diversification creates economies of scale and cross-business synergies then firms can thrive. The synergistic benefits to Carillion of providing school meals, maintaining prisons, building hospitals and arranging project finance are questionable. It is also clear that increased diversification and complexity were not matched by more effective governance structures or capable management.

2. Aggressive growth strategy – Stop growing if you don't have a thorough grasp on your business

Over the last 15 years Carillion continually acquired businesses, furthering their internal complexity. Carillion had a complicated organisational structure consisting of 326 subsidiaries governed by 169 Directors. This made it extremely difficult to identify high risk projects, as well as managing their day-to-day operations. The fine margins across the business, coupled with uncontrolled costs and political uncertainties affecting cash-flows in overseas projects, proved to be overwhelming.

3. Debts and cost overruns - Manage your day-to-day operations

Debt is not always a bad thing as it can be a easy and cheap source of funding. However, when operating in an industry, which is infamous for low profit margins, high debts can be deadly. Firms operating within the construction industry must avoid high levels of debt, to ensure cash is readily available when big projects go wrong and experience cost over-runs. In some cases, problems are compounded because contracts contain a series of penalty clauses which increase the costs when the firm fails to deliver. This created a snowball effect for Carillion pushing costs higher as projects were delayed projects. Carillion not only commonly experienced cost over-runs, but were also tackling a huge pension deficit. In 2016, Carillion's operating profit was required to fund a whopping £60m on interest and pension payments, and £79.8m in dividends.

4. Cash flow - Cash is King

Many focus on profits as an important performance measurement, and often overlook cash flow. Although profits are important, it is the cash that pays the bills (salaries, interest, tax etc.). Therefore, when clients are looking for work they must look at the balance sheet and cash flow statement first, before profits. More specifically, the UK Government should have spent more time investigating how safe Carillion were first before issuing PPIs.

5. Corporate governance - Firms in the UK need to be more effectively regulated

Carillion's Board, its senior management team and its auditor individually and in combination have serious questions to answer about senior-level decision-making leading up to the firm's collapse. This is not a new phenomenon and while corporate responsibility remains lax, tighter rules and penalties need to be applied to change the behaviour of those who tend to benefit from the upside but not bear the costs of the downside of competitive capitalism.

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